The Big Short

Strategic market cap size or strategic market capsize?

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Listing badly using the same old broken water pumps to salvage a lost cause

Oh how the tables have turned

A funny thing happened the other day on Facebook. A buy-sider was lamenting that the sell-side brokers don't invite her out anymore. I joked to her that a sell-sider's real worth now is measured by the lonely underperforming buy-sider inviting him/her to lunch and paying for it PA. While there is some tongue in cheek with the above there is no doubt that the financial services industry has almost always been 'fair-weathered' and self-serving. As the old adage goes, *"when you have everything your friends know who you are. When you have nothing you know who your friends are."*

Post GFC compliance

Such is the vice of modern-day post GFC compliance that brokers feel they can't entertain clients much beyond a fast food chain given crimped per head allowances. Not to mention having to fill out permission forms granted on high from the Grand Pooh-bah of compliance. Sure the lunacy of brokers lavishing clients with expensive Michelin starred restaurants and ordering from dusty wine lists was excessive. Now buy-siders are left with even more lacklustre analysis and stuck with a choice of Starbucks, Denny's or if really posh the formal dining side of Aux Bacchanales. The ignominy of it all. It reminded me of lining up at the x-ray screen at Zurich Airport in 2003 behind some Lehman Brothers investment bankers who were moaning they had to catch black cabs from Heathrow to home after limousines were banned. Such has been the culture of self-entitlement.

No sugar coatings

We have no intention to sugar coat realities to placate the hundreds of egos that may crumble under the weight of the bleeding obvious herein. Some will be aghast with horror and be quick to protest the findings of the contents, others who truly understand will begrudgingly nod in semi-fatalistic agreement and a few will laugh at the folly of donning their life vests as they take their seats on the remaining leaky life boats. How can the industry save itself from itself? All the signs point to the majority of brokers listing heavily with furious bailing doing nothing to avert the inevitable capsize.

Nemesis with hubris thinking

While nemesis is yet to fully play out financial services firms are trapped in their own watertight compartment. For an industry that is often highly critical of the management of the corporates it conducts research on, how is it that financial services companies do not apply the same strict standards on themselves? It is the ultimate in hypocrisy. How many times have financial firms blown their own trumpets despite the consensus hugging group think? Is the ego stroking confirmation bias that pervades the industry something to be proud of? Is it a worthy exercise in any industry to self-evaluate one's own product and promote that affirmation as a legitimate warranty to clients? Surely a customer's true appreciation will be borne out at the cash register.

KYI or KYC? Which is more important? That is the question!

Compliance & KYC

Compliance has done an admirable job removing the fun the industry used to enjoy. Now sell-siders play internal politics, focus on filling in sometimes fictitious client meetings and logging phone calls into ever more complex and detail oriented client service systems. These systems store reams of largely useless information that won't have the slightest bearing on revenue generation. The irony of these account management systems is that if they are supposed to be all about 'know your client (KYC)' how come most of the sell-side has not effectively used the information to reverse crumbling fortunes?

Actually KYI is much more important

Behind the 8-ball

KYI (Know Your Industry) is far more important than conventional KYC. Buy-side firms are being forced to rapidly adapt to industry and regulatory changes at a speed which causes leap-frog adjustment rather than mere tinkering at the margin. Biting compliance on the buy-side only complicates proactively passing on that message to often flaky broker relationships. The buy-side is time-constrained enough through staff cuts and fitting into the new regime so using what time they have to outperform benchmarks is far more important than spending it educating brokers that rarely listen nor can provide the value-added services required. If brokers are busy formulating strategies to tackle aggregated issues arising from data or previous broker reviews that are 6 months old it is doomed to failure. If senior management are not constantly on top of client change and future direction they will be guaranteed to miss the bus and investors will have increasingly less time for those who cannot keep up.

Changing strategy is rarely overnight

Partnerships

It should not be forgotten that implementing new strategy from within the sell-side takes a lot of time. If brokers stumble over the fact they are well behind the curve it is likely by the time they have prepared to offset new found challenges they will be further behind future shifts. No amount of PowerPoint presentations and external survey gazing will trump true client relationships anymore. Never has the opportunity to form 'partnerships' with the buy-side been more important. Bespoke is the new ball game. Instead of churning reams of one size fits all compliance dumbed-down commoditised research that very few will read, the smarter sell-side firms will realise that customised approaches will offer the 'value added' content clients will be willing to pay for.

The regulators are also at fault in encouraging further dumbing down

Regulators don't get it either

Pricing services is futile

There is the case to be made against the regulator here on commoditisation. Regulators around the world are intending to force a pricing mechanism on the buy-side to ensure commissions match service. But how does one honestly price such services? The regulator looks to harmonise a price of $1,000 for an analyst meeting on a sector. However a fund manager might think the meeting is worth $100,000 if deeply value added or minus $5,000 if the hour is a complete waste of time. Yet how can the regulator possibly know all of this? None-the-less if the authorities keep pushing this line of thinking they are only inviting the sell-side to continue to serve up even more mediocrity as appetising as a prison kitchen dinner to a shrinking client base who wish to be served the complete opposite. The buy-side has continually cried for 'quality' but the sell-side continues to serve up 'quantity'.

Bulge bracket super tankers

Many bulge bracket firms operate like a super tanker so changing direction often takes time. We've seen Barclays close (a stroke of genius?) most of its Asian equities franchise in January 2016. While some in the financial world argue these actions are healthy for the industry (to a point they are) there is still a very long way to go before sustainably profitable industry can prevail. If half the market players have not exited equities in the next 5 years it will be a surprise. There is little space for the existing players that stick to conventional strategies. 10 Toyota analysts will be plenty.

MiFID II

MiFID II should expose the industry much more than many expect. As research and trading become unbundled, clients will need to put a 'price' on research. It will be an excellent introduction. Importantly clients will be forced to discriminate on the few that add value. In order to minimise administrative bureaucracy expect that little more than a quarter of the analysts of each sell-side firm gets selected. That will also give sell-side management a reality check on whether bonuses have been based on internal politics or actual performance. It won't be based on the number of calls or emails but on clients in aggregate telling the sell-side who they will actually pay for. Even worse, these sell-side firms will face the problem of analysts being able to flaunt their 'true' client **value** to competitors. It will be totally transparent.

Climbing commission rates?

Brokers should realise that commission rates could climb! It is not an absurd argument. If the sell-side offer customised solutions then surely clients can consider paying more and comfortably convince the regulators that this is 'putting a price on value'. It is not rocket science.

