

Internal Consistency - Simple, yet Complex

New York, NY – 07/14/05 – One of the most intuitively simple concepts in measuring the value added by a research firm is the concept of internal consistency. If a firm is internally consistent, then the return of its BUY recommendations should outperform its HOLD recommendations and its HOLD recommendations ought to outperform its SELL recommendations. Measurement of this concept is less agreed upon, with many of the ERPMs taking differing approaches.

In the interests of providing a simple measure of internal consistency, the team at Integrity has taken an extremely simple approach. For the purposes of this article, we are using a points system. One wrinkle is in separating the conviction of the research firm. When a research company issues a BUY or a SELL they ought to have a strong conviction about the direction of the stock. If they issue a hold, they may not have the same level of conviction. As a result, our point system awards 2 points if the BUY return exceeds the SELL return, while for the other two categories get one point. The research company either gets a point or not and the sum of the points is the internal consistency of the recommendations. Here's how it works:

BUY > SELL = 2

BUY > HOLD = 1

HOLD > SELL = 1

If the firm is fully internally consistent (by this measure) it will receive a score of four; if completely inconsistent it will receive a score of zero. Below we list the firms in alphabetical order that had perfect internal consistency during the one year period.

Firms with Perfect Internal Consistency Scores, Year ended June 30, 2005

Independent Research Providers (24) and the top 12 Investment Banks

Research Company	IRP/IB	Internal Consistency
Callard Research	IRP	4
Channel Trend	IRP	4
Columbine Capital	IRP	4
Deutschebank	IB	4
Ford Equity Research	IRP	4
JM Dutton & Associates	IRP	4
JP Morgan Chase	IB	4
Price Target Research	IRP	4
Rochdale	IRP	4
Union Bank Switzerland	IB	4
Weiss Ratings Inc.	IRP	4

Caveats

There are of course many ways to assess internal consistency. The above method does not indicate what the magnitude of outperformance is for each research company – arguably and important distinction, since a wider spread between the categories implies greater returns for investors.

Secondly, there is no way in our analysis to quantify the ability of the firm in putting stocks in the correct bucket. For example, there may be stocks in the hold portfolio

that could have been allocated to the BUY or SELL portfolios which would have increased the overall investment return for investors. For example if the HOLD portfolio is slightly less than the BUY portfolio but greatly exceeds the return of the market over the period, we would argue that some of the HOLD stocks should rightfully be in the BUY camp.

Thirdly, the HOLD portfolio could have an average return equal to the return of the market, but still contain individual stocks that should have been allocated to the BUY or SELL portfolios.

The Investars open access web site (www.investars.com) uses the return of the BUYS minus the return of the sells as its internal consistency measure – again a simple a totally defensible approach. We should note that Investars Institutional product contains a much more complex approach to internal consistency.

However the Investars team feels that the overall value of a performance measurement system, relates more to process than to result. Given the variations in style, coverage and methodology of research firms, the investars systems is designed to meet the investment needs of a broad number of clients. By compacting these results into a summary statistic, we gain some insight, but we also lose some detail. Informed investors will use all of the information to arrive at their own investment decisions.

In light of these complications, the team at Integrity has chosen the simple points system as a guide to those firms that get the stock selection process mostly right.

** - The Equity Research Performance Measurement data used is Investars' Internal Consistency Score, one of the most referred to algorithms in Investars' open client-driven product offering. However, the data used for this analysis was not reviewed by Investars nor was Investars involved in the selection of the group of firms or the methodology included in this analysis.*