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The Stock Valuation Process: The Analysts' View

How do analysts evaluate common stocks? A survey of 2,000 members of the Financial Analysts Federation indicates that analysts consistently emphasize the long term over the short term. Expected changes in EPS, expected return on equity, and prospects for the relevant industry were considered the most important variables over the long term; industry prospects, expected changes in EPS and general economic conditions were given greatest weight over the short term. Analysts look to qualitative factors such as quality and depth of management, market dominance and strategic credibility (ability to achieve stated goals) to validate quantitative financial and economic variables.

The majority of analysts surveyed also felt that corporate strategic plans and planning systems are of great importance in the stock valuation process, but that the information on strategic plans and planning provided by management is of generally low quality. Analysts view management presentations as both the medium for assessing the quality and depth of management and the source of information regarding management's plans.

"The money managers' power acts as a Damoclean sword over companies today, forcing chief executives to keep earnings on a consistently upward track, quarter by quarter, even if it means frustrating their long-range plans. And because the low value assigned to their stocks closes equity markets to most companies, managements are borrowing more to operate their businesses."
—"Will Money Managers Wreck the Economy?" *Business Week,* August 13, 1984, p. 86.

HAS A FRENZIED search by investors for short-term gains distorted managements' view of their stewardship function? The long-term implications for optimal allocation of resources, industrial performance and economic growth are extremely serious, especially in view of the increasingly competitive international marketplace within which U.S. firms now operate.

Theories of stock valuation abound, but hard evidence on how analysts view performance is relatively scarce. We went to the source—security analysts themselves—to find out:

- the relative importance in the stock valuation process of short-term versus long-term economic, industrial and financial variables;
- the relative importance of the specific financial factors used in the determination of stock values;
- the relevance of a company's long-term strategic plans and strategic planning systems to stock valuation; and
- the quality of information provided by companies.

Method

We developed, in cooperation with the officers of the Boston Security Analysts Society, Inc., a comprehensive stock valuation questionnaire. This was sent to 1,000 members of the Boston Security Analysts Society, Inc. and to 1,000 U.S. members of the Financial Analysts Federation outside the Boston Society.[1]

The questionnaire had four sections. The first asked the analyst to rank various economic and financial factors in terms of their importance for stock valuation in the next quarter and in the next five years. The second section, listing vari-

1. Footnotes appear at end of article.

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Table I Importance Attached by Analysts to Variables Over Short Term and Long Term*

Variable	In the Next Quarter 1	2	3	Over the Next 5 Years 1	2	3
General Economic Conditions	18	43	39	10	35	55
Prospects of the Relevant Industry	17	36	47	8	19	73
Expected Change in EPS	20	41	39	7	17	76
Expected Change in Dividend Payment	31	44	25	13	48	39
Expected Return on Assets	31	44	25	8	31	61
Expected Return on Equity	26	41	33	7	20	73
Gross Profit Margin	23	55	22	9	44	47
Expected Rate of Sales Growth	27	53	20	8	37	55
Asset Turnover Ratio	42	50	8	18	56	26

Percentage Distribution of Responses

* 1 = little importance; 2 = moderate importance; 3 = great importance.

ous indicators of long-term strategic plans being implemented by a company, was designed to validate the consistency of responses to the earlier questions.

The third section of the questionnaire asked the analysts to assess the relative importance of formal strategic plans and planning systems for four different classes of companies—(1) more established and healthy firms, (2) more established and troubled firms, (3) less established and healthy firms, and (4) less established and troubled firms. The last section asked analysts to evaluate the quality and sources of information on companies' strategic plans and planning processes. Here, analysts were also asked for suggestions for improving the quality and availability of such information.

Investment Horizons

Analysts evaluating a stock tend to emphasize the long-run economic and financial performance of a company. Table I gives the distribution of the analysts' responses to our questions regarding the relevant importance of various economic and financial variables for both the short run and the long run. Every variable was accorded more importance over the long run than the short run, by a wide margin. Furthermore, all analysts—whatever their institutional affiliations or functional categories—exhibited this attitude.

Analysts attached greatest importance, in the long run, to (1) expected change in EPS, (2) expected return on equity and (3) prospects of the relevant industry. Each of these three factors achieved a rating of "great importance" by more than 73 per cent of responding analysts. Over the long run, all the variables except expected change in dividend payment and asset turnover ratio were thought to be of "great importance" by the largest percentage of analysts. In contrast, no variable over a short-run horizon got a rating of "great importance" by even a majority of the respondents.

