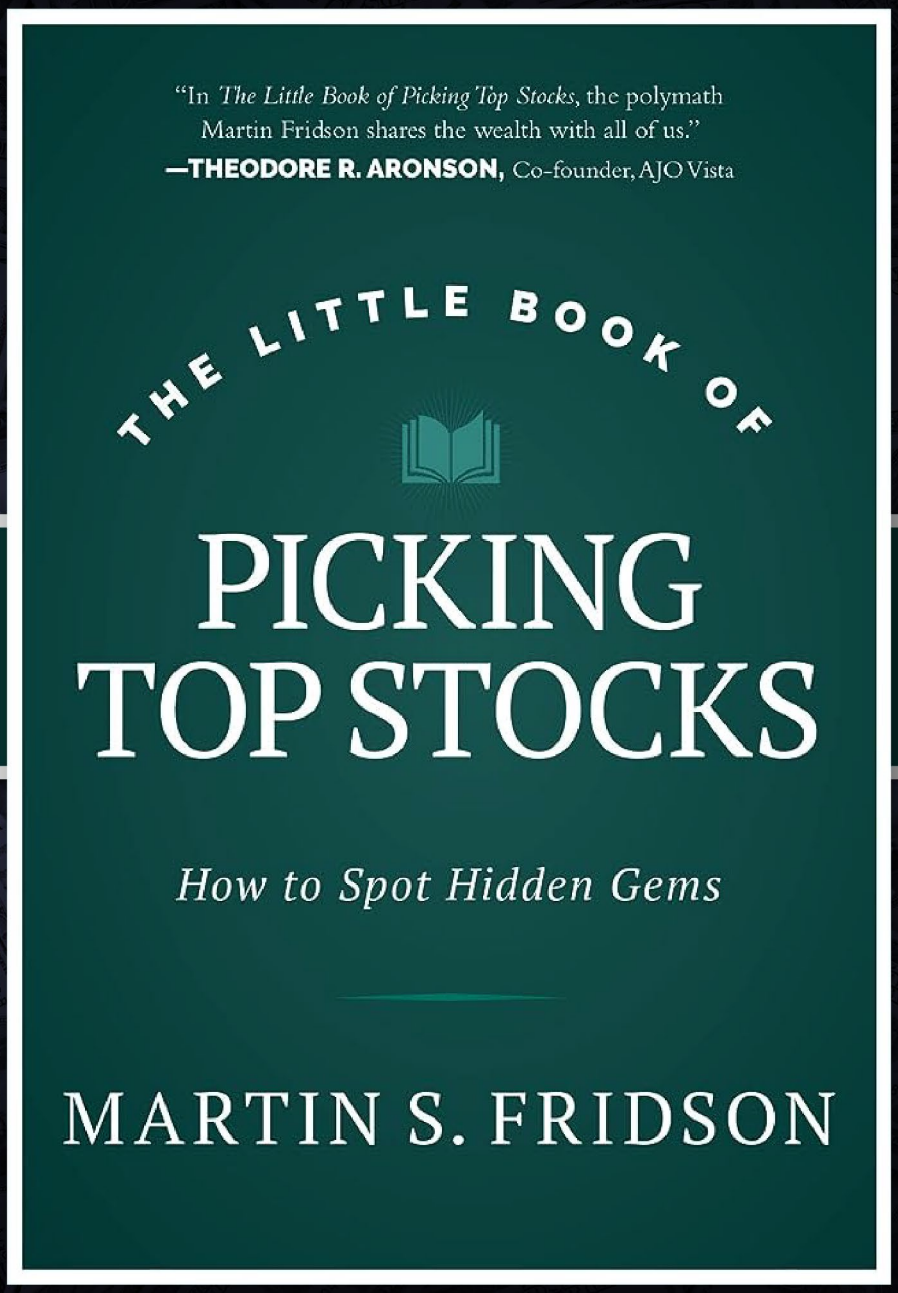
SPECIAL REPORT

THE BIG SECRET ON WALL STREET

SPECIAL PREVIEW OF:



FROM THE DESK OF PORTER STANSBERRY

Porter & Co.

The Little Book of Picking Top Stocks Chapter 1 Preview

*Renowned credit analyst and author Martin Fridson has arranged with his publisher to give Porter & Co. readers a special look at the first chapter of his latest book, **The Little Book of Picking Top Stocks**. This book focuses on the top-performing stock in the S&P 500 over the years - and what caused them to achieve that distinction.*

In the first chapter of the book — which Martin condenses for us in this special report — he exposes the fallacy behind conventional securities analysis. Simply put, Wall Street's research methods won't help you zero in on the stock that will lead the pack in the coming year. Those celebrity analysts focus on long-discredited metrics like earnings per share, perpetuating the mistaken belief that low-volatility earnings produce superior returns for shareholders. (And sometimes they rely on even wackier methods, like astrology.)

