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The Analyst Whisperer

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Bay Street's research shops are in crisis, and they're calling on analyst coach Mike Binette for help. But can one man save a whole profession in decline?

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Mike Binette is in a conference room high up over Toronto's financial district, in the capital-markets arm of a Big Six bank. Huddled around him at a gleaming oak table are 12 souls from the research department: associates, junior and senior analysts, and the big boss—the director of research.

Though Binette himself retired as an analyst eight years ago, he still looks the part: beard neatly clipped, tailored sports jacket (not too flashy), shoes scrupulously shined. Binette is about to kick off his first workshop of the day: how to put a "sell" rating on a stock without pissing everyone off. It's a doozy, because "going negative" has a tendency to fray the relationship between the analyst and the company whose stock he's urging investors to sell. It could also jeopardize the firm's investment-banking relationship with said company—which means it could lose lucrative corporate financing business.

Just as he's about to launch into his spiel, a 30-something analyst pipes up.

"Mike, Mike, this is so difficult," he whines. The guy's a dead ringer for Kiefer Sutherland—blond, good-looking, a little more casually dressed than his colleagues, with no jacket or tie. (Like all the other analysts at the table, he didn't want us to use his real name.)

It's clear that Kiefer is terrified of the repercussions of slapping a sell rating on a stock. The company will cut him off, he says, and refuse to answer his questions on quarterly earnings calls. Worse than that, it might damage his ability to set up non-deal road shows—private meetings between companies and fund managers that help generate money for the firm and factor into an analyst's compensation.

Analysts have always occupied an ethically awkward place in the Bay Street ecosystem. Their primary function is to come up with investment ideas that the firm's traders and salespeople—the "sell side"—can hawk to fund managers on the "buy side." Analysts must cultivate a strong relationship with the management of the companies they follow, and with the fund managers who put billions of dollars to work in those companies. Plus, any report an analyst publishes will affect the firm's investment banking department, which likely does business with those same companies. Through all of this, they're expected to retain their independence and provide unbiased research.

That's not the only aspect of the job that's making life harder. Thanks to new rules ushered in after the dot-com bust, and a further crackdown after the great financial crisis, analysts no longer have the same competitive edge. They aren't making nearly as much money for their brokerages, which means the pressure to protect the lucrative corporate financing side of the business—by staying positive on stocks, or at least downplaying the negatives—has been ratcheted up. The ubiquity of real-time financial data has turned research into a commodity and cheapened its value. Analysts also face more competition than ever, from buy-side researchers, hedge fund managers, and legions of bloggers and journalists with instant reach via social media. And widespread job losses since the 2008 financial crisis means there are now fewer analysts covering more stocks for less money.

Enter Binette, who spent 25 years in re-search, the last six as director of research at Blackmont Capital. Five years ago, he returned to Bay Street as a self-styled "analyst coach." His clients now include Canada's biggest bank-owned and independent brokerages, who are hoping Binette can help his former compadres navigate this treacherous new world. He's concerned that it's a profession in decline—and that's worrying, because in an age of manufactured news and inflammatory reports from dubious sources, investors need reliable company information. One thing is clear: If analysts are going to survive, it's going to take sweeping changes in the industry.

Canadian equity research began in earnest after the Second World War, growing along with the first mutual and pension funds. The first research providers were actually the old trust companies, which managed wealth and estate assets for rich Canadians.

In the 1960s, boutique brokerage Burns Bros. and Denton Ltd. began to focus on the nascent field of equity research. Burns Bros. (which later became Burns Fry and is now BMO Nesbitt Burns) quickly became the go-to firm. A report on the uranium market in the 1960s that took a Burns analyst more than a year to put together was so thorough that the Russian embassy called to request a copy. (Burns was allegedly advised by the Canadian government to say no.) At Burns, analyst independence was sacrosanct, with firewalls put in place between investment banking and research to avoid any conflicts of interest.

Yet, in those early days, it was acceptable for analysts to glean proprietary information from a company's management and then pass it on to traders at their own firms or directly to buy-side clients. That gave analysts an enormous edge. Fund managers compensated brokers for research obliquely, by directing their trades through the desks of dealers with the best reports.

In the 1980s, the big Canadian banks started buying independent shops like Dominion Securities and Wood Gundy. Suddenly, the bank-owned dealers could offer a quid pro quo that the indies couldn't: lower commissions on stock trades in exchange for corporate loans. The banks didn't care much about the falling commissions, since their massive balance sheets gave them the leverage to participate in lucrative corporate financing deals. By then, analysts were increasingly being paid based on how much investment banking business they helped to generate.