The three most important variables for stock valuation over the short run appear to be (1) prospects of the relevant industry, (2) expected change in EPS and (3) general economic conditions. In the short run, environmental, economic and industry conditions are relatively more important than financial statement data. Least important in the short run, according to analysts, are (1) asset turnover ratio, (2) expected change in dividends and expected return on assets and (3) expected rate of sales growth. Firm-specific data assume greater importance over the long run. Analysts attach little importance to bursts in sales, asset utilization and dividend payments unless they are supported by favorable long-term prospects.

Surrogates for Investment Horizon

Analysts did not consider the surrogate measures for a short-term valuation perspective—introduction of new products and dividend yield—to be very important, Table II reveals. Rather, when determining stock value analysts appear to look most closely at long-term predictors of qualitative growth and earnings, particularly the quality and depth of management, the company's market dominance and the company's history of achieving stated goals (which we call "strategic credibility").

Analysts are clearly "systemic-process" oriented, as opposed to "event" oriented. No single operating ratio from the company's finan-

Table II Surrogate Measures of Short-Term vs. Long-Term Horizons*

Variable	*Percentage Distribution of Responses*		
	1	*2*	*3*
Short-Term Orientation			
Dividend Yield	23	57	20
New Product Introduction	23	52	26
Long-Term Orientation			
Quality and Depth of Management	7	19	74
Company's Market Dominance	10	23	67
Company's History of Achieving Stated Goals ("Strategic Credibility")	12	25	63

* 1 = little importance; 2 = moderate importance; 3 = great importance.

cial statements, nor any single product or market event, captures for the analyst the long-term prospective value of the stock. Analysts appear to view a company in its entirety—its history, capabilities and position in the industry.

Analysts ranked the surrogates for a long-term perspective higher than the comparable surrogates for a short-term perspective. They attached more importance to the regularity of new product introduction and product refinement, for example, than to anticipated introduction of a new product. Similarly, analysts weighted the consistency of dividend payments more heavily than dividend yield.

Table III Cross-Correlation Coefficients Between Long-Term Factors and Qualitative Surrogates for Long-Term Horizon*

	Long-Term Factors		
Surrogate Factors	*Expected Change In EPS*	*Expected ROE*	*Prospects of the Relevant Industry*
Quality and Depth of Management	0.31	0.36	0.36
Market Dominance	0.41	0.32	0.37
History of Achieving Stated Goals ("Strategic Credibility")	0.32	0.37	0.35

* Pearson rank cross-correlations. In all cases, computed probability of error is 0.00.

Table III presents the significant correlation coefficients between the long-term quantitative valuation variables and the qualitative, surrogate measures. These results indicate that the analysts placed consistent emphasis on the long-term horizon. Furthermore, they seemed to look to qualitative factors such as quality and depth of management, market dominance and strategic credibility to validate quantitative financial and economic variables.

Assessment Media

The analysts' responses showed that the quality and depth of a company's management are very important in stock valuation. When asked how they assess these characteristics, analysts supplied a variety of answers: "This is both the most critical and the most difficult factor to evaluate"; "intuition"; "cross references"; "recent decisions"; "the pattern of management succession"; "talks and visits"; "historical record of the company"; "management's adaptability to change in good times and bad"; and "the ability to improve a company's position relative to its competition." The most common answers were:

- the performance record of management;
- interviews, meetings and presentations of management to analysts; and
- evidence of management's strategic planning and ability to meet stated objectives.

The analysts emphasized that meetings with management must be of a substantive nature to be of value in assessing management quality. They felt that such meetings should enable them to make judgments about the breadth and quality of the top management team, as well as its ability to formulate and meet realistic strategic goals. Analysts would prefer to base their assessments on meaningful information, rather than on general statements of intent.

Relevance of Strategic Plans and Systems

The analysts' emphasis on long-term financial strength may indicate the importance they attach to the presence (or absence) of sound strategic plans and planning systems. Table IV shows analysts' responses to questions dealing with strategic plans and planning systems.

Over 60 per cent of the analysts viewed plans and planning systems as being of "great importance," except in the case of established, healthy companies. Analysts believed that a sound strategic plan (which describes the future direction of the company, including the reallocation of resources and assets) and a sound strategic planning system (a system by which the company formulates or reformulates its strategic plan) are important in evaluating the stock

Table IV Importance Analysts Attach to Strategic Plans and Planning Systems in Stock Valuation*