*To learn a more effective method for stock-picking.... well, you'll have to read our exclusive preview here, and then the full **Little Book of Picking Top Stocks**, available wherever your favorite books are sold.*

Forget About Conventional Analysis

Seeking a professional's opinion makes sense in lots of situations. Suppose you can afford a painting by a famous artist to hang on a wall in that house, but you don't know the art market well. You'd be wise to pay a consultant who can tell you where comparable works sell at auction.

It might seem to follow that if you're trying to pick next year's #1 stock, you'd want to look for it in research produced by people who analyze stocks for a living. Equity analysts employed at Wall Street firms or independent research organizations know the companies they follow inside out, thanks to specializing by industry and concentrating on a small number of stocks. Over many years of studying their industries, they've developed valuable contacts at their companies' suppliers and customers.

No doubt about it, there's a lot of intellectual firepower for you to draw on as you attempt to identify the year's highest-return stock before it takes off for the moon. The question is whether any of it is useful in that quest. I'm not disputing the value of the skills that enable premier analysts to command bigtime compensation packages. It's just that the system they're part of isn't geared toward the objective that's the focus of this book.

From Earnings Forecasts to Recommendations

Analysts boil their work down to a uniform, easy-to-understand set of acronyms. Each analyst projects the company's earnings for the coming year and divides that amount by number of shares outstanding to produce an earnings per share (EPS) estimate. Dividing the company's share price by its projected EPS produces the price-earnings (PE) multiple.

PE multiples vary according to companies' perceived earnings quality and expected future EPS growth rate. The analyst assigned to a given company renders an opinion on what its PE ought to be, based on how it stacks up on those factors against other companies in its industry. Multiplying the company's "correct" PE multiple by its projected EPS produces a price target (PT).

Based on where the stock's current price stands relative to its PT, the analyst assigns a rating to the stock. The ratings terminology varies by firm, but the most straightforward setup consists of a Buy, Hold, or Sell recommendation. The investor can examine a full list of a firm's recommendations and determine which stock has the biggest upside, based on where it stands in comparison to its PT.

There's just one small problem.

The Irrelevance of EPS

Almost half a century before this book's publication, the distinguished financial economist Joel Stern demonstrated that EPS has no bearing on stock prices. Stern's findings weren't by any means buried in obscurity and forgotten. His article, "Earnings per Share Don't Count" appeared in the widely read *Financial Analysts Journal* of July-August 1974.

The fallacy of regarding a company's share price as a function of its EPS can be seen by considering two companies, NWRQ and YMDO. Both earned $1.00 a share in the latest 12 months and both are expected to grow their earnings at 10% a year. Neither company has any debt on its balance sheet and neither intends to use debt in the future. Based on what you know so far, you'd expect the two companies' shares to sell at the same PE multiple. Let's assume that's 20x, meaning that NWRQ and YMDO shares are both trading at $20.

But now let's add one more piece of information. NWRQ can achieve its 10% earnings growth without needing to add to its present capital. It's an "asset-lite" company that generates sales primarily from the brainpower of software developers whose office space and computer terminals are already in place. YMDO, on the other hand, will need one additional dollar of capital for each additional dollar of sales it must generate in order to increase its earnings. Where will YMDO get that additional capital? Having ruled out the use of debt, the company has just two possible sources.

One possibility for YMDO is to sell additional shares to fund the investments required to produce the projected 10% earnings increase over the next 12 months. In that case, YMDO's earnings will be spread out over a larger number of shares than formerly. Its EPS will go down, relative to the EPS of NWRQ, which won't need to issue any more shares. If EPS is truly the basis on which the market prices stocks, then on a forward-multiple basis, NWRQ's shares must carry a higher price today than YMDO's shares, yet in fact they're both currently at $20.

The other way YMDO can raise the capital it requires to increase its earnings is by reinvesting some of its earnings in the business. NWRQ, on the other hand, can pay out all of its earnings to shareholders as a dividend. Reviewing the facts, would you really pay as much for YMDO's stock, with equivalent current-year EPS and projected earnings growth as NWRQ but with a smaller dividend?

Alternatively, NWRQ can return 100% of its earnings to shareholders by repurchasing stock. That will reduce its number of shares outstanding and increase its EPS over the next 12 months. If YMDO tries to follow the same strategy, it will have less money to spend on stock repurchases because it needs to reinvest some of its earnings in its business. Compared to NWRQ, YMDO will have more shares outstanding a year from now and less projected EPS. Once again, the market will put a lower price on its shares than on NWRQ's today, even if it applies the same 20 times PE multiple to both companies' projected EPS. Yet that contradicts the original premise that both stocks are currently trading at $20.

Clearly, it's impossible for NWRQ and YMDO to trade at both the same price and at different prices at the same time. Stern untangles this paradox with an inescapable conclusion: The market doesn't really value shares on the basis of EPS. What it really cares about is, in Stern's words, "earnings net of the amount of capital required to be invested in order to maintain an expected rate of growth in profits." He dubbed this metric free cash flow. The Corporate Finance Institute defines free cash flow as Operating Cash Flow – Capital Expenditures.