The Canadian industry's first great crisis came in the late 1990s, with the Bre-X Minerals fraud. Analysts were duped en masse by false claims of a huge gold deposit in Busang, Indonesia. Ebullient analyst reports helped to push the tiny miner's market cap to north of $5 billion. In 1997, after a gargantuan fraud was uncovered, Bre-X—and the credibility of analysts—was wiped out.

As damaging as the Bre-X scandal was in Canada, U.S. analysts were about to lose the plot entirely. By 1999, they'd effectively become shills for the dot-com sector, issuing glowing reports on companies with no track record and no business plan. That mindless optimism helped investment bankers scoop up billions in corporate financings. When the Nasdaq imploded in 2000, tens of billions in investor dollars disappeared—and analysts incurred much of the wrath.

Regulation Fair Disclosure (Reg FD), introduced by the U.S. Securities and Exchange Commission in 2000, mandated that companies disclose material information to all investors at the same time—no more slipping tidbits to favoured analysts or fund managers in private. Then came the Global Analyst Research Settlement in 2003, under which 10 brokerages paid a collective fine of $1.4 billion (U.S.) for shoddy and conflicted research during the tech mania. Two individual analysts were also fined—most famously, Merrill Lynch's Henry Blodget, who was forced to pay $4 million (U.S.) and was permanently barred from the industry, after privately calling companies he touted to investors "POS" (pieces of shit).

As part of the settlement, regulators also mandated that permanent firewalls be erected to prevent any communication between in-vestment bankers and analysts. And brokerages could no longer tie analyst compensation to banking revenue.

While the new rules helped level the playing field for investors and gave the research industry a much-needed credibility boost, the regulations—particularly Reg FD—have taken away much of the edge analysts once had.

"Everybody's scared to death about going to jail if they reveal information they don't reveal to everybody in timely disclosure," says David Baskin, whose Baskin Wealth Management manages $900 million for high-net-worth clients. "The ability of a sell-side guy to know stuff I don't know is much more limited than it was 30 years ago. And even if he did know something, he probably shouldn't tell me."

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The great financial crisis of 2008 made things orders-of-magnitude worse. Active fund managers, traditionally among the heaviest consumers of research, saw their returns decimated, and could no longer afford to pay for it. At the same time, the rise of electronic trading systems meant the buy side could execute many of their own trades, instead of having to run them through the brokerages. That put the squeeze on commissions, making research far less profitable.

Bank-owned and independent brokerages alike started laying off analysts. Some smaller boutiques went out of business entirely. Many individual analysts have also fled the industry. In 2013 alone, roughly 15 Calgary-based analysts left research for corporate roles. For those who chose to stay, the rewards have dwindled.

"Back in the day, when the top analysts were making somewhere between $1 million to $2.5 million a year, one could easily justify making whatever sacrifices needed to be made," says veteran Bay Street headhunter Joe Kan. Those sacrifices include 70-hour weeks, near-constant travel, earnings calls held at ungodly hours—and the stress of potentially making a disastrous call. "With comp down by half, and even more at the smaller boutiques," says Kan, "some analysts have begun to question whether it's still worth it."

Back in the boardroom, Binette is teasing out a lesson with a top-ranked analyst in his 40s. We'll call him Ali.

"Why are you ranked as highly as you are?" Binette asks Ali. "What's your brand?"

"Good research," Ali replies.

Binette rolls his eyes. "That's like Loblaws saying, 'We sell good food.' Come on!"

A few of the other analysts chuckle as Ali drops his head.

"You have to have an idea," Binette says. Then he fires off a list of factors that might give Ali an edge over his peers: "Quality of your models? Industry insights? Timeliness? Contrarian views?"

"It's my sources of information, particularly in the U.S.," Ali finally blurts out. "I can translate that into numbers very quickly."

Bingo.

So how does Ali make sure that his competitive advantage—Binette calls it his "differentiator"—sets him apart? For starters, Binette suggests he drop a backward-looking, 25-page quarterly update that takes two days to complete and, in the age of Twitter, nobody reads anyway. Instead, he suggests it would make more sense for Ali to produce a one-pager each quarter, and put the leftover energy into, say, organizing conference calls between buy-side clients and his U.S. sources.