Sell-side research continues to focus on commoditised product – why?

Why can't brokers wake up to the fact large caps don't need extra coverage?

It should come as no surprise that the sell-side has consistently covered large cap stocks. The simple mathematics are that stronger liquidity should ultimately lead to greater turnover hence higher commission. However the buy-side has rarely seen the need for 31 analysts (twelve more than 2010) to cover Toyota Motor. How often brokers like to tout their new 'star analyst' - who more often than not has been recycled from another firm and already well known to their clients. The problem for some supposed star analysts was the franchise they left actually gave them the spotlight or ranking thanks to the broad product suites of prime broking and dedicated sector investment banking coverage offered. The holes in their credentials quickly became evident in a smaller operation without such depth of product.

Fig.1 – The market cap merry-go-round

	Current # of Analysts	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004
Recommendation to Company Mkt-cap above 3500	17.5	18.3	17.5	19.2	19.3	16.8	17.3	17.3	10.2	8.0	6.7	5.9	4.8
Recommendation to Company Mkt-cap below 150	1.8	1.7	1.7	2.4	2.4	2.1	2.2	2.5	1.1	0.8	0.6	0.5	0.4

Source: Custom Products Research

Large cap dominates coverage

Information arbitrage effectively zero

Fig.1 shows that lessons are rarely learnt. Large caps dominate while small-mid cap coverage has withered. In an ever-growing commoditised market, what is behind the thinking of a broker to cover the same stocks that are already well established? Have they heard clients specifically ask for it? It is highly unlikely. The information arbitrage available in the large cap sector is effectively zero. Large-cap corporates often have 30-person deep investor relations teams that regularly update information. Shareholders will automatically be prioritised over the sell-side analysts for any meetings, which effectively means any quarterly updates are less than useful.

2016 vs 2010

Fig.2 highlights the expansion in large cap stocks (2010 vs. 2016). Among the mega caps, with the exception of a few names, broker coverage (even excluding quant based stock pickers e.g. EVA Dimensions) has continued to rise. Do we need 31 Toyota analysts or 28 Honda and Nissan analysts?

Fig. 2 – Large Cap coverage has expanded in most cases

Ticker	Company Name	Mkt-Cap JPY bn	Current # of Analysts	Change in Coverage 2016 vs 2010	5 year Absolute Performance	Average Rating (Buy/Hold/Sell)
7203	Toyota Motor Corp.	20628.8	31	+12	87.1%	19/11/1
9437	NTT DoCoMo, Inc.	10778.3	19	+2	108.7%	10/9/2
9432	NTT Corporation	10360.4	19	+2	196.1%	15/4/0
2914	Japan Tobacco Inc.	9256.0	17	+2	261.5%	12/4/1
9433	KDDI Corporation	8304.1	20	+3	289.1%	13/6/1
8306	Mitsubishi UFJ Financial Group	7590.3	17	+4	52.4%	11/3/2
6178	Japan Post Holdings Co. Ltd.	6948.0	14	N/A	7.5%*	5/9/1
9984	SoftBank Group Corp.	6646.9	22	+4	75.2%	15/6/1
7182	Japan Post Bank Co., Ltd.	6399.0	15	N/A	-5.5%	**4/10/1**
7267	Honda Motor Co., Ltd.	5602.7	28	+11	8.8%	13/12/3
8316	Sumitomo Mitsui Financial Grp	4994.4	17	+5	51.8%	13/3/1
7201	Nissan Motor Co., Ltd.	4918.5	26	+6	55.1%	15/10/1
7751	Canon Inc.	4498.8	15	-3	7.4%	**3/11/1**
8411	Mizuho Financial Group, Inc.	4314.6	18	+4	47.3%	**6/10/2**
4502	Takeda Pharmaceutical	4288.6	11	-5	56.7%	**2/12/0**

Note: Japan Post since listing, 5yr Topix performance was 68.1% (to April 4, 2016). Underperforming names highlighted in Red text. Neutral rating in bold,
Source: Custom Products Research

Does it force Yamato to change strategy?

Are analysts incapable of providing a medium term outlook and scenario based assessment on Japan Post Holdings (6178) or Japan Post Bank (7182) to warrant higher conviction? Surely such former government behemoths have interesting tales to tell on marginal improvements to their business models should they shake off their public sector thinking? Was it worth analysts spending months preparing a report which essentially advises clients to stand pat? What if Japan Post was ultra-aggressive in utilising the recently acquired Toll Holdings to take a swipe at domestic logistics firms like Yamato (9064)? Of course Japan Post has a massive real estate footprint in Japan which Yamato cannot match and could offer domestic clients innovative products on global logistics which Yamato couldn't match. Does it force Yamato to change its strategy? As a government entity, Japan Post had no real desire to be much more than a sleepy post office. It now must become a 'corporate governance code' abiding shareholder friendly fire-breathing dragon of returns. It must reinvent itself. Does it need 400,000 employees or 25,000 branches? What was the experience of Deutsche Post and DHL? What were the returns experienced after its listing?

Scenarios for Japan Post Bank?

What of Japan Post Bank? As the world's biggest deposit holder, how could it transform its 'boring and conventional' product suite to 'rev-up' returns? Will it embark on domestic and international M&A to buy in product expertise? Did any sell-side report run into detail on these matters? Sure there may have been a fleeting mention of such prospects but scant detail on what such hypothetical deals could do to operating performance. Therein would lie true value added.

