RESEARCH

ANALYSTS WHO GET IT

A few are willing to rile companies–and investment pros love them

(PHOTOGRAPHY OF KEVIN P. LANE) TODD FRANCE

PacificCare Health Systems Inc.'s stock had been a loser for years. The Cypress (Calif.) health-maintenance organization was mired in an accounting scandal; Medicare plans were siphoning profits; and top management had bailed. "Everything about the company was horrible," says Michael W. Green, a money manager for Moody, Aldrich & Sullivan LLC in Marblehead, Mass. A former highflier that hit $93 in 1999, it had plunged as low as $10.

But in late October, Green had a change of heart. He bought $5 million worth of shares after getting a hot contrarian tip from Kevin P. Lane, chief market strategist at Technimentals Research Group, an independent research firm in New York. Lane said the new chief executive, Howard G. Phanstiel, had cleaned house, and the company had turned profitable. Hardly anyone on Wall Street had noticed. All but one of the 14 analysts covering the company had a sell on it. The next week, the stock soared 40% when PacifiCare surprised analysts by more than doubling third-quarter profits. Green now expects the $29 stock to double in the next 12 months. Of Lane, whom he has known for a year, Green says: "He's moved to the top of my radar screen."

For all the brouhaha about tainted research, there are still quite a few analysts like Lane who command the respect of investment pros. Many work for major investment banks and brokerages, but others labor in obscurity at independent research firms that don't sell stocks or investment banking services. Instead, they shop their insights to money managers in return for commissions on trades that result from the recommendations. The ace analysts are mostly seasoned vets with Rolodexes of industry contacts. They're early risers and skeptics, detail junkies who bury themselves in balance sheets and complex stock models. In bull or bear markets, they make money for their clients, largely institutional money managers who consider their reports a must-read.

Fans among hedge-fund and mutual-fund managers, derivatives traders, and other pros say the best analysts often sense trouble before the company management does. Kevin O'Brien, co-manager of the $4 billion Neuberger Berman Genesis Fund, took a closer look at reinsurer Trenwick Group Ltd.'s books last summer after V.J. Dowling of Hartford-based Dowling & Partners Securities, known for his nitty-gritty work on insurers, warned that the company was overstating earnings. O'Brien said Trenwick executives dismissed Dowling's assessment–but he cashed out at about $26 a share anyway. The company has since posted losses, and the stock dived to a low of 46 cents on Nov. 14. "Dowling doesn't care what anybody thinks," says O'Brien. "And he'll put it in writing."

The bear market has helped to raise the best analysts' profile. Unlike most on Wall Street, they have a few qualms about bashing popular companies. For example, Fox-Pitt, Kelton Inc. finance analyst E. Reilly Tierney downgraded J.P. Morgan Chase & Co. in May, 2001, at $50 and remained bearish. The stock now trades at $24. "We could care less whether stocks go up or down," he says. "Our clients make money either way."

A willingness to stand up to management is a common denominator of this elite group, Michelle R. Clayman, CEO of New York's New Amsterdam Partners LLC, a pension fund manager, singles out Morgan Stanley automotive analyst Stephen J. Girsky as one of the best. Last year, Girsky zeroed in on the way Ford Motor Credit Co. booked car loans that it packaged and sold to other investors using so-called gain-on-scale accounting. The company was getting a third of its profits from such sales, said Girsky, who believed the strategy was unsustainable–because it booked most of the income from loans up front instead of over their life. "it was a distortion of the true results," he says. He raised his concerns with Ford executives at a private dinner in Dearborn, Mich., then sent them a summary, which was published in an October, 2001, report. The company continued to refute his findings, he says. Two months later, Ford Credit announced a $297 million loss for the fourth quarter, the first quarterly loss in 42 years. This year, Ford Motor Co.'s stock has tanked 37%.

