Sell-Side Analysts

Research approach

The aim of this research is to examine the practices of top sell-side analysts around ESG integration.

Some of the key questions this research is trying to address include:
• How important are sell side analysts in investment decision-making?
• Are top sell-side analysts asking questions around ESG issues or long-term value creation?
• How frequently do these questions come up? Are specific sectors more likely to attract attention on these issues?
• Does in house ESG research influence the behaviors of analysts?
• How do analysts’ questions compare with existing frameworks?

Sample selection and research methodology

Identification of top sell-side analysts

In order to identify top sell-side analysts for our research we used the rankings provided by Institutional Investor for the top sell-side analysts in 2015. This is an important sample given the reputation these analysts have in the investment community.

The Institutional Investor list contains 57 analysts from 15 different organizations. These organizations are: Bank of America Merrill Lynch, Barclays, Citi, Cornerstone Macro, Credit Suisse, Deutsche Bank Securities, Evercore ISI, Goldman Sachs, JP Morgan, Keefe Bruyette and Woods, Morgan Stanley, Renaissance Macro Research, Sanford C. Bernstein, Wells Fargo Securities and Wolfe Research.

Our goal is to collect data on all 57 analysts. At the time of writing this preliminary report we have collected data on 16 analysts from 3 of the organizations above (Morgan Stanley, JP Morgan, Citi) and the order was randomly selected.

Data collection

For each of the analysts that we have researched up to the time of writing this preliminary report, we selected 2-3 companies they cover. The selection of the companies was done to ensure:
• There is a diverse representation of sectors. The sectors in our sample so far include: Automotive, Aviation, Energy, Services, Financials, Healthcare, Materials, Infrastructure, Technology, Transportation.
• The analyst has provided an updated recommendation on the company relatively recently (within the last 2 years).

All companies at this stage are US headquartered (apart from TransCanada, based in Canada).

For each company, transcripts of quarterly earnings calls that took place between Q1 2014 and Q1 2016 were analyzed for questions asked by the analysts in the sample. The range of quarters was selected so that enough questions could potentially be gathered per analyst. So far out of all the quarterly earnings calls we have researched, in 187 of them the analysts in our sample asked question(s).

The content of these questions was evaluated to identify cases where the analyst asked about ESG integration and / or aspects of long-term value creation. Whenever a question was identified as ESG / long-term value, it was coded and assigned a category relevant to the context of the question asked. We took an agnostic approach towards the categories emerging as a result of the coding and these were subsequently refined as the data sample increased (i.e. if a question was around GHG emissions then an environmental category was created).

For the questions identified as ESG or long-term value related we compared them with:
• Issues described as material in the company’s sustainability report
• Material issues according to SASB for the sector in which each company operates
• Material issues according to the Delphi framework

The rationale of such a comparison was to:
1. Understand if analysts utilize the information provided in sustainability reports / mainstream frameworks
2. Evaluate how important this type of information is within the context of quarterly earnings calls
3. Examine if analysts’ thinking is aligned with current frameworks

Data limitations:
• Research is still in progress and therefore results are not conclusive. Currently, our sample includes 16 analysts. The final dataset will contain all 57 analysts and all sectors.
• Our data collection was restricted to publicly available information in the form of quarterly earnings calls and sustainability reports. At the time of this report we had no access to sell-side reports for the companies covered.
Sell-Side Analysts

Introduction

Sell-side analysts are one of the major players in capital markets. They usually specialise in a particular sector and provide equity recommendations and investment research to buy-side asset management firms and their fund managers.

Analysts can guide investor behavior by interpreting information about industry trends, company strategy, corporate finance and profit potential. Analysts make summary judgements in the form of earnings forecasts and stock recommendations, the latter considered to be the more important output.1

A sell-side analyst report will typically cover financial performance, earnings growth, equity value and also highlight specific risks relevant to the company and its business sector based on a variety of sources such as analyst briefings, press releases, preliminary results and the annual report.

Sell-side research can have a large effect on market perceptions about particular stocks. This research can be influential and the companies being tracked might also scrutinize analysts’ statements and recommendations and react to their content. These reports might have a negative impact on a company’s prospects since companies’ determination to meet analysts’ earnings expectations has created a bias towards short-term strategies.