Investors have better access than sell-side analysts

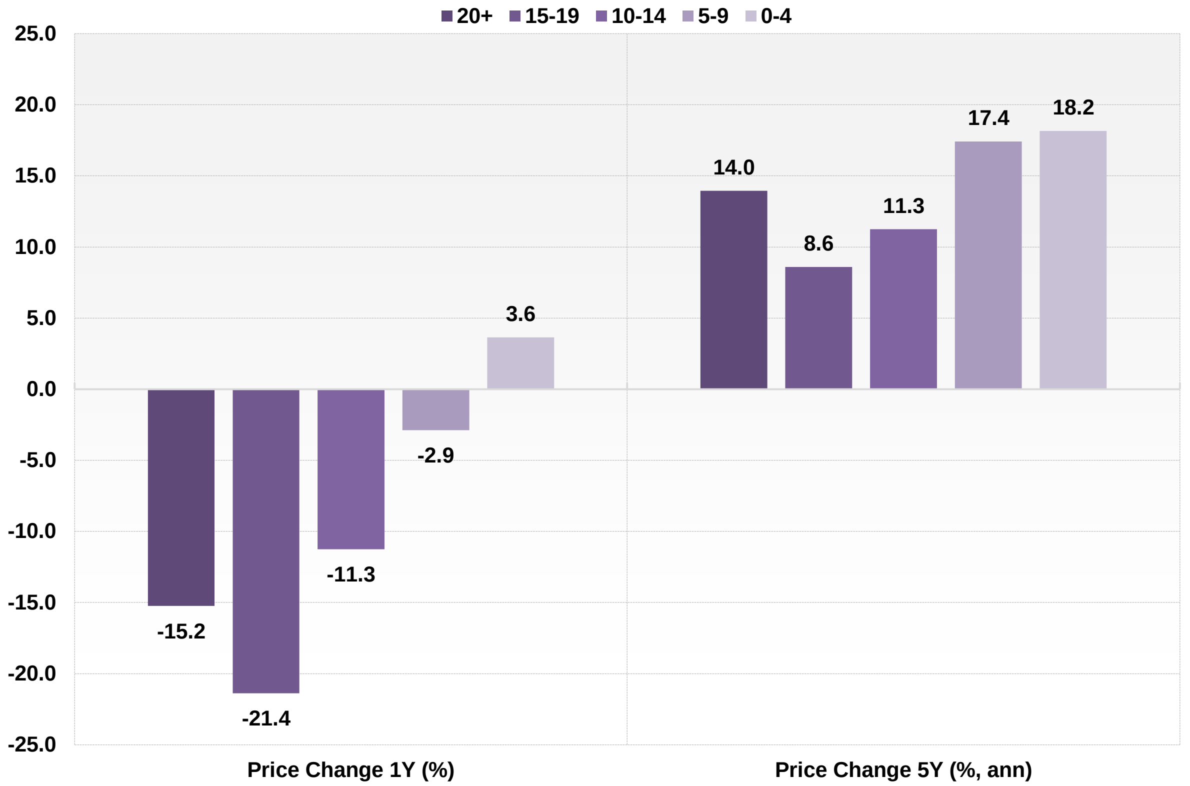
We should not forget that the investors (which in many cases are shareholders) have better access to the corporate than the sell-side. It is no surprise that companies should prioritise their owners. With that, large shareholders will get to meet with board director level while sell-side brokers meet more often than not with investor relations (IR). The larger the organisation often the bigger disconnect between management and IR. The President is generally a busy man or woman so with limited time, he or she may not have time to offer lower priorities, including smaller shareholders.

So has large cap coverage bias helped with performance?

Large Cap bias

The short answer is no. Looking at 1 year and 5 year total returns clustered by analyst coverage we see that the under-covered (zero to four analysts) trumped the 5-9, 10-14, 15-19 and 20+ analyst segments in a study of 1,000 stocks, Fig. 3.

Fig. 3 : Performance of 1,000 stocks grouped by the amount of analyst coverage



Source: Custom Products Research

More cooks spoil the broth…

Put another way, the 57 stocks with an average of ¥2.56 trillion market cap in the 15-20 analyst band had the worst performance and the 604 stocks with an average market cap of ¥136bn (coverage 0-4 analysts) performed best and was the only cohort that saw positive territory in both periods.

Sweet spot is 3-4 analysts

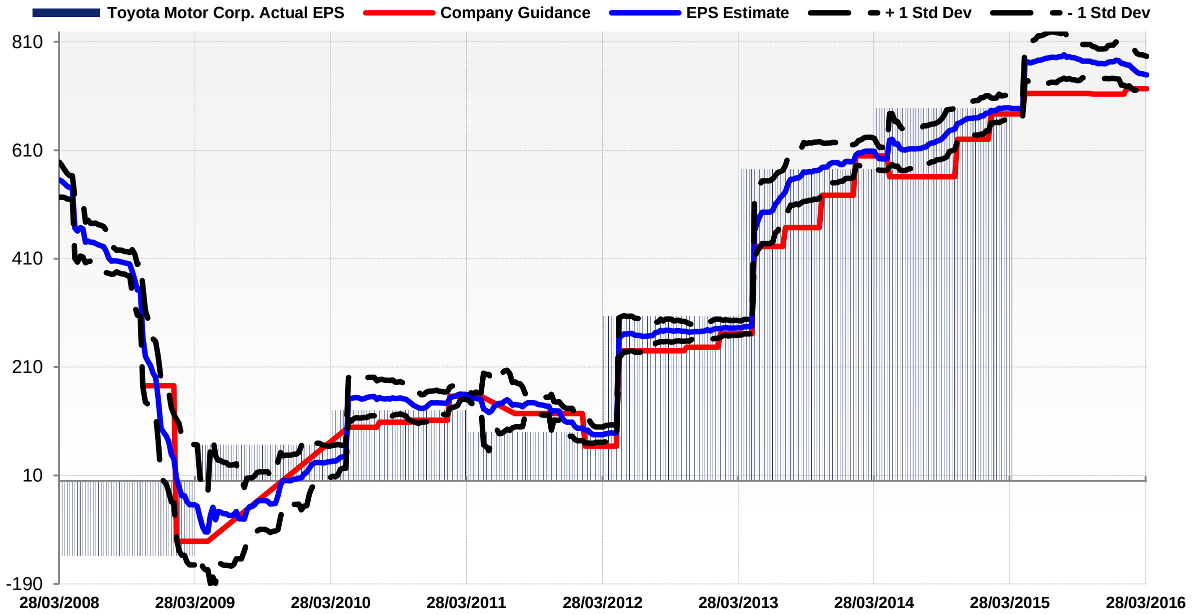
The study would certainly suggest that the lack of coverage leads to higher information arbitrage and when we look at some stocks that have just three or four analysts the returns climb to 6.1% and 19.4% respectively. Naturally small-cap bias does play a part but it is clear for asset managers to consistently get superior returns, it will not happen via excess noise created in the large cap space.

Consensus Hugging

Consensus hugging

If we take Toyota as the most covered stock in Japan, we see that the range of estimates from analysts has a very tight dispersion. After the Lehman bankruptcy, analyst estimates blew out somewhat but once things settled analysts rarely strayed far from each other or away from company guidance, Fig. 4. The similar is true for most stocks in our survey.