Telling it like it is is usually a thankless job. After Stanford C. Bernstein & Co. analyst Paul Sagawa downgraded Cisco Systems Inc. in late 2000, anticipating the end of the telecom boom, Cisco Chief Executive John T. Chambers called to "respectfully disagree" with the forecast. Soon after, Cisco's earnings slumped. "Chambers told investors that no one could have predicted it; it was a 100-year flood," says Sagawa. "I was like, 'Guys, I had this conversation with you five months ago, and you told me I was out to lunch.'"

Sometimes, telling people what they don't want to hear can get downright nasty. Daniel T. Niles, Lehman Brothers Inc.'s semiconductor and hardware analyst, says he received anonymous threats–presumably from angry investors–after downgrading cult tech stocks in the late 1990s. "It didn't matter that I was right," he says. Likewise, Bernstein's phone lines were jammed after Sagawa panned Cisco in 2000. "Investors were saying that I crashed their favorite stocks, and that I was incompetent, only not using language that nice," he says. "I took a lot of abuse."

In hindsight, the most radical calls look like common sense–backed by hours of homework. Sagawa downgraded Nortel Networks Ltd. and Cisco in September 2000, after analyzing trends for big telecom service providers, their main customers. He ran some 40 different ratios on a handful of companies and found that telecom capital spending had reached 36% of sales, which cash flows from operations were less than 20% of sales. Add a heap of debt, and clearly service providers couldn't keep buying. "It was entirely predictable, to be honest," Sagawa says. Improving cash flow and a slow recovery in capital spending prompted him to turn bullish in April on Nortel, Nokia, and Lucent Technologies, before the Street and the stocks' rally in October.

But common sense rarely rules markets–as money managers ruefully admit. When Gimme Credit, a fixed-income research shop, issued a warning on Qwest Communications International last November, Greg Hosbein, a principal at Segall Bryant & Hamill Investment Counsel, a Chicago money manager, sat tight. "The bonds were in high

The A Team

KEVIN P. LANE
Chief market strategist, Technimentals Research Group
Recommended selling both Enron and IBM before their stocks tanked. Rated PacificCare a buy before its earnings surprise and 40% runup in November.

STEPHEN J. GIRSKY
Automotive analyst, Morgan Stanley
Predicted disaster at Ford Motor Credit despite upbeat forecasts from company execs months before it reported $297 million of losses in Q4 2001.

VINCENT J. DOWLING, JR.
Insurance analyst, Dowling & Partners Securities
Had sell recommendation on Trenwick Group, down 87% this year, and a buy on W.R. Berkley, up 10%

(PHOTOGRAPHY OF CAROL LEVENSON) LOREN SANTOW

CAROL LEVENSON
Director of corporate bond research, Gimme Credit Publications
Issued warnings on WorldCom, Lucent, Dynegy, Conseco, and J.P. Morgan Chase months before their stocks's steep declines.

ARAM H. RUBINSON
Retail analyst, Banc of America Securities LLC
Downgraded Home Depot in Feb., 2002, at $50, three months before it slid to a $23 low. It now trades at $26.

PAUL SAGAWA
Telecom-equipment analyst, Sanford C. Bernstein
Downgraded Cisco and Nortel in September, 2000, when he predicted an impending crash in telecom equipment. Eight months ago reversed his bearish stance.

E. REILLY TIERNEY
Analyst, Speciality finance and brokers, Fox-Pitt, Kelton
One of the first to downgrade J.P. Morgan Chase in May, 2001, at $50. The stock now trades at $24.70.

STEVE WORTMAN
Aerospace and defense analyst, Sidoti & Co.
Made bullish calls in 2002 on Engineered Support Systems and Signal Tech, up 52% and 64%, respectively. Now neutral on both, but bullish on Herley Industries, down 10%.

Data: *BusinessWeek*

One analyst says he got anonymous threats–presumably from irate investors–after downgrading tech stocks in the late '90s

demand," says Hosbein, who held $10 million in Qwest bonds at the time. After a second warning in April from Carol Levenson, Gimme Credit's director of corporate bond research, he sold. The bonds, which traded around par a year ago, now trade at 60¢ on the dollar. "You do your own research, but then look at Levenson's reports and say, 'I must have been asleep during that part of the [company] conference call,'" he says. Gimme Credit's plain-talking daily missives now recommend buying the bonds of SBC Communications and ConocoPhillips– which most analysts still consider too risky.