Stern laid out these irrefutable facts nearly 50 years before this book went to press. Yet to this day, as Hans Wagner lamented in a 2022 Investopedia article, "very few people look at how much free cash flow (FCF) is available vis-à-vis the value of the company."

EPS: Flawed but Dominant

Simplicity helps to explain why EPS takes on such great importance in Wall Street's equity research machine. But EPS prediction has also intrigued finance professors, who are far from intimidated by complexity. They've done studies on such questions as why analysts' estimates are biased in the direction of excessive optimism and how analyst incentives lead to forecast errors. Another study found that 40% of the time, an EPS forecast derived from a time series of past data was as accurate or more accurate than the analysts' consensus forecast.

EPS versus Underlying Reality

The equity research Establishment's overreliance on EPS might be more excusable if earnings invariably represented a genuine creation of economic value on behalf of shareholders. In practice, the gap between reported earnings and bona fide profits can be vast. Sometimes the mismatch reflects outright accounting fraud. But investors shouldn't be lulled into believing that they're getting the straight dope on a company's earnings merely because none of its executives are under indictment. Reported EPS can diverge from the underlying reality because of perfectly lawful accounting practices or because the numbers dispensed in quarterly financial statements are later said to have been mistakes.

Before we examine how companies present a distorted picture without violating any securities laws, let's get clear on why they routinely do it. All else being equal, they reckon, investors prefer EPS that climbs year by year at a steady clip to one that moves up in fits and starts. So between two otherwise similar stocks, the one with less volatile EPS should receive a higher PE multiple and deliver a higher return.

That, at least, is what corporate managers believe. But that's not what a 2013 study by Tim Koller, Bin Jiang, and Rishi Raj[7] concluded. Those researchers at the management consulting firm McKinsey found no statistically valid evidence that lower earnings volatility produces higher returns for shareholders.

It's important to note that the McKinsey authors mentioned above don't recommend realigning corporate revenues in pursuit of steadier EPS progression. But that's exactly what some companies do. They attempt to reduce their earnings volatility through diversifying acquisitions. The idea is that industries have different business cycles, so one business line's peak earnings will offset the trough at another's.

It sounds good in theory, but it doesn't work out so well in practice. Koller, Jiang, and Raj found that of the 50 S&P 500 companies with the lowest earnings volatility over a 10-year period, fewer than 10 were diversified, as defined by owning businesses in more than two distinct businesses. Furthermore, the McKinsey experts uncovered no evidence that low-earning-volatility companies commanded premium prices. They reported that in their experience, the sum of the values of diversified companies' businesses almost never differed materially from the market values of their stocks.

So much for the available methods of reducing volatility in quarterly earnings reports by actually addressing the underlying reality. When those methods don't accomplish everything management had hoped for—probably because no business actually grows by the same percentage year in and year out, much less quarter to quarter—there are ways to create the appearance of earnings stability without breaking any laws.

Just accelerate some of the regular maintenance work scheduled for the third quarter to the second quarter. With an extra quarter's worth of that expense booked in the second quarter, second-quarter earnings won't be far above trendline. So it will be possible to report the desired year-over-year percentage gain in next year's second quarter. The benefits of the short-run demand boom won't be lost. They'll just be more conveniently timed.

A further step into the realm of financial reporting fantasy involves *arbitrary timing of discretionary accounting decisions*. That phrase may sound like gobbledygook, but what it represents is easy to understand. Suppose, for example, that a company does have some stale merchandise in its inventory. At some point, it will have to write down that value of those goods to a level that represents prices it can now realistically expect to obtain. But there's some judgment involved in determining exactly when the merchandise's current carrying stops being a realistic number.

Management's professional judgment is that the current quarter isn't the best time to come to that conclusion. By an incredibly amazing coincidence, earnings are threating to come in a bit below trendline this quarter. Taking a write-down at this particular time would worsen that problem.

Everything points to a profit rebound a couple to quarters from now. In fact, at that point EPS will be in danger of going too far *above* trendline. Upon very careful consideration, management concludes that the loss of value on that stale merchandise will become indisputable just about six months from. So that's when the company will take the write-down.

These examples don't by any means exhaust the range of non-illegal gimmicks that companies have devised over the years for manipulating their earnings. In his heyday in the 1980s and 1990s, the legendary General Electric Jack Welch was determined to make EPS rise at a steady rate every quarter, come rain or come shine. Every division of the company was expected to do its part.

An executive in GE's financial services business recounted that if quarter-end was approaching and divisional earnings were in danger of falling short of their target, he and his colleagues would scramble to find an acquisition. The acquired company's earnings could be counted for the full quarter, enabling the division to meet its quota. It's not unreasonable to suppose that GE's selection of acquisition targets would have been different if it had been based strictly on maximizing the company's long-run economic value, instead of satisfying Wall Street's demands for an ultra-smooth earnings progression.