Fig. 4 : Toyota Consensus vs Company Guidance and standard deviation of all estimates

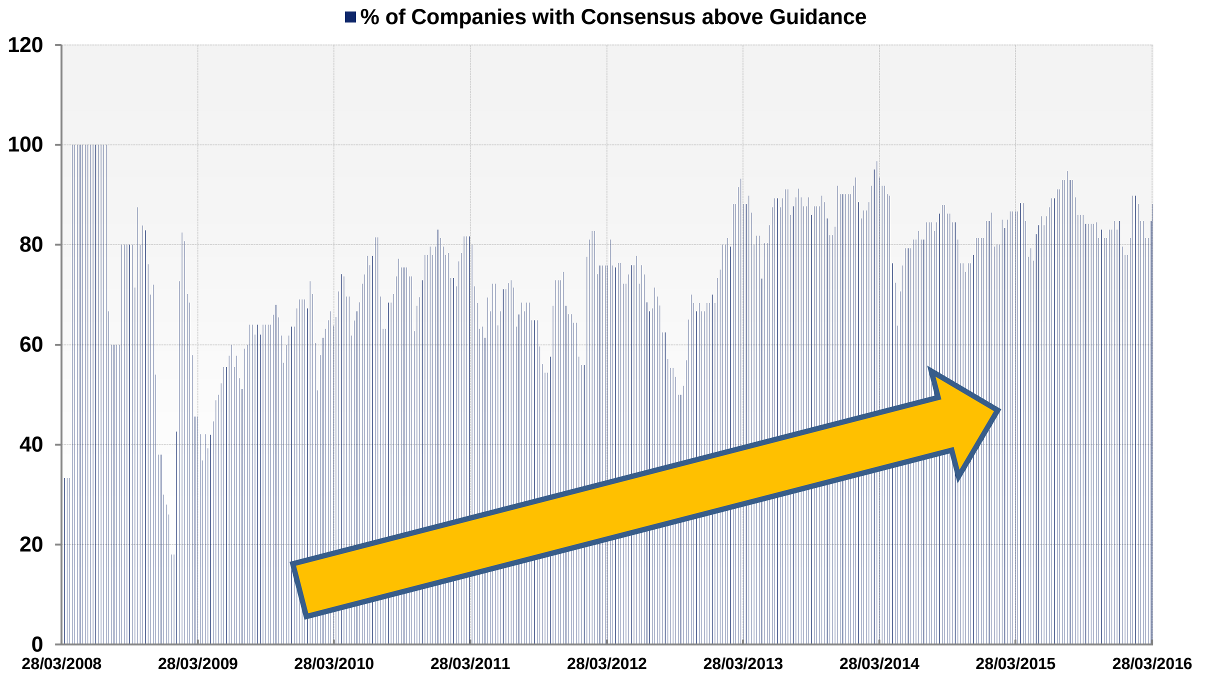


Source: Custom Products Research

90% positive bias

When looking at analysts placing estimates above company guidance we see a gradual shift back toward 90%, Fig. 5. While still off the 100% we experienced prior to the global financial crisis of 2008, it seems complacency is becoming a hallmark of financial forecasting. Perhaps that in and of itself is a harbinger for tougher conditions ahead?

Fig. 5 : Bias of positive consensus estimates above company guidance over time

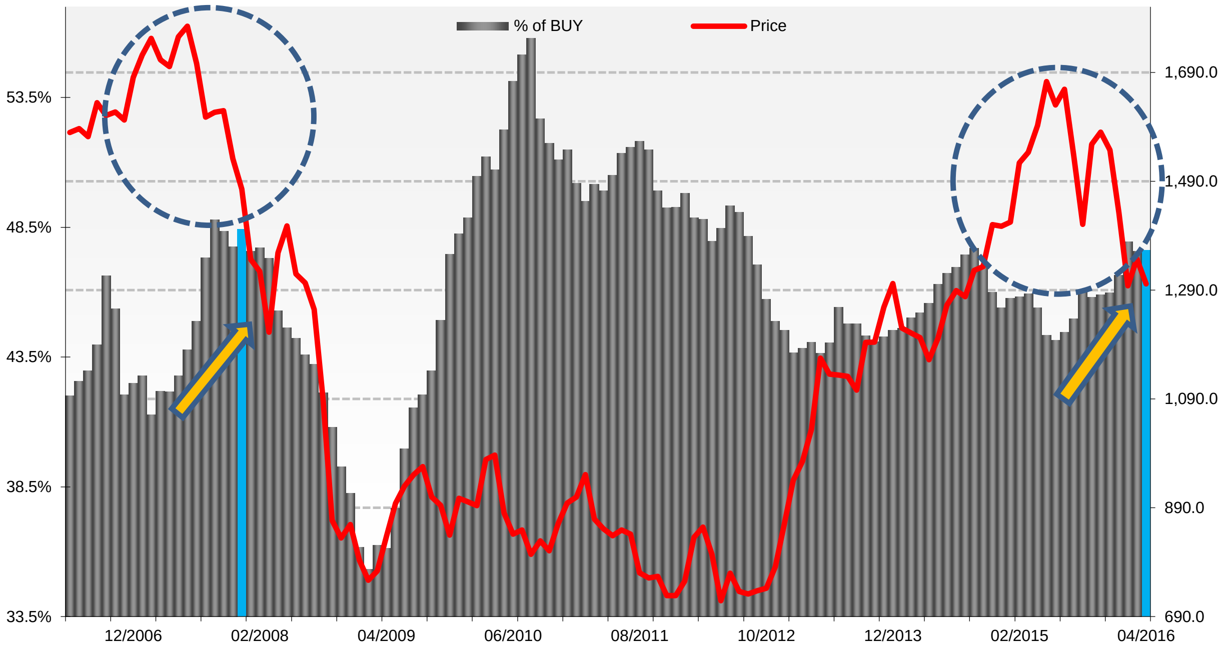


Source: Custom Products Research

2016 looks like pre GFC

Fig. 6 shows the bias of the percentage of buy ratings on the sell-side versus the direction of Topix. What we see is some eerie similarity with the action pre GFC. The bias of positive ratings stood at around 48.5% in early 2008 however the market reaction was generally negative. Rolling 8 years forward we see a very similar trend emerging. As of April 2nd, 2016 we see that the percentage of buy ratings is at 47.6% with Topix behaving much like 2008. Note Custom Products Research updates this chart weekly so please contact us on sales@custprd.com should you wish to be added to our distribution list.

