

small & Savvy

Investors are discovering that many big ideas can be found at smaller firms. • **By Pam Abramowitz**



October 19 was a big day for independent research companies and smaller securities firms. That was the day the Securities and Exchange Commission issued its long-awaited guidance on soft dollars, effectively permitting their continued use as payment for research (see “Sins of Commissions,” page 36). With an estimated 80 percent of research currently paid for through soft dollars, or what the SEC calls client-commission arrangements, research providers were worried that the economic foundation of their business might be swept away.

“There was a three-year cloud over the research industry,” says Scott Cleland, founder and chief executive officer of independent research provider Precursor and chairman of the Investorside Research Association, a trade group of independent firms, both based in Washington. During that time, he says, some institutions, especially those mutual fund firms under regulatory scrutiny, cut back on soft-dollar payments and reduced their purchases of independent research.

Now that the cloud has lifted, the smaller firms can get on with making a case for their products and building their businesses. If research quality drives that process, the boutique, regional and independent firms judged best by the analysts and portfolio managers polled for *Institutional Investor*’s All-America Research Team should be optimistic about their prospects.

Among boutiques and regional firms, two firms lead the way, each winning in five categories. FTN Midwest Securities Corp., based in Cleveland, earns top honors in Food, Health Care Facilities, Machinery, Retailing/Broadlines & Department Stores

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Portales sales and marketing chief Steiner: "We give our analysts the freedom to look at tangential companies"

Best boutiques and regional firms

In polling for our 2005 All-America Research Team, we asked investors to name the best boutique or regional firms by sector. Here are the winners in their respective categories.

Sector	Best firm	Honorable mention
BASIC MATERIALS		
Chemicals/Commodity	Fulcrum Global Partners*	
Metals & Mining	Longbow Research*	
Paper & Forest Products	Buckingham Research Group*	
CAPITAL GOODS/INDUSTRIALS		
Airfreight & Surface Transportation	Stephens	
Machinery	FTN Midwest Securities Corp.	Robert W. Baird & Co.
CONSUMER		
Apparel, Footwear & Textiles	Susquehanna Financial Group	
Autos & Auto Parts	KeyBanc Capital Markets	
Beverages	Legg Mason	
Food	FTN Midwest Securities Corp.	
Gaming & Lodging	Susquehanna Financial Group	
Leisure	A.G. Edwards & Sons	
Retailing/Broadlines & Department Stores	FTN Midwest Securities Corp.	
Retailing/Food & Drug Chains	FTN Midwest Securities Corp.	
ENERGY		
Electric Utilities	A.G. Edwards & Sons	
Integrated Oil	Simmons & Co. International	Howard Weil
Oil & Gas Exploration & Production	Simmons & Co. International	Hibernia Southcoast Capital Howard Weil
Oil Services & Equipment	Simmons & Co. International	Howard Weil Pickering Energy Partners
FINANCIAL INSTITUTIONS		
Banks/Large-Cap	Keefe, Bruyette & Woods	Fox-Pitt, Kelton Sandler O'Neill & Partners
Banks/Midcap	Keefe, Bruyette & Woods	Sandler O'Neill & Partners
Brokers & Asset Managers	Keefe, Bruyette & Woods	Buckingham Research Group* Fox-Pitt, Kelton Sandler O'Neill & Partners
Insurance/Life	Fox-Pitt, Kelton	Dowling & Partners Securities Keefe, Bruyette & Woods
Insurance/Nonlife	Dowling & Partners Securities	Fox-Pitt, Kelton Keefe, Bruyette & Woods
Mortgage Finance	Keefe, Bruyette & Woods	Friedman, Billings, Ramsey & Co.
REITs	Green Street Advisors*	
Specialty Finance	Keefe, Bruyette & Woods	
HEALTH CARE		
Biotechnology	Leerink Swann & Co.	SG Cowen & Co.
Health Care Facilities	FTN Midwest Securities Corp.	
Managed Care	Dowling & Partners Securities	
Medical Supplies & Devices	Leerink Swann & Co.	Piper Jaffray
Pharmaceuticals/Major	Leerink Swann & Co.	
Pharmaceuticals/Specialty	Leerink Swann & Co.	
MEDIA		
Cable & Satellite	Fulcrum Global Partners*	
Entertainment	Fulcrum Global Partners*	
TECHNOLOGY		
IT Hardware	Pacific Crest Securities	
Software	Pacific Crest Securities	
MACRO		
Convertibles	McMahan Securities Co.	
Economics	International Strategy & Investment Group*	
Portfolio Strategy	Empirical Research Partners*	International Strategy & Investment Group*
Quantitative Research	Empirical Research Partners*	
Washington Research	International Strategy & Investment Group*	

* Voters also named these firms as among the best independents.

and Retailing/Food & Drug Chains; FTN also had five first-place finishes in 2004. New York's Keefe, Bruyette & Woods dominates the Financial Services sectors, capturing the top spot in Banks/Large-Cap, Banks/Mid-cap, Brokers & Asset Managers, Mortgage Finance and Specialty Finance. In 2004, KBW won in four categories.