Hooray! There's Less Accounting Fraud Than There Used to Be

Up to this point, I've described only techniques for artificially reporting steady EPS growth that don't violate the accounting rules and land senior management in the

slammer. There's some good news on this front for investors who want to know what's actually going on at companies: Outright financial fraud has become less frequent in the United States over the past several years.

Is it necessary to add that this wasn't the result of CEOs suddenly deciding that collecting big bonuses based on their stocks' performance was less important than providing a true and transparent picture of their companies' performance? No, the real reason that making stuff up became a less favored tactic is that the Sarbanes-Oxley Act of 2002 made it harder for the CEO to shift the blame for fraud to subordinates.

That law required CEOs to sign the financial statements that their companies submitted to the Securities and Exchange Commission. Previously, a CEO could get away with implausibly claiming that the fraud was entirely the Chief Financial Officer's doing, even if that executive's bonus plan wasn't tied in any way to the company's stock performance. In that case, the CFO had no obvious motive for falsifying the financial results.

A study by Joshua Livnat and Christine E.L. Tan of New York University's Stern School of Business Administration examined thousands of earnings restatements. The authors found evidence that, as they diplomatically put it, "the originally reported earnings may have been strategically managed." *Investopedia* defines earnings management as "the use of accounting techniques to produce financial statements that present an overly positive view of a company's business activities and financial position."

Livnat and Tan reported that restatements occurred in only 3.4% of the 220,000 quarterly financial reports in their database. But that isn't necessarily a good enough reason to be complacent about the reliability of the EPS figures that Corporate America pumps out. Midway through 2021 the Wall Street Journal reported that more than 540 companies had restated earnings in the previous three months, an amount higher than in any full year since 2013.

The upsurge resulted from an SEC determination that many special-purpose acquisition companies (SPACs) were improperly accounting for warrants they'd issued in the course of raising capital. On top of that, some SPACs and companies acquired by them disclosed more serious accounting problems in their restatements. For example, Lordstown Motors Corp. said it had "substantial doubt" about its ability to finish the year as a going concern. The company's top two executives subsequently resigned over inaccurate recording of preorders for its electric trucks.

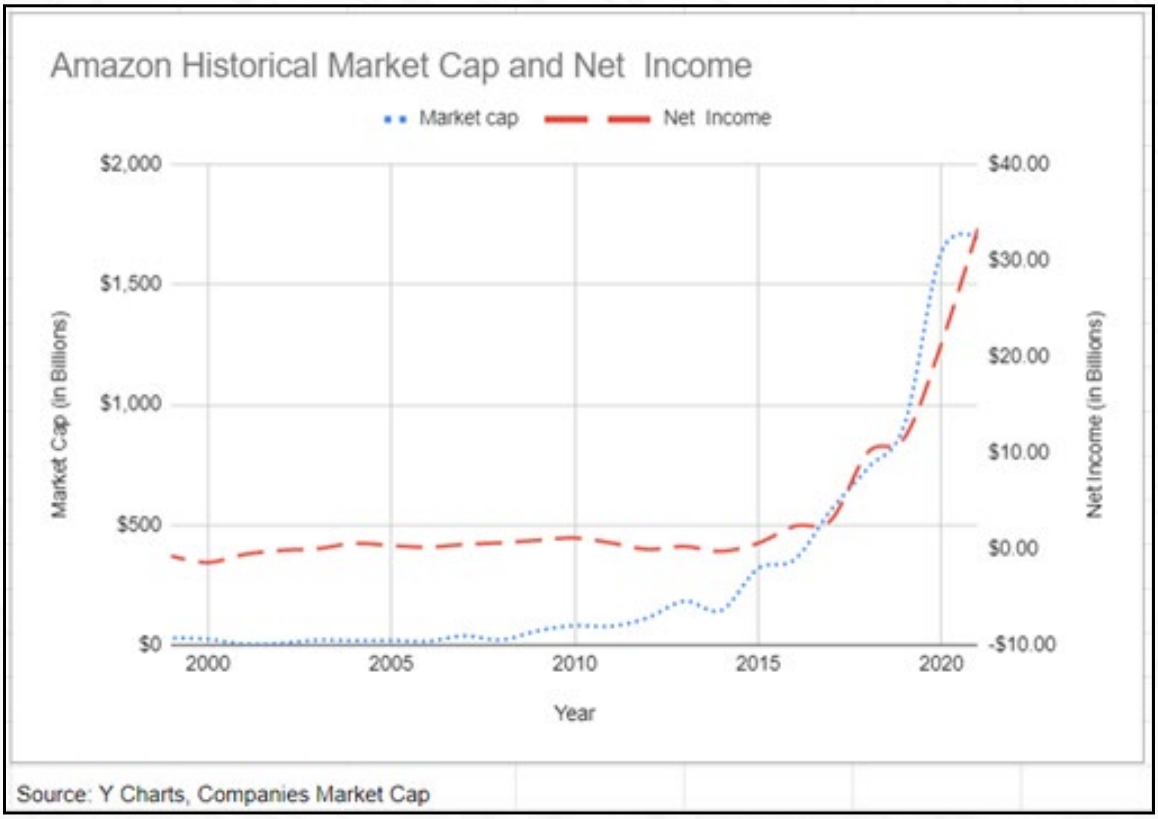
Earnings versus Value Creation

Many investment pundits are so wedded to the fallacy that wealth is created when a company borrows two cents a share from next quarter's earnings to beat