Research suggests that over half of businesses would forego projects with positive net present value if they conflict with their planning around meeting analyst expectations.3

Recent research (a survey of 365 sell-side analysts and detailed follow-up interviews) into the inputs analysts use in their decisions and the incentives that influence these decisions has shown that:4

• Industry knowledge is the most important determinant of analysts’ compensation and the most important input into both their earnings forecasts and stock recommendations
• Client demand for information was the most important determinant of analysts’ coverage decision
• Private phone calls are the most useful type of direct contact with management for the purpose of generating both earnings forecasts and stock recommendations, even more useful than earnings conference calls
• Analysts use P/E and PEG valuation models rather than more sophisticated models, such as residual income models
• Accurate earnings forecasts and profitable stock recommendations have relatively little impact on their compensation
• Broker or client votes are very important for analysts’ compensation, more than the Institutional Investor surveys

What drives sell-side analyst compensation at high-status investment banks?5

• “All-Star” recognition
• Investment banking contributions
• Size of analysts’ portfolios
• Whether an analyst is identified as a top stock picker by the Wall Street Journal

There is no evidence that compensation is related to earnings forecast accuracy

Analyst compensation is designed to reward actions that increase brokerage and investment-banking revenues

In a typical semi-annual performance-evaluation period, the average analyst:2

Supplies 80 research notes and 3 reports

Spends around 1 week brokering meetings between client investors and corporate managers

Holds approximately 750 private calls and 45 one-on-one meetings with client investors

References


In the 187 quarterly earnings calls where these 16 analysts asked questions, we identified that 26% of the calls had a question classified either as ESG or as focusing on long-term value creation.

The categories can be further broken down into individual issues, depending on the context of each question.

The pie chart shows the rate of occurrence of these issues across questions coded as ESG / long-term value relevant.
### ESG Related Question

**Sector:** Infrastructure  
**Analyst question:** How are you thinking about the retention policy for key management or people in place on the CPGX (acquisition)?  
**Our classification:** Employee recruitment and retention

**Questions focused on long-term value creation**

**Sector:** Technology & Communications  
**Analyst question:** When you scenario plan out HBO over the long-term, do you ever think about what a significant increase in content investment would do globally to the business? In other words, I think you spend about $2 billion a year. Is there a business model where that number doubles and you go big, global, more direct to consumer? Is there enough content out there to make it worth that kind of investment?  
**Our classification:** Strategic Management

**Sector:** Transportation  
**Analyst question:** Could you elaborate on something said earlier about e-commerce and being careful about growing some of the high cost residential deliveries too quickly? Does the UPS experience in December create an opportunity or is it more of a lesson learned about what can happen when you grow that business too fast or don’t have sort of the proper controls in place to measure it into a network?  
**Our classification:** Strategic Management

### Sustainability / SASB / Delphi

Do any of these 48 questions correspond to the material issues as identified by the companies’ sustainability report, SASB or the framework outlined by Delphi?

**Sector:** Financials  
**Analyst question:** You have been in the press with the lay-offs indicated and also some of the hiring that you’re pursuing and you mentioned in the prepared remarks asset or resource allocation changes. From a higher level perspective, can you give us the sense of what’s getting less and what’s getting more in terms of resources?  
**Our classification:** Employee recruitment and retention

**Sustainability report:** Talent management and engagement

**Sector:** Financials  
**Analyst question:** One question on the regulatory front, really looking at FSOC and SIFIs, is how is the conversation evolving with regulators on systemic risk today? To what extent is the conversation still moving for the corporate risk to the product risk? How effectively do you think the asset management industry is at kind of regulator education, and is it really effectively making its case?  
**Our classification:** Systemic risk management

**SASB’s classification:** Systemic risk management  
**Delphi framework:** Risk processes

**Sector:** Healthcare  
**Analyst question:** Can we take a step back and have a bigger discussion around 2016…and your ability to touch a patient beginning of life to end of life? Are you in those discussions? Do you see anything in 2016 that, having all the pieces on your enterprise, is really coming to fruition, and we'll start to see that impact in 2016, or are those things that are going to come longer-term on this platform?  
**Our classification:** Strategic Management

**Delphi framework:** Customer satisfaction and retention
The emergence of ESG research

A notable moment of change arrived in 2006, when Citi’s Head of Research Bruce Rolph published a research paper together with an external consultant named Elaine Prior, titled ‘Climate Change and the ASX100: An Assessment of Risks and Opportunities.’ At the time the report came out, the Australian government was considering carbon trading, but the investment community initially lagged behind. Meanwhile, the media started linking the Australian drought to climate change, the Al Gore movie ‘An Inconvenient Truth’ and Stern Review came out, and the setting was right for Australian investors to begin addressing the issue. Elaine was offered a full-time role and became the world’s first ESG analyst.