	Percentage Distribution of Responses											
	More Established Companies						*Less Established Companies*					
	Healthy			*Troubled*			*Healthy*			*Troubled*		
	1	*2*	*3*	*1*	*2*	*3*	*1*	*2*	*3*	*1*	*2*	*3*
A. A company's strategic *plan*—i.e., a plan that describes the future direction of the company including the reallocation of assets and resources.												
1. How important is a company's strategic *plan* that you believe to be sound?	8	47	45	4	18	78	5	24	71	9	14	77
2. How important is a company's strategic *plan* that you believe to be unsound?	11	33	56	13	9	78	10	18	72	13	6	81
B. A company's strategic planning *system*—i.e., a system by which the company formulates or reformulates its strategic plan.												
1. How important is it that a company has a sound strategic planning *system* in place?	9	44	47	6	16	78	7	31	62	10	11	79
2. How important is it that a company does not have a sound strategic planning *system* in place?	13	29	58	8	16	76	8	26	66	10	10	80

* 1 = little importance; 2 = moderate importance; 3 = great importance.

of both established and less established companies. And when valuing troubled companies, analysts viewed strategic plans and planning as critical.

Sources of Information

In order to assess the nature of the information gap between analysts and management, we asked respondents specific questions about the quality and availability of information, its sources, and how the flow of information relating to a company's strategic plans and planning systems could be improved. Table V reports the results.

Only 16 per cent of the respondents found information on strategic plans and planning systems to be highly relevant and timely in terms of quality. Over one-third regarded such information as bland generalities of little use. In view of the importance analysts assign strategic planning in the stock valuation process, corporate management should probably consider upgrading the quality of information they provide.

The principal source of strategic planning information is presentations to analysts by top management. The analysts do not view newspapers and other publications as being of any great value, and rate annual reports and 10-K reports as only "moderately useful."

Management presentations play a dual role. They help analysts judge the quality and depth of management, as well as providing long-term strategic planning information. Analysts evidently regard these meetings as both the medium (for assessing the quality and depth of management) and the message (as a source of information regarding the soundness and the credibility of strategic plans and planning systems). The analysts' responses contrast sharply with managements' apparent view of such presentations. Investor relations personnel seem to regard them primarily as opportunities for stock promotion.[2]

Table V Quality and Sources of Strategic Planning Information

	Percentage Distribution of Responses		
	Bland Generalities of Little Use	*Moderately Useful*	*Highly Relevant and Timely*
Quality of Strategic Planning Information	34	50	16
Sources of Strategic Planning Information	*Little Importance*	*Moderate Importance*	*Great Importance*
Annual Reports and 10-K Reports	22	50	28
Presentations by Top Management	9	42	49
Newspapers and Other Publications	36	50	14

Analysts suggested a number of ways to improve the quality and availability of strategic planning information—more disclosure about strategic plans in discussions, meetings, annual and other reports; interviews; and more comprehensive responses to specific queries. Some analysts felt that it is their responsibility to obtain more information. Others recommended a boycott of companies unwilling to offer such information.

Interestingly, 20 per cent of the respondents felt that managements, for competitive reasons, should not make information on strategic plans and planning systems available. Most analysts, however, favored increased disclosure. They cited most frequently as a medium for greater disclosure "discussion during management presentations, meetings, and interviews with the analysts"; "greater discussion in annual reports" also received substantial support.

How Analysts Evaluate Stocks

Do analysts use a dividend discount model to value stocks? Their responses to the questionnaire suggest not. As noted, expected change in dividend payment during the next quarter and during the next five years, as well as dividend yield, were regarded by analysts as among the least important factors in the stock valuation process. The low rankings of all dividend-related questions are corroborated by cross-correlation analysis of responses to separate sections of the questionnaire (see Table VI).