the analysts' consensus forecast that they deny the reality of billions of dollars of legitimate wealth creation in some of the world's most dynamic growth industries. They deride companies that have never reported a profit according to Generally Accepted Accounting Principles (GAAP, pronounced "gap"), yet are awarded with *market capitalizations* in the billions by allegedly deluded investors. ("Market cap" = Share Price x Total Number of Shares Outstanding.) These companies trade on multiples of sales rather than PE multiples, like normal ones. "It's the Dutch tulip craze all over again!" shout the naysayers.

Have there been examples of companies that went public with no bottom line, obtaining astronomical market valuations, only to crash and burn a few years later? Certainly. But did every company that amassed a gigantic market capitalization without producing positive GAAP earnings prove to be a speculative bubble that burst, leaving its credulous investors in tears? Absolutely not.

Amazon (AMZN) can be considered the poster child for bona fide value that's unrelated to EPS. In its first several years after going public in 1997, the online retailer unfailingly reported losses. The first year in which it showed a GAAP profit was 2003. But before that "breakthrough" year began, Amazon had attained a $7.3 billion market capitalization. The accompanying graph illustrates just how long it took for GAAP to catch up with the reality that Amazon was generating a substantial *economic profit*.



How were the allegedly gullible investors who bought AMZN punished for their supposed folly? By the end of 2021, the company's market capitalization had risen by more than 20,000% to $1.7 trillion. From the end of 2002 to the end of 2021, Amazon shareholders realized a 31.27% total return versus 11.49% for the S&P 500. If that's what a fool and his money soon being parted looks like, bring it on!

Here's what the Amazon bashers missed and what their present-day kindred spirits continue to miss: GAAP is an accounting system that's very well designed... for nineteenth century manufacturing companies. Through most of the twentieth century, GAAP served investors in most industries reasonably well. But GAAP hasn't adapted well to the transformation of America's industrial base beginning in the 1990s. The problem arises from failing to acknowledge what constitutes an asset in this day and age.

In a correct, non-jargony way, Oracle Netsuite defines an asset as: "anything that has current or future economic value to a business." Let's consider an infotech company that spends $10 million in 2023 on designing a software package for small businesses. The project proves successful, the company copyrights the new software, and customers love it. In the first year, sales of the new product total $4 million, exceeding management's most optimistic expectations. Note that the company hasn't sold its ownership of the software package, only licenses to use it. Cash is flowing in, the owners are high-fiving each other, but the picture presented by the company's income statement is much less rosy.

Under the rules laid down by GAAP, the $10 million research expenditure was classified as an expense. That's despite the fact that the outlay produced something that definitely delivers current and future value to the business—a proprietary software package that will generate revenue for years to come. But according to GAAP, the company lost $6 million on the new software in 2023, before even taking into account the selling costs and corporate overhead.

One likely response to the idea of treating a *New Economy* company's intellectual property as an asset is, "That's not something I can touch and feel, like an oil refinery or a truck fleet." But it's eminently feasible, outside of the GAAP world, to assign values to these non-physical assets. For example, cable or satellite television subscribers pay a known subscription fee and on average continue as subscribers for a determinable number of years. Those predictable future revenues can be converted into an asset value by well-established financial methodology.

Let's pick up the stories of Joel Stern, who documented the disconnect between EPS and valuation way back in 1974, and Amazon, the poster child for value creation without benefit of EPS. Stern went into the consulting business with another outstanding innovator in financial analysis. Bennett Stewart created an improved profit measured called Economic Value Added (EVA).

One feature of Stewart's alternative approach was to put R&D and advertising expenditures on the company's balance sheet, rather than treating them as

expenses that reduce income. Amazon measured up more favorably with EVA than in conventional securities analysis. That was because its comparatively narrow profit margins were offset by high turnover of its merchandise. In his 2013 book, *Best Practice EVA*, Stewart wrote about what happened in the period after Amazon first reported positive annual earnings, according to GAAP.

Over a five-year span, Amazon's EPS plunged from a peak of $2.50 a share to -$0.33. During that time, the online retailer's margins collapsed, deeply negative cash flow from operations forced it to raise tons of new capital, and the company missed consensus EPS estimates for 11 consecutive quarters. The share price did exactly what you'd expect, given those facts. Well, no, actually. The price more than quadrupled, making AMZN one of the period's best-performing large-cap U.S. stocks.