Fig. 6 : Topix Price versus % of Buy Recommendations on the sell side



Source: Custom Products Research

Topix back at 700 handle?

If one buys into the idea that the sharp selloff post Lehman Shock could occur again do we see Topix back with a 700 handle with a three-year sideways move? After we survived the GFC the sell-side was overwhelmingly positive on the basis of stocks bottoming. However the impact on share prices was negligible. Only when buy ratings had bottomed out, one presumes on capitulation, did the market rally again. So perhaps sell-side analyst capitulation will be the signal to buy the market but watch for the 48.5% bias level.

The Statistics of Share Price Target hikes

Confirmation bias

Ratings and target prices tend to be pretty pointless as they tend to hold an analyst to selectively look to information that confirms a bias.

Why the Sector Premiums?

In our August 25th report of *'Why The Fancy Multiples?'* we noted that defensive sectors were trading at heady premiums in the week before the sharp decline (Aug, 17th 2015) versus the week before Lehman Shock. For instance, the Topix Pharmaceutical Index was trading at a 76% PER (1 year forward) premium, Retail Trade a 52% premium, Food a 21% premium and Land Transport a 15% premium.

Per stock basis

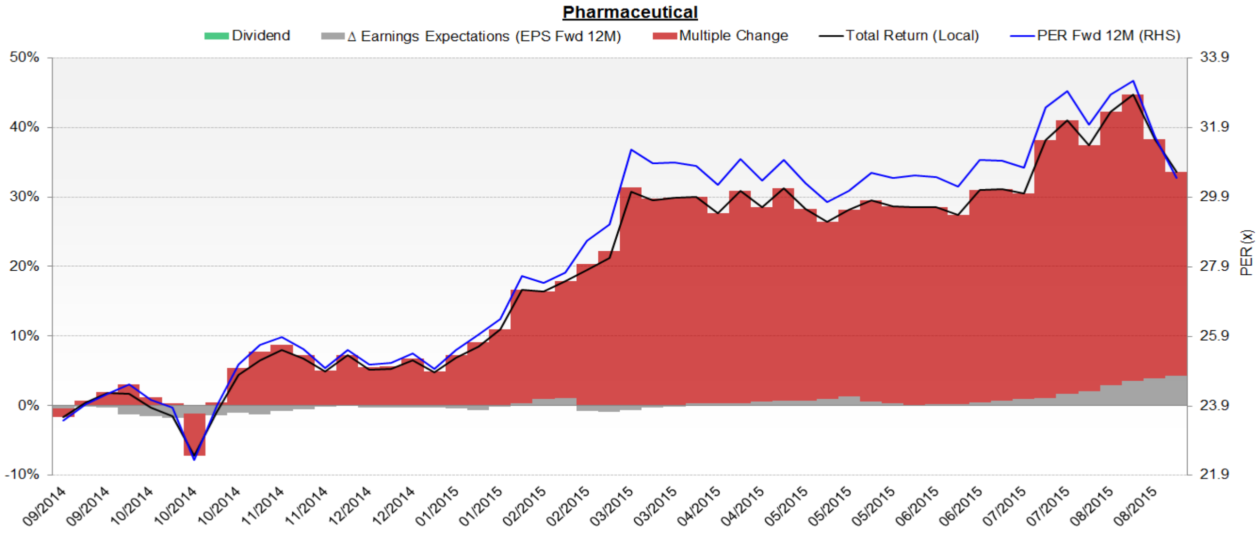
When we explored deeper on a per stock basis, the Pharmaceutical sector had Eisai, ONO Pharmaceutical, Takeda and Kyowa Hakko at 100-400% premiums over the same period. Food

Stock price chasing

was lightly less exaggerated with Itoen, Rock Field, Kikkoman, Kirin and Dydo Drinco at 50-150% premiums.

We conducted a study of target price changes among the sell side versus their EPS revisions. There is a definite pattern of 'stock-price' chasing with multiple expansion the largest component. Interestingly, the defensive sectors have been the biggest offenders. Starting with Pharmaceuticals.

Fig. 7 – Pharmaceutical Sector stock target price chasing



Source: Custom Products Research

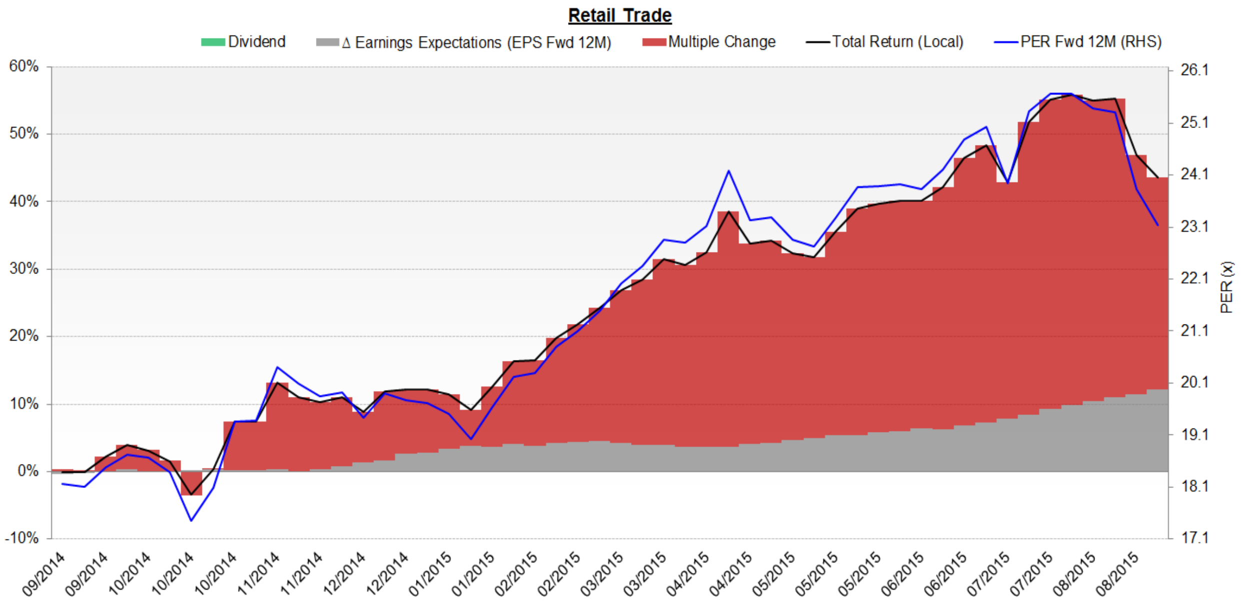
Dividends featureless

In essence, changes in earnings expectations has been negligible. Dividend changes have been featureless.