Boston-based health care specialist Leerink Swann & Co. leads four sectors: Biotechnology, Medical Supplies & Devices, Pharmaceuticals/Major and Pharmaceuticals/Specialty. New York-based Fulcrum Global Partners wins in Cable & Satellite, Chemicals/Commodity and Entertainment; and Houston-based energy boutique Simmons & Co. International walks away with the Integrated Oil, Oil & Gas Exploration & Production and Oil Services & Equipment categories.

Among independent firms, New York-based Sanford C. Bernstein & Co. easily outpaces its peers, ranking in 26 categories and earning first-place positions in 19. Fulcrum takes top honors in five categories. Buckingham Research Group, also based in New York, places in seven categories and captures two No. 1 slots. International Strategy & Investment Group, Portales Partners and Precursor each place in four categories.

Winners were chosen by portfolio managers and analysts at asset management firms and hedge funds. More than 1,100 voters from nearly 400 asset managers cast ballots for boutiques and regional firms; some 600 voters at nearly 300 firms cast votes for independent researchers. For boutiques and regionals, we received sufficient depth of voting to publish results in 40 of the 71 categories appearing in the 2005 All-America Research Team; for independent firms, we received voting that enabled us to name winners in 49 categories. Some firms garnered votes in boutique and independent categories; survey respondents were free to characterize firms as they chose.

Although investors may blur distinctions among smaller firms, they clearly note a big firm-small firm divide. "Independents come at things from a unique perspective, and bou-



KBW research director Howard: "We're geeks. We follow companies that others don't, we're focused"

tiques specialize, giving them more expertise," says a portfolio manager at a major New York firm who appreciates the early reads he receives on new trends. An example of such insight from boutique brokerages came in a May report from KBW on option-adjustable-rate mortgages on the West Coast. The firm said the increasing popularity of these instruments could pose risks for certain lenders, especially if home prices were to fall. It pointed to option-ARM exposure at S&Ls FirstFed Financial Corp., Golden West Financial Corp. and Washington Mutual. Such insights, says one voter, "allow me to stay ahead of economic changes that have an impact on my holdings."

KBW research director John Howard attributes his firm's success to its specialization: "We're geeks. We follow companies that others don't, and, since we're focused on one thing

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and aren't distracted, we follow them better than others do. What's more, we have a stellar sales force that's more knowledgeable than Street firms that are generalists."

That view is confirmed by an institutional analyst and portfolio manager who says: "If I get a call from a [bulge-bracket] salesperson, he's a generalist, and he's probably telling me what's already in the e-mail. But when a KBW salesman calls, he's got a lot of expertise in the field. He probably has his own perspective and opinion, and it adds to the dialogue."

Howard says that downsizing at major Wall Street firms has enabled KBW to rebuild its research capabilities, which were stricken on September 11, 2001, when the firm lost 67 of its 170 New York-based employees. "A lot of the analysts we hired came from bulge-bracket firms," he says.

Howard says that despite the financial sector being out of favor this year among investors, his firm's commissions and research staff have been growing. Over the past 18 months, the firm has built a ten-person London-based research team that follows about 120 European companies. That's in addition to the 30 publishing analysts who follow about 340 U.S. financial companies.

Strength in other categories was demonstrated by three newcomers to the best of the boutiques and regional firms: Cleveland-based KeyBanc Capital Markets in Autos & Auto Parts; Greenwich, Connecticut-based McMahan Securities Co. in Convertibles; and Susquehanna Financial Group, a Bala Cynwyd, Pennsylvania-based firm that institutions judge best in Apparel, Footwear & Textiles and Gaming & Lodging.

Susquehanna's research arm, which has 27 senior analysts covering 300 stocks in consumer, health care and technology sectors, says Eric Noll, research director, is only two and a half years old. Launched as an options market maker, Susquehanna added institutional brokerage services in 2002 and research

a year later, after finding that its clients were directing most of their commission dollars to firms that provided research. "We wanted to get into the business when everyone else wanted to get out," Noll says. "We wanted to marry a boutique research capability with bulge-bracket execution."

Noll says his firm's roots in options market making gives its analysts an edge. "If a biotech company is having a Food & Drug Administration approval meeting four months from now, options-trading patterns can give us a read on sentiment toward those results."

Susquehanna has a team of 30 "market intelligence" analysts who watch trading activity for signs that something out of the ordinary is going on. "We work backwards from a trade to try to find out the events that are driving it, then build a context or case for that trading; we marry that with the fundamental analysis," he says.