Stewart recounted how the pundits offered a totally wrong explanation for this price response, which defied everything they'd previously said about how the equity market works. It wasn't that AMZN was a unique "story stock" driven by its visionary CEO Jeff Bezos, exempt from the forces that governed all other stocks' valuations. Instead, said Stewart, the investors who really matter looked through Amazon's GAAP earnings and focused instead on genuine economic profits.

Even as the company's EPS was spiraling downward, its EVA profits nearly tripled in the five years ending in mid-2013. AMZN's price went up and up as this happened, rather than down and down, as the doctrines tirelessly promoted by equity analysts and their enablers in the media said it had to. There could hardly be a more forceful demonstration that Joel Stern was correct way back in 1974, when he wrote that earnings per share don't matter for stock valuations.

The Guidance Game

In a perfect world, every corporation would shift its focus from EPS to a superior measure that truly advanced the objective of building shareholder wealth, be it EVA or another well-conceived yardstick. Here on earth, inertia controls much of what goes on in the business world. An immense infrastructure has been built up over many years on the foundation of predicting EPS, translating the predictions into price targets, debating the price targets in the media, and grading analysts and their firms on the accuracy of their predictions.

Refusing to conform to the established system could penalize a company in terms of the number of analysts following it. Omaima A.G.Hassan and Frank S. Skinner stated in a 2016 article that "it is well documented that analyst coverage affects firm value." According to the previous research they cited, wide coverage makes it less costly for investors to monitor companies' activities. So owning the shares of widely covered companies is more profitable than owning stocks followed by only a few analysts.

An essential part of playing along with the system is providing earnings guidance to analysts. This consists of management telling investors the level of EPS it

expects to report for the current quarter and beyond. Guidance is carefully couched in language that allows the company to escape legal liability if the actual numbers differ.

When the company releases its artificially constructed EPS number, the analysts who've based their forecasts on the reality underlying the reported number wind up being much too high. Getting blindsided in this way makes the analysts look bad. Seeing that the company isn't playing by the rules, they may decide to stop following it in favor of another company that won't embarrass them.

A better strategy is to guide analysts to a number close to the largely predetermined EPS figure. Not exactly to the number, mind you. The ideal outcome is for the analyst consensus to be at least $0.01 below the number that eventually gets reported.

This way, if everything goes as planned, the stock will rally on the EPS beat. By the rules of the game, nobody will fault analysts for being off by a penny or two. The analysts get credit for being able to forecast earnings with a high degree of accuracy. And even if the price spurt last for only a day, the stock builds a reputation as the kind you want to own. The message is, "The company's outstanding management team consistently exceeds expectations."

To paraphrase an old Wall Street joke, this cozy little system works out well for the companies, it works out well for the analysts, and two out of three ain't bad. The investors can't be said to benefit from an arrangement that discourages the sort of independent thinking that might just lead them to a hidden gem within the universe of stocks. But they're not the ones running this game.

Making Nice to Management

One more reason for analysts to defer to companies' guidance is to preserve access to management. This includes obtaining face time for clients with companies' senior executives. Entrée at the corner office pays off.

A 2016 study by Ling Cen, Jing Chen, Sudipto Dasgupta, and Vanitha Ragunathan indicated that analysts who get invited to ask questions early during earnings calls have superior career trajectories. And that sort of treatment by management isn't a random thing. According to a 2014 study by Lauren Cohen, Dong Lou, and Christopher J. Malloy, 59% of surveyed investor relations officers said that they actively manage the order in which analysts are called on to ask questions.

A standing joke on Wall Street is the frequency with which analysts suck up to corporate bigwigs with the phrase, "Great quarter, guys!" The research firm Sentieo reported that in August 2021, mentions of those words and their synonyms set an all-time record of 327. "Congratulations" also made a strong showing, according to the financial website's analysis of earnings call transcripts.

In 2017 the Wall Street Journal's Jason Zweig reported on research by Jonathan Milian and Antoinette Smith. They analyzed 16,000 earnings calls of 500 companies. Analysts on those calls described the quarterly results with the adjectives "good," "great," or "strong" more than 215,000 times.

Companies had good reason to encourage such obeisance. Milian and Smith calculated that the more lavishly analysts praised management's performance, the more the stock shot up after the earnings announcement. Zweig's description of analysts' behavior on earnings calls included the phrases "craven flattery," "lapdog," "snivel," and "bootlicking sycophants." Newsletter writer Marc Rubinstein's account invoked "cozy up to management" and "public debasement in exchange for private access."

Potholes in the Road Paved with EPS

No one expects perfect foresight from stock analysts. But at the very least, you might hope for a clear signal when things are starting to change direction. Your hopes for that modest benefit may remain unfulfilled. In July 2022, long-time market strategist Richard Bernstein commented that Wall Street analysts' outlooks are invariably positioned in the middle of a market cycle. "When you start getting 'negative surprises' in corporate earnings — when a lot of companies aren't meeting expectations — analysts will say at first that it's an aberration."

