CANALYST NEWSLETTER: READING BETWEEN THE ROWS

The dog days of summer seem like a distant memory now, as the back to school season has us refreshed and re-energized to make the last quarter of 2018 the best one yet. In this edition, we dig in to the stats updating thousands of models generates, and discuss why the current state of the market has us all fired up about disruption, and financial models, but not necessarily in that order.

CAN MODEL COMPLEXITY PREDICT PERFORMANCE?

At Canalyst, we have the pleasure of updating over 4,000 models every earnings season. As any analyst who has covered a universe of stocks can attest, there's a wide range of how "effortful" it is to keep the names in a sector up-to-date. Some companies have very clean financials (fewer line items, no historical restructurings or resegmentation, etc.) whereas some models fill you with pre-earnings-day dread (a notable example is General Electric and its restatements).

This led us to start thinking, is there a relationship between how onerous a model is to update, and how that stock or subsector has performed over time? Qualitatively, this might make sense. Warren Buffett has always espoused eschewing investments that are too hard to understand, and portfolio managers and analysts only have so much time in a day. Therefore, it seems to be an interesting hypothesis that companies that keep their financials "cleaner" might outperform over time.

At Canalyst, we were uniquely positioned to test this theory. Since our models incorporate all line items that a company has ever reported, we can use the total number of rows in each company's model as a proxy for complexity. We summed the number of rows that have ever appeared in that company's 3 major financial statements and compared that to annualized return over time. The results were very interesting!

To begin our testing, we first ran a linear regression using the total number of financial model rows to predict annualized stock returns since January 2009 for US public companies with at least 5 years of trading history. Our model yielded a R^2 of 3.6%, roughly corresponding to the percentage of return variation that could be explained by our independent variable (financial statement complexity) alone. The independent variable coefficient was a statistically significant -11bps (p-value of essentially zero). This indicates that for each additional row a company adds to its financial statements, expected annualized return decreases by 11bps.

ANNUALIZED RETURN VS. FINANCIAL STATEMENT COMPLEXITY

Source: Canalyst

After controlling for market capitalization and subsector, the predictive power of our model improved dramatically with an adjusted R^2 of 14.7%; financial statement length remained a statistically significant predictor with a coefficient of -8bps. This ultimately substantiates our belief that firm complexity is inversely related to stock performance.

Running the same test across a sample of different subsectors (and controlling for market capitalization), we also noticed that the significance of complexity in predicting returns varies between subsectors. For a broader look at this trend, we aggregated our data by subsector, and re-ran the same test. Each data point in the graph below represents a unique subsector. As expected, subsectors with greater average financial statement complexity tend to underperform their more straightforward counterparts.

SUBSECTOR AVG. ANNUALIZED RETURN VS. SUBSECTOR AVG. FINANCIAL STATEMENT COMPLEXITY
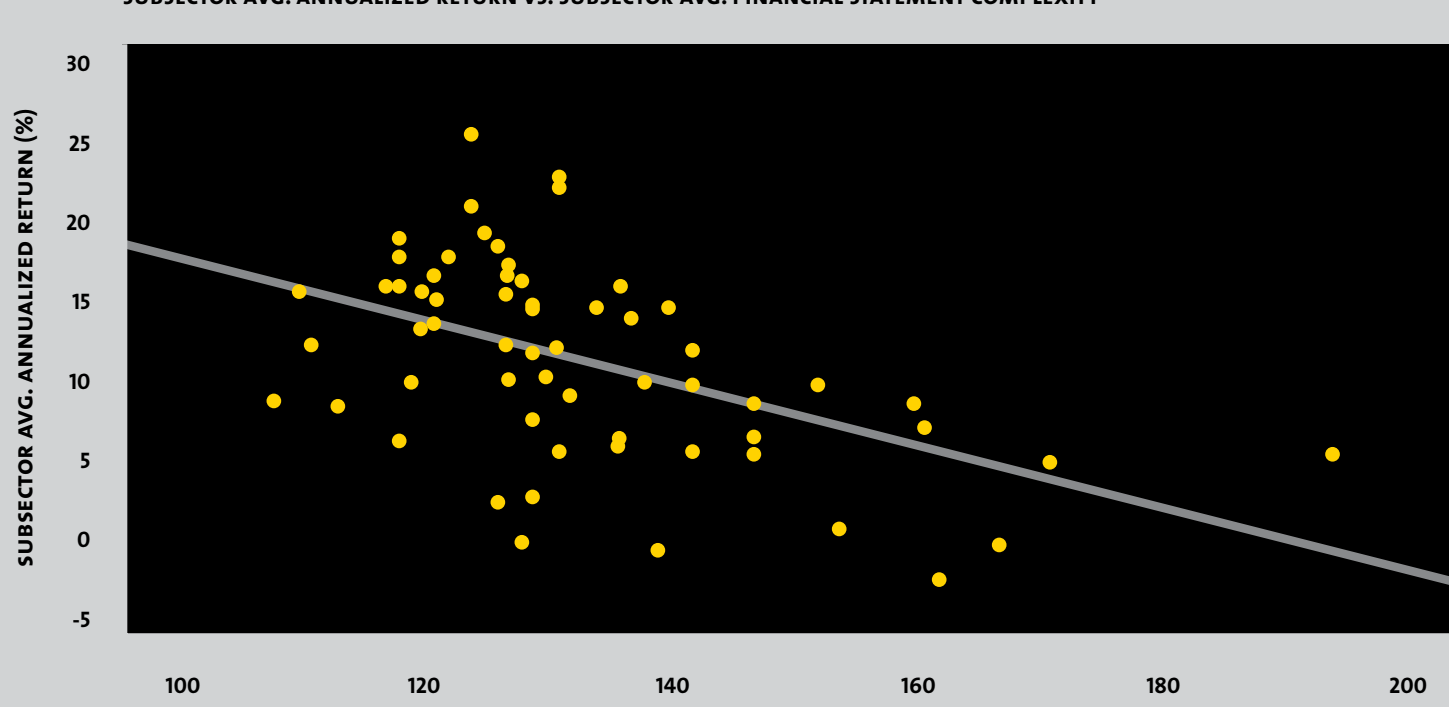
Source: Canalyst

