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Focus Lists Were Out of Focus in 2011's Turmoil

By VITO J. RACANELLI

Two West Coast investment firms took top honors in our latest ranking. But for many others, last year's volatility took a deep toll.

The market's calmer waters In this still-young year offer a welcome refuge from 2011's nerve-racking sea of volatility, but the bad memories linger. Just look at the poor average results in the semi-annual *Barron's*-Zacks ranking of Wall Street brokers' stock-focus lists.

For the second consecutive ranking, the average return of the recommendation lists trailed the stock market—this time badly.

With dividends included, the S&P 500 index, which frequently saw daily swings of 1% or more in the half, lost 3.7% in the half. In that same period, the brokers' focus lists—which contain what the firms consider their best stock ideas—did significantly worse, down 6% on average. Ouch! They underperformed for the year, too.

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Gary Hovland for Barron's

In the four periods covered, Wedbush surfed to three gold medals, McAdams Wright to one.

The results are broadly consistent with previous rankings. Over the years, the *Barron's*-Zacks survey has shown that the average focus-list return tends to exceed the market's during bull runs, as was the case in 2009 and 2010. However, the mean return typically trails the S&P 500 in bear cycles or in herky-jerky markets, as was the case for much of 2011, when the market actually finished little changed. Unfortunately, that's just when investors need good ideas the most.

Every six months, *Barron's* and Zacks rank the stock picks of a number of America's brokers—some of them big-name banks like **Morgan Stanley** (ticker: MS), but others little-known nationally, like McAdams Wright Ragen. (For a more detailed description of how we evaluate the results, see "Behind the Lists" at the end of this article.)

What did in the brokers as a group—though some did much better than others—was the market's singular concern last year with macroeconomic factors, such as the U.S. economy and the European debt crisis. It was tough for many brokerage firms to show their stock-picking skills when equity correlations were so high that most stocks moved in unison up and down, according to whether the "risk off" or "risk on" trade was dominant. For the market, company fundamentals took a back seat in the second half, and it shows.

Nevertheless, as always, there were winners and losers in the four periods our evaluation covers. This contest marks the arrival of the West Coast crew, if you will, dominated as it was by two regional brokers far away from Wall Street.

Los Angeles-based Wedbush Securities surfed to top honors by wide margins over the six, 12 and 36 months ended Dec. 31, 2011.

McAdams Wright, based in Seattle, won the five-year contest, doubling up the second-place finisher. A strong five-year performance is notable because that means a broker has done well over a lengthy period. In this case, the significance is amplified because the period included both 2008's terrible bear market and the strong 2009-2010 bull market. McAdams Wright, a small regional broker with a relatively narrow base of analysts —should take a deep bow. Indeed, this broker has consistently punched above its weight over the past three years.

Besides our winners, good performances were also turned in by Morgan Keegan, another regional broker and one that has often been at or near the top of this survey for many years. The Memphis-based firm, which is being sold to **Raymond James Financial** (RJF) by **Regions Financial** (RF), finished second in the six- and 60-month challenges.

Honorable mention also goes to St. Louis-based Edward Jones, a consistent proponent of a conservative buy-and-hold strategy involving large-cap, dividend-paying, quality stocks. Unsurprisingly, whenever the "risk off" trade made itself felt last year—which was often—that helped Edward Jones, which took third in the six-month contest and was second for all of 2011.

Showing that fortunes can reverse quickly, discount broker **Charles Schwab** (SCHW) brought up the rear in the six-month contest. Schwab's performance represents a first-to-worst fall—a drastic shift that in recent contests has become less uncommon. Wedbush, for example, has had similar position changes (more on that below). In our previous contest, Schwab had scored a double victory, being first over both six and 12 months.

The other cellar-dwellers this time around were New Constructs for 12 months, Morgan Stanley Smith Barney for 36 months and Schwab again for 60.

The impact on the brokers' lists of last year's high correlation among stocks is confirmed in Zacks' analysis. Says Zacks equity strategist Tracey Ryniec, almost apologetically: "Usually, there is something that distinguishes the winners and losers by stock sectors. This time, there isn't. There's nothing sector-specific."

That said, any focus list with a large overweighting in financial stocks at just about any time in the past five years was likely penalized. The S&P 500

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Big Differences

In all the listings, the winner's margin of victory over the second-place finisher was quite large.