Binette's own differentiator as an analyst was his storytelling skills, a crucial trait on Bay Street, where ideas are sold, not bought. Binette was hired as an energy and chemicals analyst by Burns Fry in 1983, directly out of the Ivey Business School's MBA program. He'd often spend his days poring over books at the library—say, looking up Japan's ethylene production. "Then I'd come in to the office and say, 'The best I got is two-month-old data, but it looks like a trend,'" he says with a laugh.

By the mid-1990s, he'd risen to director of research at TD Securities. He spent much of the 2000s at Blackmont Capital before being packaged out in 2008, along with a number of other senior employees.

He took a stab at retirement: He climbed Mount Kilimanjaro, toured around Iceland and played a lot of hockey. He even started working with minor-league hockey coaches, helping to mould them into better leaders. Out of the blue in 2011, a former colleague, now working at a bank-owned dealer, called him up with a plea: to return to Bay Street, not as an analyst, but as a coach.

"He wanted someone he could trust, who could coach effectively, who knew what was needed to excel in the research business," says Binette.

Drawing on his own experience and by talking to colleagues, Binette put together a "best practices" program for analysts that he now delivers via interactive group workshops and even one-on-one. His 15 "modules" include how to generate more money for the firm, how to build a personal brand and how to reverse a bad call.

But with fewer analysts covering more companies, and all of them fighting to be heard above the glut of investing information online, on the Bloomberg terminal and on social media, Binette's No. 1 piece of advice is this: "Figure out what you're good at, do more of that, and weed out the stuff that isn't value-added."

Binette's mantra of specialization could be the way forward for the industry writ large. While bank-owned dealers can still afford to be all things to all people, increasingly, the smaller shops are picking their spots.

Independent brokerage Cormark Securities covers a broad swath of small- and mid-cap companies, but it's a little choosier with its large-caps. None of Cormark's 20 publishing analysts cover RioCan REIT—there are seven other competitors already covering the stock. But it does cover Fairfax India Holdings Corp., one of just two Bay Street brokerages to do so.

The nature of Cormark's research has also evolved over the past decade. Analysts are dedicating less time to reactionary earnings reports and more to proactive forecasts. They're also taking big swings on in-depth, thematic studies. Recent "deep dives" into mid-cap companies Painted Pony Petroleum and Birchcliff Energy were particularly well-received, according to Cormark's director of research, Susan Streeter. "Because information is so readily available," she says, "you have to spend more time actually analyzing in order to offer value to a client."

The best and worst analyst calls of all time

WORST CALLS

Egizio Bianchini (Nesbitt Burns Inc.)
Buy: Bre-X Minerals
"Bre-X has made one of the great gold discoveries of our generation." (Feb. 1996)
Fallout: Shareholders were completely wiped out.

Richard Kelertas (Dundee Securities)
Buy: Sino-Forest Corp.
"Sino-Forest is the class act in timberland management in China." (Feb. 2011)
Fallout: Sino-Forest collapsed in June, 2011, after U.S. short-seller Carson Block accused the company of fraud.

Grant Daunheimer (Dundee Securities)
Buy: Poseidon Concepts
"We believe 2012 is a slam dunk for Poseidon shareholders." (Jan. 2012)
Fallout: Poseidon's stock plummeted 90% in 2012, and it eventually went bankrupt amid SEC allegations that it grossly overstated revenue.

Henry Blodget (Merrill Lynch)
Buy: eToys and Pets.com
Publicly, in 1999 and 2000, he told investors that dot-com stocks would soar, but privately admitted many of them were crap.
Fallout: Along came the dot-com crash. The SEC ended up fining Blodget, and banned him from the securities industry for life.

BEST CALLS

Dimitry Khmelnitsky (Veritas Investment Research Corp.)
Sell: Valeant Pharmaceuticals
"We see little reason for investors to have faith at this time." (July 2014)
Fallout: Valeant's stock has fallen by 94% from its 2015 high amid doubts about its accounting practices, debt load and M&A strategy.

Meredith Whitney (CIBC World Markets Inc.)
Sell: Citigroup
"Citigroup will need to raise over $30 billion in capital through either asset sales, a dividend cut, a capital raise, or combination thereof." (Oct. 2007)
Fallout: Investors dumped Citigroup, and CEO Charles Prince resigned. It eventually got a multibillion-dollar bailout.

Macquarie Capital Canada, a global dealer, meantime, is shining a spotlight on its own research to see what works, and encouraging its analysts to collaborate worldwide on their reports in the hope that quality improves.

"We score every piece of research that comes out of Macquarie," says the firm's director of research, Greg MacDonald. Reports are judged by the originality of their ideas and their commerciality—whether they make money for clients. Only a small percentage of Macquarie's reports are grand slams, but the firm is hoping it can improve those numbers.