His firm is looking to hire two to five more analysts and to increase coverage to 450 stocks over the next six months; in

first-quarter 2006 it plans to launch a small-cap research effort. Noll says his analysts conduct research the old-fashioned way: "Our semiconductor analysts, for example, go to Asia four or five times a year to talk to the people making the chips, to see what's going on inside the business and to find out who's struggling. Our specialty retail analyst counts the number of shoppers walking out of stores with bags to help determine who is winning the shoppers' dollars."

Also planning to expand coverage is New York-based independent Portales Partners, which takes the No. 1 spot in Banks/Large-Cap and Mortgage Finance and grabs second place in Banks/Midcap and Specialty Finance. The firm, which follows 60 U.S. companies with five analysts, expects to beef up its financial services analysis, says Barbara Steiner, partner in charge of sales and marketing. "We give our analysts the freedom to look at tangential companies," she says. In addition to its research analysts, the firm employs a forensic accountant who supports analysts and looks into topical financial services issues. His work contributed to a Portales sell rating on mortgage buyer and repackager Fannie Mae in April 2004, near \$74, based on competitive pressures in its core business, questions about its accounting practices and risks from its derivatives positions. In mid-November 2005 the stock traded at \$46.55. "Portales Partners offers an unconventional view," says one voter. "They do 'think pieces' with good breadth, and they also sponsor trips and set up meetings."

Precursor, which takes top honors in Data Networking & Wireline Equipment and both Telecom Services categories as well as the No. 2 spot in Software, is praised for its detailed modeling of the broad tech business, including hardware, software and telecom. CEO Cleland says the firm has called several inflection points in tech demand over the past few years, including a low point in October 2002 and, most recently, the return of revenue growth in June 2005. It also provided a warning about the woes of WorldCom in the second quarter of 2000. Precursor's ten analysts follow about

three quarters of the market cap in U.S. technology, media and telecommunications, Cleland says.

Off the Record Research, a San Francisco-based independent that wins first-place honors in the Food and Restaurants categories and a second-place spot in Beverages, uses a journalistic model rather than a traditional one. It calls its analysts editors and uses worldwide market surveys to gather data on trends affecting 80 industries and 400 companies, says Craig Gordon, a director. "All sell-side firms write reports the same way," he says. "We try to move data to information and information to intelligence."

Although his firm does no financial modeling or earnings forecasting, it recently provided an early read on just how severe the repercussions might be for Guidant Corp. after the medical-device maker issued a recall of implantable cardiac devices in June 2005. The research firm noted Guidant's deteriorating fundamentals and remained negative despite share support provided by Johnson & Johnson's plans to acquire the company. "It now looks like the merger may be in trouble," Gordon says. Guidant shares fell from almost \$74 in early June to \$62.55 in mid-November.

Cleland is optimistic about the future for independents, asserting that the SEC's soft-dollar decision will have an effect far greater than the global settlement arranged by New York State Attorney General Eliot Spitzer and other regulators in 2002. That agreement required 12 major brokerage firms to spend nearly \$500 million to add independent research to their offerings through 2009. But Cleland concedes that his business is unlikely to boom immediately. "Clients tend to choose providers once a year; we aren't likely to see changes until 2007," he says. Increasing the footprint of independent research may require salesmanship: The most recent *II* survey indicates that the use of independent research among those responding slipped from 77.22 percent in 2004 to 72.39 percent this year, even as those likely to increase their use of independent research declined from 46.70 percent to 42.32 percent.

Picking the best boutiques, regionals and independents

In its polling for the 2005 All-America Research Team, *Institutional Investor* asked participating analysts and portfolio managers at asset management companies to name the boutique or regional firm that they believed had done the best research work over the preceding 12 months in each of the 71 industry and macroeconomic categories in the ranking. Separately, we also asked respondents to identify the sources of independent U.S. equity research that they found most valuable.

In choosing the best boutiques and regionals, we rank entire firms; any votes for individuals are aggregated with their employers' totals. Scores are produced by taking the number of votes awarded to a firm and

weighting that based on the size of the voting institution. The rankings are determined based on the numerical score each firm receives. *II* requires a minimum number of votes to rank a boutique or regional; firms met this requirement in 40 categories. The identities of the survey respondents and the institutions that employ them are kept confidential to ensure their continuing cooperation. Our boutiques ranking is based on the opinions of more than 1,150 individuals at some 395 firms.

For independents — defined as those that did no investment banking or corporate finance — scores are determined by the asset size of the voter as well as the place (first, second or third) awarded to the

provider by the voter. In our independents list we rank up to three top-scoring research firms; all remaining firms that received more than the required minimum number of votes garner honorable mention. Independent research providers met our minimum vote requirements in 49 of the 71 research sectors. More than 600 voters at more than 290 firms voted in this portion of the survey.

Our rankings of the best boutiques, regionals and independents were compiled by *II* staff under the direction of Director of Research Operations Group Sathya Rajavelu, Assistant Managing Editor for Research Evan Cooper and Senior Editor Jane B. Kenney, with Associate Editors Sivert Hagen and Donovan Hervig.