Later, according to the head of Richard Bernstein Advisors, the analysts will gang together and cut their forecasts sharply. Then, when things finally start to turn around, analysts will be slow to recognize it. "Nobody will want to be the first to say that, either," said Bernstein.

There's also a risk that an analyst's conclusions will be influenced, even if only subconsciously, by considerations that have nothing to do with recommending the best possible stocks. Sometimes an analyst's assigned industry falls out of favor. That situation may persist for years, unfortunately for the analyst's career ambitions or yearning for the limelight. It would be only human in the face of such a roadblock to convince oneself that the great mass of decisionmakers have it all wrong.

The resulting narrative is familiar: "These stocks are unjustly disfavored. The way to make money in the market is to buy what everybody hates." If it's too much of a stretch to make a case for the group, there's another route available. The analyst may try to convince investors that one stock within the group differs in some essential way from its competitors but "has been tarred with the same brush." Or, "They've thrown out the baby with the bathwater." An even more colorful cliché goes, "When the police raid the brothel they even arrest the piano player."

It Doesn't All Even Out in the End

Self-serving bias toward optimism isn't a potential problem only in out-of-favor industries. And it isn't just a potential problem, judging by data compiled by

FactSet. In April 2022, John Butters from that company reported the following breakdown of thousands of analyst ratings on S&P 500 stocks, based on monthly averages over the preceding five years:

Buy	**52.9%**
Hold	**41.1%**
Sell	**6.0%**

This breakdown doesn't directly tell us how many of the S&P 500 companies are rated Buy, Hold, or Sell by a majority of the analysts following them. But it's mathematically impossible for every research organization represented in the survey to have an equal balance between Buy and Sell recommendations, yet produce so lopsided a mix of Buys and Sells in aggregate. We can therefore infer that the split between Buys and Sells within many research organizations tends to be closer to the nearly 9 to 1 ratio (52.9%/6.0%) shown above than to a 50/50 split.

That inference is supported by an analysis of recommendations issued by leading brokerage houses during August 2022. According to the MarketBeat data, the median ratio of Buys to Sells among the 18 firms was 7.1 times. The least unbalanced output among the 18 research departments was "only" 2.0 times as many Buys as Sells. At the opposite extreme, one brokerage house's mix included 60% Buys and 0% Sells, resulting in a ratio of infinity. The next most lopsided distribution was a 33 to 1 Buys-to-Sells ratio.

An overwhelming preponderance of Buys might seem to signal some sort of malfunction. Certainly, a dairy that set out to make equivalent amounts of chocolate and vanilla ice cream but instead produced two to 30 times as much chocolate as vanilla would reckon that something went wrong in the production process.

But consider the matter from the standpoint of an equity salesperson, whose compensation depends on generating lots of transactions. A Sell recommendation is useful only to customers who already own the stock. A Buy recommendation, on the other hand, is relevant to everybody on the salesperson's coverage list. As far as the salesperson's bottom line is concerned, if analysts are working on reports that will culminate in Sell recommendations, they're not making the most productive use of their time.

Some market pros reading this will say that I don't understand how things actuallywork. Those Holds, they'll explain, are really Sells. If you count that way, the wildly skewed 52.9%/6.0% Buy/Sell ratio cited above magically turns into a 52.9%/47.1% Buy/Sell ratio. Not a perfect 50/50 split, but then again, neither is the proverbial coin flip. (Rigorous testing by Persi Diaconis, Susan Holmes, and Richard Montgomery found that 51% of the time, a coin will land on the side that was facing up when it was flipped.)

"You see," the pros will continue informing me, "by taking the irresponsibly radical step of putting a Sell on a stock, an analyst would instantly become *persona non grata* with the company's management." No more front of the line to get picked to ask questions on earnings calls. No more open door at corporate headquarters for the analyst's VIP buy-side customers. A total freezeout. Think Michael Corleone: "Fredo, you're nothing to me now. You're not a brother, you're not a friend. I don't want to know you or what you do."

Fortunately, there's a way to avoid that terrible fate without losing all credibility by continuing to recommend an obviously overpriced stock. If the company's outlook is undeniably horrible, the analyst can lower the boom on it by downgrading it… all the way to Hold. This is done with a wink to those in the know. ("You understand, without my saying so, that this means 'Get out immediately,' right?") It's not exactly in line with the biblical injunction, make your yea a yea and your nay a nay. But it does get the point across and everybody saves face. What's the harm?

I get all that, but putting myself in the portfolio manager's shoes, I have some gnawing questions about this cozy arrangement. First of all, what's the difference between an actual Sell and a wink-wink Sell, otherwise known as a Hold)? Maybe Sell means, "Really, truly. I'm serious. Dump it right away!" Or maybe it just means, "Don't add to position." Am I supposed to exit the Holds but sell the Sells short, or what?