At times of uncertainty, money managers look to these pros to help them navigate. By mid-January, 2002, Tyco International Ltd. was on the ropes. The Securities & Exchange Commission was investigating the company for fraud, and the shares were in a free fall. Chief Executive and Chairman L. Dennis Kozlowski was on the defensive, telling investors there was nothing wrong with Tyco's accounting. At the time, institutions owned 95% of the stock, and most of the 15 or so analysts covering the company rated it a buy or strong buy. But Technimentals' models suggested the market wasn't going to buy Kozlowski's line for long. By Jan. 18, weekly trading volume was five times the average for the previous 12 months, coupled with a sharp price drop to $45. Lane called about 70 clients on Jan. 25 telling them to sell at $45. "Everyone thought that we were crazy," he recalls.

Sure, Lane would rather have made the Tyco call in early January, when the stock was at $60. Even so, the clients who listened avoided a debacle: Two weeks later the stock hit $30, eventually sinking as low as $7. Now, Lanes says to short AutoZone Inc., which he figures could fall to $48 from $78 now, and the drug distributor AmerisourceBergen Corp., which could go from $60 to $40 in the next three to six months. "They're overloved and overowned," he says.

Most money managers hate to admit they take cues even from the best analysts. On Oct. 27, star stock-picker Tom Marsico, manager of the $1.3 billion Marisco Growth Fund, lauded Tenet Healthcare Corp., a top holding, in *The New York Times*. The next day, UBS Warburg's Kenneth R. Weakley released a negative report. A week later Marsico sold. A press release said "new information" had soured him on the stock.

His coyness is understandable. If you have a secret weapon, why let everyone on Wall Street in on it?

By Mara Der Hovanesian in New York

The Best of the Independents

Investars.com, an online analyst-rating service, tracks the research of 104 firms, including Wall Street brokerages and boutiques. At BusinessWeek's request, Investars ranked the top performers among the independent shops that mostly offer investment banking. To evaluate each firm's performance, Investars creates a hypothetical portfolio, which "buys" or "sells" whenever a stock is upgraded or downgraded. The number of shares varies according to the strength of the recommendation–more shares for a strong buy, for example, than for a buy. The final score is a weighted average of returns for all stocks a firm covers for which Investars has a complete history of recommendations. The best calls may involve multiple buy or sell recommendations. Calls and returns are for the 12 months through Nov. 20.

BULL'S EYE: *CEO François Parenteau*

FIRM/ LOCATION	STOCKS COVERED/TRACKED BY INVESTARS	BEST CALLS	AVERAGE RETURN
PARENTEAU Montreal	19/19	Verisign Palm	81.4%
AVALON RESEARCH Boca Raton, Fla.	50/109	Genesis Microchip Imclone	41.2
STANDARD & POOR'S New York	1,200/ 1,604	US Airways i2 Technologies	13.9
ANALYTIQ GROUP Irvine, Calif.	37/32	Amkor Technology Maxtor	13.2
GLOBAL CAPITAL INSTITUTE (THOMAS WHITE) Chicago	3,900/ 2,538	Cytogen H Power	10.4
RDEX RESEARCH Irvine, Calif.	25/25	Rambus Intl. Rectifier	8.0
CORINTHIAN PARTNERS* New York	10/10	General Growth Prop. Bedford Properties	7.1
CALLARD ASSET MGMT. Chicago	4,000/ 4,474	Adelphia Enterasys	3.2
FULCRUM GLOBAL PARTNERS New York	135/124	Integrated Device ESS Technology	2.9
MARKET PROFILE THEOREMS Seattle	2,517/ 2,652	Covanta Energy Level 3	1.0
BARRINGTON RESEARCH* Chicago	90/85	Univ. of Phoenix Cablevision Systems	0.3
STANDARD & POOR'S 500 STOCK INDEX			-21.5%

*Derives 95% or more of revenues from research

MARILOU ALARIE