that it is misvalued. If the manager changes the fund's holdings accordingly and the stock price returns to its intrinsic value in the next quarter, the fund will show superior relative portfolio performance and will attract new capital. However, if the stock continues to be misvalued for several quarters, the informed fund manager will underperform the benchmark and capital will flow to other funds. In contrast, a risk-averse manager who simply follows the crowd will not be rewarded for detecting the misvaluation, but neither will this manager be blamed for a poor investment decision when the stock price ultimately corrects, since other funds made the same mistake.

There has been considerably less research on the performance of pension fund managers. Overall, the findings show little consistent evidence that pension fund managers either over- or under-perform traditional benchmarks.[32]

SUMMARY

Equity security analysis is the evaluation of a firm and its prospects from the perspective of a current or potential investor in the firm's stock. Security analysis is one component of a larger investment process that involves (1) establishing the objectives of the investor or fund, (2) forming expectations about the future returns and risks of individual securities, and then (3) combining individual securities into portfolios to maximize progress toward the investment objectives.

Some security analysis is devoted primarily to assuring that a stock possesses the proper risk profile and other desired characteristics prior to inclusion in an investor's portfolio. However, especially for many professional buy-side and sell-side security analysts, the analysis is also directed toward the identification of mispriced securities. In equilibrium, such activity will be rewarding for those with the strongest comparative advantage. They will be the ones able to identify any mispricing at the lowest cost and exert pressure on the price to correct the mispricing. What kinds of efforts are productive in this domain depends on the degree of market efficiency. A large body of evidence exists that is supportive of a high degree of efficiency in the U.S. market, but recent studies have reopened the debate on this issue.

In practice, a wide variety of approaches to fund management and security analysis are employed. However, at the core of the analyses are the same steps outlined in Chapters 2 through 8 of this book: business strategy analysis, accounting analysis, financial analysis, and prospective analysis (forecasting and valuation). For the professional analyst, the final product of the work is, of course, a forecast of the firm's future earnings and cash flows, and an estimate of the firm's value. But that final product is less important than the understanding of the business and its industry, which the analysis provides. It is such understanding that positions the analyst to interpret new information as it arrives and infer its implications.

Finally, the chapter summarizes some key findings of the research on the performance of both sell-side and buy-side security analysts.

DISCUSSION QUESTIONS

1. Despite many years of research, the evidence on market efficiency described in this chapter appears to be inconclusive. Some argue that this is because researchers have been unable to link company fundamentals to stock prices precisely. Comment.
2. Geoffrey Henley, a professor of finance, states, "The capital market is efficient. I don't know why anyone would bother devoting time to following individual stocks

and doing fundamental analysis. The best approach is to buy and hold a well-diversified portfolio of stocks." Do you agree? Why or why not?

3. What is the difference between fundamental and technical analysis? Can you think of any trading strategies that use technical analysis? What are the underlying assumptions made by these strategies?
4. Investment funds follow many different types of investment strategies. Income funds focus on stocks with high dividend yields, growth funds invest in stocks that are expected to have high capital appreciation, value funds follow stocks that are considered to be undervalued, and short funds bet against stocks they consider to be overvalued. What types of investors are likely to be attracted to each of these types of funds? Why?
5. Intergalactic Software Company went public three months ago. You are a sophisticated investor who devotes time to fundamental analysis as a way of identifying mispriced stocks. Which of the following characteristics would you focus on in deciding whether to follow this stock?
   - The market capitalization
   - The average number of shares traded per day
   - The bid–ask spread for the stock
   - Whether the underwriter that brought the firm public is a top tier investment banking firm
   - Whether the firm's audit company is a Big Four firm
   - Whether there are analysts from major brokerage firms following the company
   - Whether the stock is held mostly by retail or by institutional investors
6. Intergalactic Software Company's stock has a market price of $20 per share and a book value of $12 per share. If its cost of equity capital is 15 percent and its book value is expected to grow at 5 percent per year indefinitely, what is the market's assessment of its steady state return on equity? If the stock price increases to $35 and the market does not expect the firm's growth rate to change, what is the revised steady state ROE? If instead the price increase was due to an increase in the market's assessments about long-term book value growth rather than long-term ROE, what would the price revision imply for the steady state growth rate?
7. There are two major types of financial analysts: buy-side and sell-side. Buy-side analysts work for investment firms and make stock recommendations that are available only to the management of funds within that firm. Sell-side analysts work for brokerage firms and make recommendations that are used to sell stock to the brokerage firms' clients, which include individual investors and managers of investment funds. What would be the differences in tasks and motivations of these two types of analysts?
8. Many market participants believe that sell-side analysts are too optimistic in their recommendations to buy stocks and too slow to recommend sells. What factors might explain this bias?
9. Joe Klein is an analyst for an investment banking firm that offers both underwriting and brokerage services. Joe sends you a highly favorable report on a stock that his firm recently helped go public and for which it currently makes the market. What are the potential advantages and disadvantages in relying on Joe's report in deciding whether to buy the stock?
10. Joe states, "I can see how ratio analysis and valuation help me do fundamental analysis, but I don't see the value of doing strategy analysis." Can you explain to him how strategy analysis could be potentially useful?