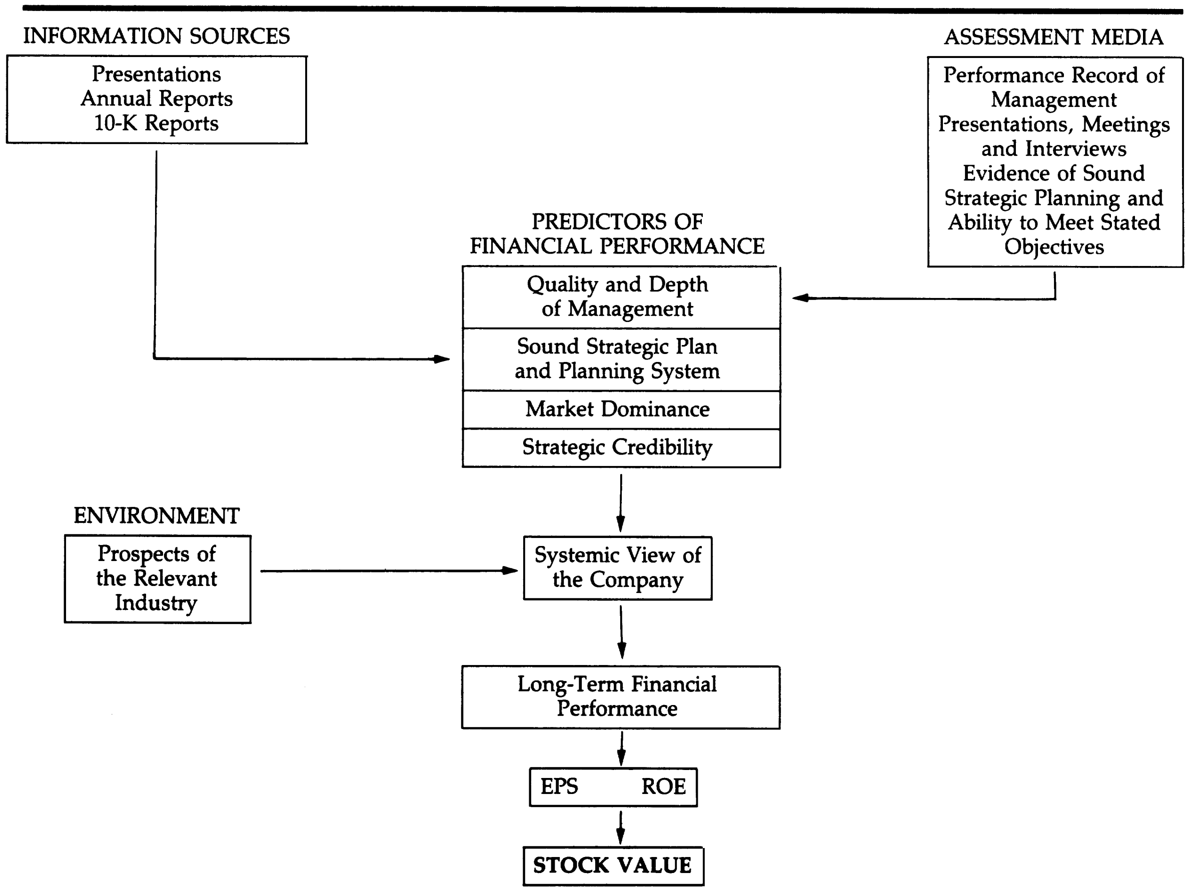
Table VI Correlation Coefficients on the Relevance of Discounted Dividend Model To Stock Valuation*

	Dividend Yield	*Consistency of Dividend Payments*
Expected Change in Dividend Payments During Next Quarter	0.35	0.26
Expected Change in Dividend Payments During Next 5 Years	0.37	0.37

* Pearson cross-correlations. In all cases, probability of error calculated to be 0.00.

On the other hand, the analysts' high rankings of long-term earnings prospects and the surrogate predictors of financial strength, as well as the high cross-correlations, reveal a substantial interest in expected growth in quality earnings. The survey evidence thus lends considerable credence to the earnings approach,

Table VII Stock Valuation: A Process Model*



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rather than the discounted dividend approach, to stock valuation.

In our opinion, the analysts' approach to stock valuation can best be described by the process flow chart depicted in Table VII. This model demonstrates how analysts incorporate their assessments of industry and economic environments, their methods of processing information, and their available sources of information to develop an integrated prediction of financial performance.

The predictive process is based primarily on the quality and depth of management, market dominance, presence of a sound strategic plan and planning system, and the strategic credibility of a company. In assessing the quality and depth of management, analysts look at management's performance record, presentations, evidence of sound strategic planning, and ability to meet stated objectives. A sound strategic plan and planning system serve two functions—as independent variables in the prediction of financial performance and as media for evaluating the quality and depth of management. Presentations by management offer analysts an opportunity to learn about strategic plans and planning systems and to evaluate the quality and depth of management.

By processing all such information, along with assessments of the external economic and industry environments, analysts develop a systemic appraisal of the firm. This evaluation becomes the foundation for a forecast of long-term financial performance in terms of EPS and ROE, which determine the investment value analysts place on a stock. ■

Footnotes

1. The Boston survey elicited a response rate of 23 per cent and the U.S. survey one of 17 per cent. The figures in this article are based on the national survey. There were no significant differences between the two surveys. The questionnaire and complete set of responses are available from the authors.

   The authors also surveyed members of the National Investor Relations Institute to elicit the corporate view. They report on their results in "Break the barrier between you & your analysts," in the September 1984 issue of *Financial Executive.*
2. Robert E. Kennedy and Mollie H. Wilson, "Are Investor Relations Programs Giving Analysts What They Need?", *Financial Analysts Journal,* March/April 1980, pp. 63–69.