"It's becoming more important to have differentiation in the research product," says MacDonald.

Veritas Investment Research differentiates itself with its entire business model. It's the only privately owned, research-only firm of significant scale in Canada. Co-founder and ***CEO Anthony Scilipoti*** says the firm has been growing in terms of clients, revenue and analysts (***Veritas*** has 19 people in its research department) since its creation in 2000. And it's profitable.

With no investment banking department or trading desk, ***Veritas's*** research is about as conflict-free as you can get. Not surprisingly, its analysts have a reputation for making non-consensus calls. In 2014, ***Veritas's Dimitry Khmelnitsky*** did a deep dive on Valeant Pharmaceuticals and didn't like what he saw. In July, 2014, he slapped a sell rating on the stock—the only analyst to do so.

"We reiterated that sell maybe 10 times as the stock was climbing," he says.

In the fall of 2015, Valeant imploded, eventually erasing $85 billion (U.S.) in market value.

Unlike most other shops, which rely on dwindling trading commissions to get paid, "we're getting paid directly from the portfolio manager," says ***Scilipoti***.

Veritas's direct-compensation model could end up being the industry standard. In Europe, regulations due to take effect in 2018 will unbundle research fees from trading commissions; fund managers will have to pay for it directly. The new environment will put a spotlight on quality: If a brokerage doesn't produce outstanding research, it won't get paid. The new regulation will have a big impact on Canadian brokers. Some bank-owned dealers, and independents like Canaccord Genuity, have sizable capital-markets operations in Europe. Some have already decided the looming regulatory changes are too onerous; GMP Capital, for one, pared back significantly in the United Kingdom in 2016.

Though the regulatory environment isn't yet as stringent in Canada as it is in Europe, or even the U.S., some large dealers are adopting a "better safe than sorry" approach. Raymond James, for example, recently informed its Canadian analysts that they're no longer permitted to express an opinion that deviates from a published note—either internally to a salesperson or externally to a buy-side client—unless that information is disseminated to everyone simultaneously. And it's only a matter of time before policies implemented at big players filter down to everyone else.

The death of the research analyst has been predicted before: when fixed trading commissions were done away with in 1975, after Bre-X and the dot-com bust, in the aftermath of the 2008-09 financial crisis. But as much as their powers have diminished, analysts are still an essential part of the Bay Street ecosystem.

Jay Bennett, head of equities practices at Greenwich Associates, a U.S. financial services research firm, has been studying the sell side for more than three decades. He predicts the industry will continue its slow-burn downward, particularly if the cash-for-research model takes off globally. Over time, the large buy-side asset managers may be the only ones that can afford to pay for research. Still, though fat profit margins are almost certainly a thing of the past, don't expect any of the bank-owned dealers to get out of the business any time soon. Full-service brokerages can't afford not to offer equity research as part of their offerings, he says, since it drives so much of their investment banking and trading business.

"You think that TD would ever get out of the equities business? Or Scotia? I can't see it," says Bennett.

On the lower end of the brokerage scale, Bennett thinks the niche boutiques will likely scrape by through a combination of specialization and keeping costs ultra-low. The danger zone is in the middle, where firms like Canaccord Genuity and GMP Securities currently reside. Both firms got hammered in 2016, with their stocks trading near all-time lows. They've since recovered a bit after huge cost-cutting efforts, but Bennett isn't optimistic about their chances.

When it comes to firms in the middle, "I think they get wiped out," he says.

Back on Bay Street, Binette agrees that the analyst profession will get smaller in the years to come. But he's nonetheless sanguine about the future. For one thing, he says, dealers can't function without analysts, and the finance ecosystem can't function without dealers. Plus, the ability of analysts to see the bigger picture and to home in on what really matters will become even more important as the daily avalanche of digital information continues to grow.

But the way analysts are compensated will have to be overhauled, he says, with the emphasis on the quality of published reports, not the quantity. He's hoping to see a return to the analyst as "sleuth," like the old Burns Bros. guys in the 1960s. Give analysts six months to dig for information, says Binette, and they'll end up producing an outstanding piece of research.

If that happens, we could see analysts regain a measure of their former glory within the Bay Street ecosystem. They might not make the big bucks for the brokerages any more, but the reality is, analysts have always been the real brains of the operation—the ones with all the ideas. The traders and salespeople simply can't survive without them.

"People believe that research is a dying art," says Binette. "I disagree. Good analysts are still worth their weight in gold."