Retail the same

Switching to the Topix Retail Trade Sector and it is much the same story. Multiple expansion has been the main factor behind target price hikes.

Fig. 8 –Retail Trade Sector stock target price chasing



Source: Custom Products Research

The growth of ETF

ETFs which are predominantly passive by nature will continue to exacerbate this problem as valuations are clearly not a factor. This is pushing defensive stocks to large premiums relative to history with little change in the underlying growth rates. The advent of Smart Beta ETFs will hope to address this gap somewhat but as a tiny proportion of overall ETFs at present the scope for sell-side price target forecasting becomes less relevant. It isn't a question of hiking multiples to justify these price moves as it isn't based on any fundamental reasons. It is the activity of ETFs which is distorting traditional 'fair' value. Of course value is a relative argument but these previous two charts highlight the clear misunderstanding of what is going on between the lines.

ETF market evolution

130x

Love it or leave it Exchange Traded Funds/Products (ETF/Ps) are with us. In their 25 years of existence ETF/Ps have become a cheap, effective and efficient way to gain exposure to a variety of thematics. Charles Schwab recently reported in calendar 2015 that it had US$33.8bn in ETF/P **inflow** and $17.116bn in mutual fund **outflow**.

$3tn global market in ETF

In our October 2015 report, *The problem with all-you-can-ETFs* we wrote *"ETFs are hitting the market faster than the dim-sum trolley can circle the banquet hall. Charles Schwab, in the 12mths to July 2015, saw a 130-fold preference in ETF over mutual funds given their relative simplicity, cost and transparency."*

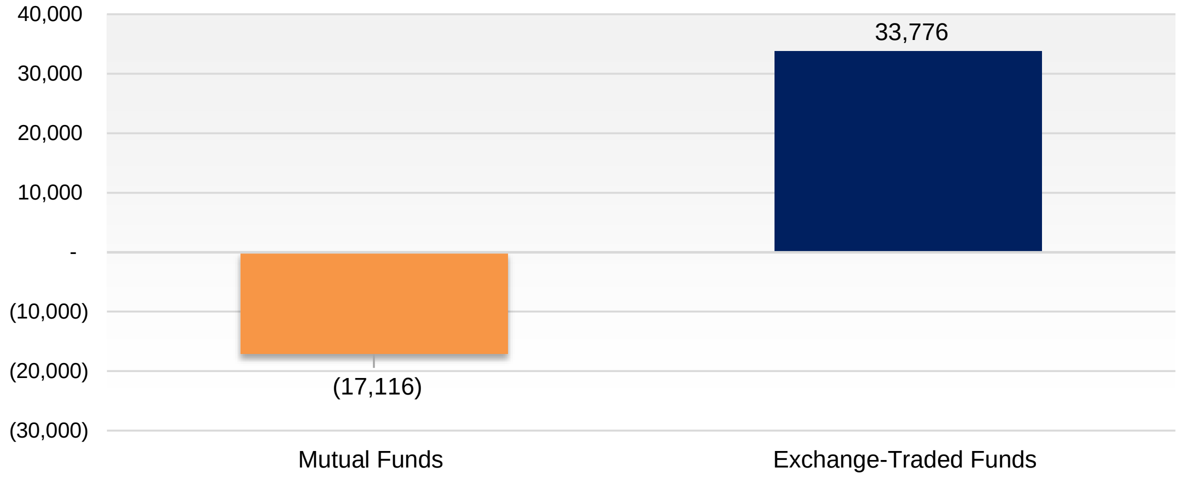
We also wrote in our September 2015 report, *ETF Behaviour in Bear Markets* that *"assets invested in ETF/Ps comprise around $3 trillion globally. Put simply the new funds flowing into ETFs vs. traditional mutual funds is at a 100:1 ratio and in terms of AUM is on par with total hedge fund assets which have been in existence for 3 times as long."*

It is no surprise following Lehman Shock that ETF/Ps are growing thanks to the simplicity and low cost and relatively transparent nature.

Japan's ETF market growing

Japan's ETF market were 15% of daily average traded value (¥369.23bn) in February 2016 versus ¥2.6tn of total turnover on TSE. ETFs hit a peak turnover of ¥374bn (19.1%) in September 2015 after the flash crash in late August 2015. While ETF turnover as a percentage of total market may still be off peak levels it is still triple that of 2014 and 7x that of 2011.

Fig. 9 : Charles Schwab Fund Flow - Calendar 2015 (US$mn)

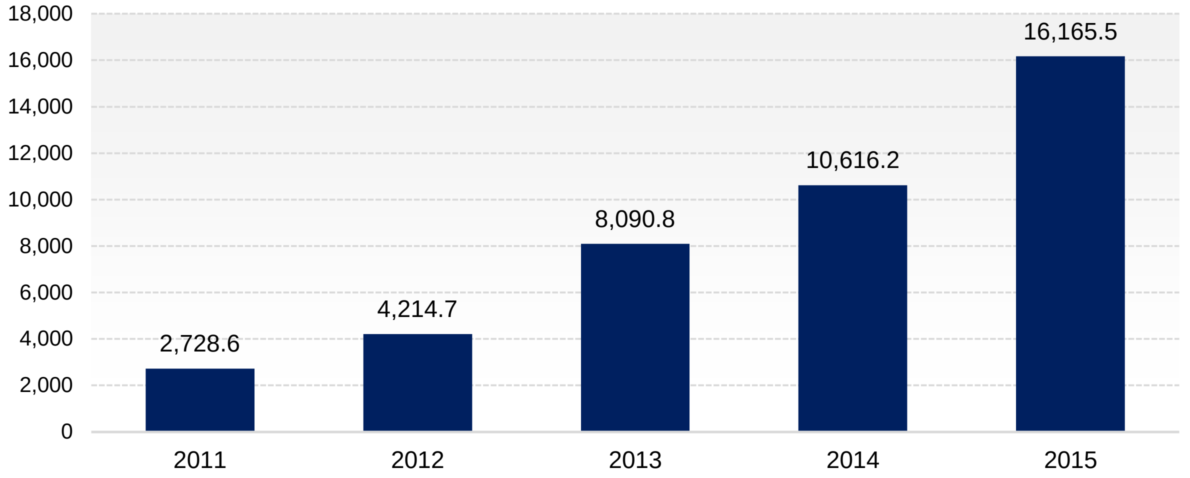


Source: Charles Schwab

Small vs Large cap ETF

ETFs in Japan are predominantly focused in large cap product. The largest ETF in small-mid cap is $178mn iShares MSCI Japan Small-Cap ETF versus the biggest AUM large cap $6.5bn in the NEXT FUNDS Nikkei 225 Leveraged ETF. The aforementioned small-mid cap fund has around 790 holdings meaning around $228,000 per stock, hardly making it worthwhile. Active management of small-mid caps must still have a future with analogue input.