Since then, the appetite for ESG research has grown. Many equity research teams have produced relevant work. Some examples of sell-side ESG research reports and work are the following:

• Goldman Sachs (GS Sustain) report ‘The Low Carbon Economy’
• Bank of America Merrill Lynch’s report ‘Globesity– The Global Fight Against Obesity’
• UBS with their ESG Analyser, mapping which ESG issues are material in the context of a typical investment portfolio
• Morgan Stanley’s (Sustainable and Responsible Equity Research Group) report ‘Embedding Sustainability into Valuation’, describing their global framework to analyze 29 different equity market sectors around ESG issues and their value for analysts and fund managers

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Colin Monks, Head of European Equity Research, HSBC.

A steady stream of evidence has linked environmental, social and governance performance with long-term business value. How are analysts responding to these trends? Are quotes like the one above by Colin Monks being backed up by actions?

A 2004 study by WBCSD and UNEPFI examined an anticipated generational shift that could drive systematic change. Young professionals across industries have been catalysts for raising the profile of ESG issues within their own companies, and analysts could potentially play the same role. The results of this research showed that this change is not taking place in the financial sector.

• Interviewed analysts were uninformed of many ESG issues, and cynical about their materiality

• Many were unconvinced that their clients would value ESG research and doubtful that their companies would reward them sufficiently for doing so

• Most were unsure how ESG integration could practically be achieved

Sell-Side Analysts
Views around ESG integration

“Interviewed analysts were uninformed of many ESG issues and cynical about their materiality”

6. WBCSD and UNEPFI, 2004 ‘Generation lost: young financial analysts and environmental, social and governance issues’
Lessons learned

On its terms, the EAI was an innovative and relatively successful project running between 2004 and 2008. However, the outcomes serve to highlight important insights into the challenges associated with integrating ESG issues into sell-side research.9

• The relatively low rate of engagement in some key economies embodies a major barrier to achieving the ultimate goal of mainstreaming ESG integration. Poor take-up in USA was a concern considering most major corporations are listed or cross listed in US stock exchanges.

• The majority of research generated took a thematic approach, comprising standalone reports on a small number of mainstream issues. This trend means only a paucity of ESG issues were integrated into company- or sector-specific analyses that hold greater market impact.

• Recognizing the abundance of buy-side firms that did not sign up as EAI members, there is reluctance to financially commit to rewarding ESG research despite the consensus around its pertinence to market health in the long-term. There is thus a lack in quality of ESG research which in turn reduces the funding available to resolve this issue.

• A perceived first-mover disadvantage restricts many mainstream asset owners from seeking progress in the integration of ESG issues.

• The concept of materiality was rarely adequately applied in research. Instead, easily quantifiable environmental issues were commonly researched, whilst social issues received relatively little coverage.10

The Enhanced Analytics Initiative (EAI) formed in 2004 to promote a longer-term investment perspective that provided advocacy and resources for analysts’ research into extra-financial issues. Such research was incentivised using both reputational rewards and financial returns based on “a commitment from EAI members to direct a minimum of 5% of their brokerage commissions or research budgets to the providers that performed best in evaluations of the published research.”8 A united effort from buy-side firms and asset owners, the ultimate goal of the EAI was to see material non-financial drivers such as ESG integrated in sell-side research.

Between 2004 and 2008, the initiative grew from 4 members to 30. It included both asset owners and managers, representing more than €2 trillion in assets. The membership was predominantly European (over 85%). By 2008, members were allocating more than double the original research funding commitments, at an average of 11%, solely based on EAI evaluations. Numerous institutions were influenced by these incentives to change their research practices, from sell-side (non)brokerages to investment banks and regional research providers. EAI research grew particularly strongly in France, with some positive response also seen in Canada and Australia. However, the EAI had comparatively little impact in the USA and Japan.

As the initiative grew in influence, its research evaluations became more stringent, requiring an increase in the quality of extra-financial analysis in order to warrant commission. With standards improving, a significant gap emerged between the leading research firms and other competitors, perhaps due to the degree of strategic specialization that took place. After four years, the EAI merged with the UNPRI with the explicit purpose of extending its influence to the extensive list of PRI signatories.

Appendix

Case study – The Enhanced Analytics Initiative