This model predicts up to 25.6% of subsector average returns, and our independent variable of average complexity was a statistically significant predictor (p=0.00) with a coefficient of -20bps.

So, what does this all mean? For companies and CFOs, it's a good argument for keeping your financial statements as easy-to-interpret as possible. For analysts and portfolio managers, it suggests tilting how you spend your time slightly towards breadth. "Slightly" is the operative word – we wouldn't suggest that any investor alter their process, or avoid a deep dive into a complex potential investment. The R^2 figures in this study are relatively small, but, as James Simon, the founder of Renaissance once said, "The signals are faint. If they weren't, someone would have found them already."

In summary, we were pleased that this study suggests the market places a tangible value on analyst effort, just like you do. Our library of 4,000 up-to-date company models remains at our clients' fingertips in order to help capture this return.

WHY MODELS, WHY NOW?

The research industry is going through a significant period of disruption with a notable decline in sell-side coverage. At the same time, hedge funds and institutional investors are looking for ways to cut costs while also becoming more creative about their use of technology to find alpha. Against that backdrop, the introduction of MiFID II in the EU is having a ripple effect across the world. For decades, the research industry and the role of the analyst has remained almost unchanged. But now, both are forced to adapt in order to survive.
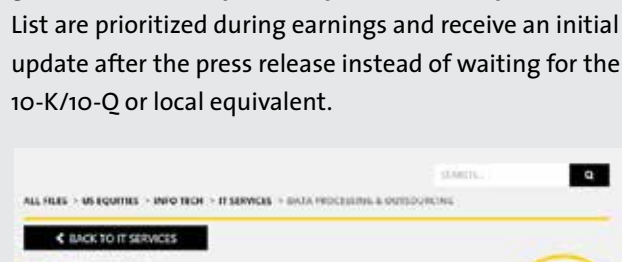
Canalyst was born out of this need to increase efficiency. Gathering and analyzing fundamental company data is an obvious starting point: it's the cornerstone of analysis and we knew as institutional investors that an ideal modeling solution was yet to be available. Data vendors uniformly cover a very broad universe of equities but often need to fit a square peg in a round hole by forcing company data into templates, and they rely too heavily on computers and outsourcing for data entry. At the other end of the spectrum, hand-built models (whether sell-side or in-house) capture individual company details and drivers but are all different and impossible to compare. So we created the best of both worlds: a massive, forward-looking database that accurately models how companies operate, as opposed to just providing historical financial data.

Not only do we free up our clients to do the more valuable work of analysis, we enable them to work more autonomously, producing more independent research. Plus, we provide the often undercovered small and mid-cap names. Their lack of sell-side coverage is a blessing in disguise for those who are willing to put in the work to investigate these companies through their own analysis. (See our eBook for more on leveraging this strategy: Is it Time for Active Managers To Shine?)

Today, multiple rounds of venture capital later, we're more than 70 employees across Vancouver, San Francisco, and New York, serving some of the most prominent and successful money managers in the world. As the industry continues to ride this wave of increased efficiency and technology adoption, we're more committed than ever to helping our clients to adapt and maintain their competitive edge.

HOMEWORK

Before going into earnings, update your Watch List to get a head start on your analysis. Models on your Watch List are prioritized during earnings and receive an initial update after the press release instead of waiting for the 10-K/10-Q or local equivalent.

WE'RE HIRING

As Canalyst continues to grow, we're looking for bright talent. If you know anyone who is passionate about stocks or technology – or both, please send them to the Canalyst careers page for current job openings. Midtown uniform optional.

James Rife
Canalyst, Head of Equities

Prior to founding Canalyst, James had 10 years' experience in equity research and portfolio management. He started his career in equity research with Fidelity Canada's investment team, covering sectors including Utilities, Forestry, Technology, and Energy from 2006 to 2010. After Fidelity, he took a role as Portfolio Manager at a Boston-based $1B long/short fund, rounding out his experience across most other sectors in the process.

James holds a Bachelor of Commerce from the University of British Columbia and is a recipient of a Leslie Wong Fellowship from UBC's Portfolio Management Foundation, and is a CFA Charterholder.

Interested in learning more about how you can uncover more investment opportunities with Canalyst financial models?
Click here for a free trial.