Fig. 10 : ETF Total Net Assets in Japan (¥bn)



Source: JPX

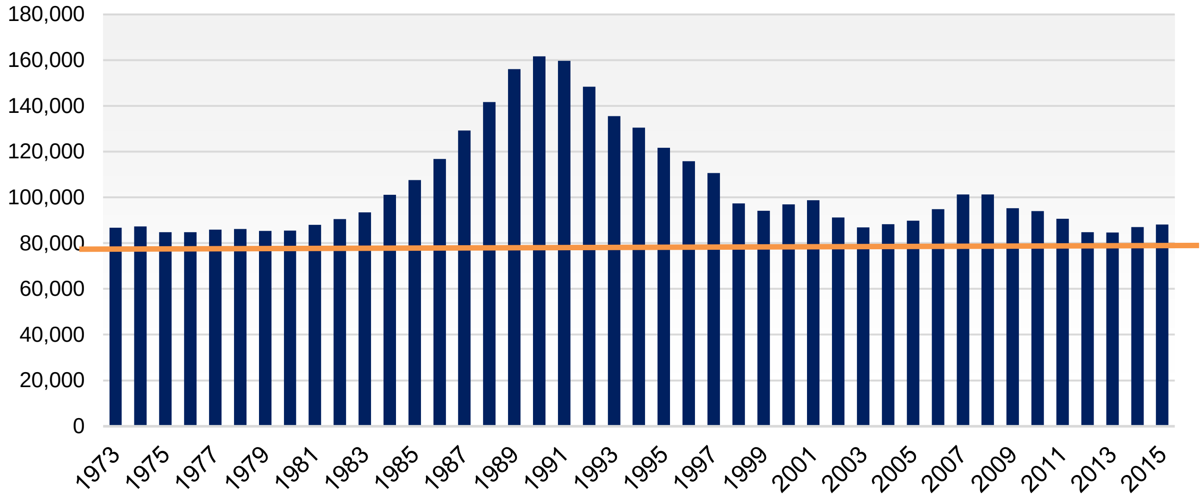
ETF AUM +6x in 5 yrs

ETFs in Japan have continued to grow sharply. Fig.10 highlights the 6-fold jump in assets held in ETFs versus 2011 with little less than a doubling of listed issues.

Writing on the wall

As large cap funds shift more and more to robotic management is it any wonder that the number of officially registered representatives in the broking industry has halved from the peak to levels seen over 40 years ago, Fig. 11 Hence our earlier question of why does the market need 'more' large cap analysis to cover fewer large cap portfolio managers? Hence our title market cap size or market capsize? Large cap analysts are becoming an endangered species but WWF has not realised yet.

Fig. 11 : Registered Brokers in Japan - at 40 year lows & almost half the peak



Source: JSDA

HFT

With commission rate compression further exacerbated by electronic execution (not helped by new firms entering the market e.g. Bloomberg Tradebook) and high frequency trading (60% of order value & c.30% of traded value) adding to volatility, the agency model is being priced to imminent oblivion. The skill of human traders is being replaced by IT budget commitment. Brokers without liquidity will wither and die as block trades to reduce market impact costs will be increasingly sought.

Clients can pay for value which helps to validate large cap investments

Ah yes but the economics of small-cap are even worse, no? Indeed the economics maybe worse in a pure agency sense but the only growth we are likely to see in actively managed funds will come from small-mid cap. As we mentioned earlier, small-mid cap ETFs are not very efficient as information arbitrage can be great. However it is highly value added for surviving large cap clients to know what is going on in the small-mid-cap supply chain.

Bespoke

Analyst teams and the infrastructure that supports them could be drastically peeled back. Perhaps MiFID II will create the easiest solution to wind back to a core handful of value added analysts who can offer 'bespoke' services that clients want.

The pride of investment banks remains an elephant in the room

Investment banks put pride ahead of efficiency

Why is it investment banks remain so pride driven? Somehow being 19th on the tombstone for a Toyota one shot deal is more important than being the sole advisor for a small-mid cap company? That company will likely grow with that investment bank over coming decades as it seeks to grow existing products, recapitalise and broaden into new areas not to mention net far more revenue in the long run. That somehow having a team of 8 bankers working 25 hours a day, 8 days a week and 53 weeks a year producing documents that no one will ever read surpasses the efficiency of a company looking to do a deal and looking for a bank to witness the marriage? Small and mid-cap companies are usually quite clear on acquisition targets and require much less intense work.

Delving a little deeper into Japanese small caps

The beauty of small caps

When looking at the bleak future of so many Japanese large caps with dyed-in-the-wool strategies from yesteryear, agile SMEs have already shown themselves to be superior long term investments. It just so happens that many investors have not been able to see them due to a lack of sell-side coverage. It may be true that liquidity early on is pitiful but as often the case with small cap investing, five year horizons are what is sought not, 6 month double digit returns. Throw the potential for sell-downs by majority owners for capital efficiency sakes and all of a sudden liquidity becomes ample.

Small Cap Performance with zero coverage

Fig. 12 puts a small collection of small cap stocks which have shown ample performance without any analyst coverage. Of course there are liquidity issues with small mid cap companies but as large cap money goes increasingly robotic, who will large cap analysts talk to?