Also, you and I both know that nothing like 40% of the stocks in the index are going to perform close to the median. Within the S&P 500, the middle 40% by total return are those ranked 151 to 350. In 2021, the returns on those stocks ranged from 15.33% to 42.45%. That compared with a median (halfway between #250 and #251) of 28.17%. So some of those Holds validated their classifications as Sells in all but name, but others were stocks that would have helped me a lot in my quest to beat my benchmark. Does that mean, in reality, that some of those 200 stocks were "strong Holds" and some were "weak Holds?" Maybe in the future you could let me know which are which?

Stepping back from all this, is the analyst's purpose to recommend good stocks to me? Or is it to avoid hurting the feelings of CEOs, whose multimillion-dollar compensation packages ought to constitute adequate cushion for such blows?

These objections, I hasten to say, haven't a prayer of changing the status quo. The established charade, in which "Hold" is code for "Sell," is too entrenched. On September 4, 2018, *Bloomberg News* reported that the mix of Wall Street analyst recommendations on Advanced Micro Devices was "balanced" at 14 Buys and 4 Sells. That 77.8%/22.2% ratio shifts to something in the vicinity of balanced, at 45.2%/54.8%, only if you count the 13 Holds as Sells.

Final Thoughts on Fundamental Analysis

The ultimate point of this extended tour of equity analysts' methods is not to dispute that they sometimes generate extremely profitable stock

recommendations. One extraordinary example occurred in August 2022. A London-based Jefferies analyst, Charles Brennan, predicted in a note to investors that a wave of takeovers in the European tech sector would continue. He helpfully included a diagram of acquirers' possible targets.

The very next evening, the Canadian software company Open Text Corp. announced that it would acquire Micro Focus International. Brennan had identified the UK enterprise software developer as the second most likely takeover target on his list. Open Text's bid represented a 99% premium over the previous close. When Micro Focus International reopened for trading, the price zoomed nearly to that level. Holders nearly doubled their money in the space of about 24 hours.

If this kind of thing happened every day, an investor really could start with a small grubstake and make enough money in the space of a year to retire for life. But as I stress throughout this book, that isn't a realistic or appropriate aspiration. Patience is an indispensable component of a successful investor's psyche.

There are two valid reasons to try to pick next year's #1 stock, if that excites you. The first is that it can provide an outlet for the speculative urge that won't harm you financially if you allocate just a percent or two of your portfolio to your annual pick. The second is that conducting the research needed to make your selection can teach you valuable things about the dynamics of stock prices. Those lessons will help you assemble a well-chosen, responsible equity portfolio.

What you should take away from the preceding overview of fundamental equity research is that the analysis published by brokerage houses and independent research firms, useful though it may be in other respects, isn't geared to the specific objective of identifying in advance the single best-performing stock in the S&P 500. Those organizations are rewarded if they enable managers of diversified portfolios to beat their investment benchmarks by modest margins and avoid large losses. Looking for #1 requires an entirely different focus.

As for Technical Analysis…

Equity analysts' study of a company's fundamentals—competitiveness, financial strength, earnings, etc.—is supplemented by the work of technical analysts who focus instead on a stock's price behavior. They construct charts of the stock's past price movements, believing that certain observable patterns provide useful indications of its future price.

In my role as Book Review Editor of the Financial Analysts Journal I reviewed a 2009 book by Andrew W. Lo and Jasmina Hasanhodzic titled The Heretics of Finance: Conversations with Leading Practitioners of Technical Analysis. Here's a sample of the technicians' responses to the suggestion that their work ought to pass the test of empirical verification:

- "I doubt that many of the theories have been—or can be—back-tested."
- "Few things in life are perfectly black or white."
- "Technical analysis is an art."

If those comments don't inspire confidence, consider how Lo and Hasanhodzic's interviewees answered the question, "Do you think that the inclusion of astrology in technical analysis undermines the credibility of the craft?" Their replies include the following:

- "Could astrology in some offhand way be beneficial or instructive? I'm going to say yes."
- "It depends on the type of astrology you're talking about."
- "I've seen some people make some very good calls using astrology."
- "Astrology is bad for technical analysis only in the eyes of closed minds."

Technical analysis has legions of fans, but its detractors seem to be more outspoken than critics of fundamental analysis. Without specifying "technical" or "fundamental," I searched Google for the phrase, "Is stock analysis bogus?" The first batch of headlines included the following:

- "Why Technical Analysis Is Useless"-Seeking Alpha
- "Is it proven that technical analysis of stocks is a fraud?"-Quora
- "Why Technical Analysis is Nonsense"-Seeking Alpha
- "Technical Analysis Is Fundamentally Flawed"-forbes.com

It's faint consolation for technicians that their image has improved from "low-level criminals." That's how they were perceived in the 1920s, according to technical analyst Anthony Tabell. The purpose here, however, is neither to bury technical analysis nor to praise it. What matters to this book's theme is what can help investors who want to take a shot at picking the #1 stock.

Porter & Co.

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P.S. If you'd like to learn more about the Porter & Co. team – all of whom are real humans, and many of whom have Twitter accounts – you can get acquainted with us **here**.

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