Fig. 12 – Little boxes on the hill side – little gems with no coverage

Ticker	Company Name	Mkt-Cap JPY bn	Current # of Analysts	5 year Absolute Performance
3914	JIG-SAW, Inc.	85.9	0	1147.0% (listed Apr 2015)
3085	Arcland Service Co., Ltd.	50.0	0	922.0%
7846	Pilot Corporation	200.6	0	481.2%
2281	Prima Meat Packers,Ltd.	71.7	0	197.6%

Note: 5yr Topix performance was 68.1% (to April 4, 2016)
Source: Custom Products Research

Adding coverage lifts exposure & generally share prices

If some of these sleepers get some coverage, the stocks get visibility and performance can be quite impressive such as that shown below in Fig.9. DIP Corporation (2379) trades an average ¥1.8bn per day in the past 12 months versus ¥4.5mn back in 2011. Likewise JIN (3046) now trades 25x more than 5 years ago. Nippon Commercial Development (3252) has risen 6,000% in 5 years and is still trading at only 6.9x FY1 Toyo Keizai EPS estimates.

Fig. 13 – Little boxes on the hill side – little gems that finally get coverage

Ticker	Company Name	Mkt-Cap JPY bn	Current # of Analysts	5 year Performance
3252	Nippon Commercial Development	34.8	1	5951.6%
2379	DIP Corporation	164.0	1	5564.6%
2124	JAC Recruitment	52.4	2	2472.9%
2931	euglena Co., Ltd.	133.5	1	2141.2%
2492	Infomart Corporation	66.3	1	1191.1%
2175	SMS Co., Ltd.	88.2	1	976.9%
3076	Ai Holdings Corporation	174.6	1	953.7%
2222	Kotobuki Spirits Co.,	73.7	1	935.3%
3046	JIN CO., LTD.	103.4	2	932.3%
2412	Benefit One Inc.	110.0	1	846.9%
7906	Yonex Co., Ltd.	104.2	2	751.9%
6055	Japan Material Co., Ltd.	55.6	1	617.6%
6420	Fukushima Industries	55.7	1	517.9%
4571	NanoCarrier Co., Ltd.	50.5	1	495.0%
7611	Hiday Hidaka Corp.	68.2	1	420.9%
7445	RIGHT ON Co., Ltd.	53.5	1	409.9%
2292	S Foods Inc.	80.7	1	332.5%

Note: 5yr Topix performance was 68.1% (to April 4, 2016)
Source: Custom Products Research

Summary

Fresh ideas please?

No matter how many times clients ask for 'fresh ideas' brokers have rarely heeded the message and continued on their self-serving market cap biased strategy. There is no question the grip of compliance has put the fear of god into many investment banks but these once 'calculated risk taking' franchises have in most cases shown more conservatism than a Scottish accountant.

Helping brokers help themselves

Our research shows that stocks with less coverage tend to outperform those with more coverage. Naturally those small-mid-cap names have less liquidity but we have seen a sharp rise in turnover once these stocks become discovered. However small cap analysts are so rare that one wonders what opportunities sell-side firms could garner from improving relationships with these companies to shore up sustainable compliant long-term investment banking revenues.

Consensus hugging no longer required

Large cap coverage tends to come with consensus hugging forecasts with tighter standard deviations and more following than forecasting with prose that smacks of reporting rather than analysing. The bias of buy recommendations maybe a simple way of looking at markets but it is eerily close to what we witnessed before the collapse of global markets in 2008.

Differentiated approach paramount

Never has the need for differentiation been more apparent. On the trading front, it is now a war based predominantly on IT budget. With the growing prevalence of electronic trading and robotics, the differentiation is masked by microseconds and algorithms not the skill of individual traders exacerbated further by the ascendance of high-frequency trading. So for what is left of the shrinking pie that is 'active trading' the value of analysts calling stocks will become even more irrelevant.

Consensus hugging not required

Not so much for the consensus hugging forecasts but the fact that the majority of the market is being moved by forces they have no control over. Historical valuation be damned. Yet why are more brokers continuing a strategy of covering more and more of the same stocks? Why are so many brokers persistent in the volume of contact over the value of contact notwithstanding the regulatory push for recorded evidence?

Custom & Bespoke

The biggest shift to come from all of the regulatory changes will be transparency which will force the buy-side to be far choosier with how they allocate payment of value-added services. To that end customisation and bespoke services have to be the way to go.

Avoiding group think

As we once again look at the group think that pervades the industry we conclude that history has at times proven not to be on the side of conventional wisdom, or the consensus view, but on the side of those who dissented from them. More significantly, we see too how the sell-side have failed clients by not being rigorous and questioning enough, resulting in many misrepresentations taking too long to be discovered. We have seen so often that the time of greatest certainty is, in fact, the time to be most sceptical. If we spent more time on corporate biopsies as financial analysts there would be far fewer autopsies.

The Big Short

It is worth mentioning I watched the '*The Big Short'* on a flight back from Australia and reminisced at the hubris of the financial sector. Michael Burry (Christian Bale) the eccentric fund manager who was constantly being criticised by group thinkers for his (eventually correct) position much the same way I copped censure for pushing a negative view. The scene where one of his fellow dissenters Mark Baum (Steve Carrell) at a Deutsche Bank conference talking with the bull Bruce Miller was so telling of the group think that still lives and breathes in so many circles. Baum essentially tells the audience that the world economy is on the brink of collapse and while he should be happy from his investment stance he has pangs of guilt and despair at how fraud has never worked in 15,000 years and that real people will be the ones picking up the mess from the banksters. During the conference Bear's stock is plummeting and at the end of the session one person in the audience says that the stock had tanked 38% in the short time they were speaking even though the bull presenter was celebrating his own tactical genius at the beginning for buying Bear stock and even suggesting he'll buy more after hearing that. As the room stampedes toward the exit, the PR person leads The Maestro Alan Greenspan into the auditorium for the next session to a now empty room and fawns over his presence none-the-less.

My own Burry & Baum moment

As a former broker I mentioned to many of my then competitors and clients (most should still remember) back in 2001 that Greenspan would go down as one of the most hated central bankers ever. How ridiculed I was at the time with the general accepted view of The Maestro being all seeing, knowing and doing and how dare some sales guy have the audacity to suggest he knew better. I never backed away from my view although deep down saw the announcement of his knighthood as further confirmation of the lack of judgement and collective wisdom of markets, regulators and the media that kept fuelling this moral hazard.

Playing with fire

With global central banks playing similar tunes does it not kind of irk you that we are not far off the day of finally having to eventually pay for our past sins? Just like the tech bubble collapse of 2000 - we never paid for that either. Now every borrowed dollar creates even less and less growth. We are fast approaching another tipping point. Of the exact timing I am not sure but it certainly feels as though we can't be too far away and 2016 is likely to be the year we stumble over the realisation that we have run out of road to kick the can down!

This could be the prelude to the real Big Short.

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