Six Months	% Change	One Year	% Change	Three Years	% Change	Five Years	% Change
Wedbush Securities	5.41%	Wedbush Securities	9.45%	Wedbush Securities	98.21%	McAdams Wright	20.99%
Morgan Keegan	-2.26	Edward Jones	2.35	McAdams Wright	89.12	Morgan Keegan	8.76
Edward Jones	-3.34	McAdams Wright	2.07	Morgan Keegan	76.66	Edward Jones	4.08
MSSB*	-4.87	MSSB	1.60	New Constructs	65.02	Goldman Sachs	1.76
McAdams Wright	-6.43	Morgan Keegan	1.41	Goldman Sachs	54.85	MSSB	1.27
Bank Of America/Merrill Lynch**	-6.56	Bank Of America/Merrill Lynch	-0.79	Charles Schwab	53.52	Charles Schwab	-3.10
Goldman Sachs***	-10.52	Charles Schwab	-3.51	Bank Of America/Merrill Lynch	51.54	Bank Of America/Merrill Lynch	NA
New Constructs	-11.59	Goldman Sachs	-4.54	Edward Jones	43.39	New Constructs	NA
Charles Schwab	-12.13	New Constructs	-12.00	MSSB	42.84	Wedbush Securities	NA
Average Broker Return	-5.81		-0.44		63.91		5.63
S&P 500 Index Total Return	-3.70		2.10		48.60		-1.24
S&P 500 Equal Weight TR	-7.59		-0.11		78.20		9.00

*Smith Barney and Morgan Stanley have merged their brokerage operations and now appear as one entity. **Merrill Lynch changed its focus-list strategy in March 2007. ***Goldman Sachs changed its focus-list strategy at the end of the third quarter 2008.
NA = Not applicable because broker is a relatively recent entry and there isn't enough data. All returns as of 12/30/11.

Source: Zacks Investment Research

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(SBUX), **Nordstrom** (JWN), **Whole Foods** (WFM), **Intel** (INTC), **3M** (MMM), **Kimberly-Clark** (KMB) and **Medtronic** (MDT), among others, propelled the focus list. The firm also benefited by having little exposure to financials and telecoms.

McAdams also finished second over three years, but has stumbled a bit lately. In the six months ended Dec. 31, 2011, it finished fifth and underperformed the market. Picks like **Corning** (GLW), and **Federated Investors** (FII), both down significantly, hurt returns, although both are still on the list. McAdams, like Wedbush, has a small list, typically just 20 names.

Elkan Scheidt, chairman of Morgan Keegan's focus-list committee, ascribes the firm's strong showing over three and five years to its multicap approach and a low level of financial stocks.

Edward Jones has a 40-to-60-name focus list that goes for high-quality companies with good and regularly increasing dividends. Last year "was our sweet spot," says Dave Powers, the St. Louis firm's director of equity research, because such stocks were often in favor.

In contrast, Charles Schwab had a tough time in 2011's last six months, finishing last. Its 100-name list looks for cheap stocks with improving fundamentals and market momentum, but when the "risk off" trade hit, its picks were hurt, says its director of equity ratings, Greg Forsythe. Particularly damaging was the third quarter, during which stocks were moving almost in unison on macro factors. "Where we saw value, the market saw market-exposed and economically sensitive stocks," Forsythe laments.

A spokeswoman for Morgan Stanley Smith Barney, which finished last in the three-year ranking, says it looks for high-quality, defensive names, which were not in demand in 2009-2010.

As for New Constructs, the worst performer in the second half of 2011, a spokesman says, "It was very much a momentum-investor's market," and the momentum for some of its picks went in the wrong direction.

Behind the Lists

Chicago-based Zacks Investment Research compiles the data and then scores the brokers by keeping a running tally of each focus list for various periods over the past five years. In tracking brokers' best ideas, Zacks puts a stock in a theoretical portfolio when the broker adds it to its focus list, and takes it out when the broker removes it. While similar in intent, these lists differ in significant ways. For example, some are updated at regular intervals, but others can be changed at any time.

The sizes of most lists are flexible. Many include 20 to 40 names, but some, like Charles Schwab's, can run to 100. The smaller the list, the more exposed it is to one or two stellar or disastrous picks. With big lists, individual picks matter less, but it's tougher to beat the index because each stock is a smaller percentage of the portfolio. Some of our participants focus on large caps and others small- and mid-cap stocks, which over long periods tend to outperform big-caps.

Additionally, Zacks ranks the brokers' picks on an equal-weighted basis, while the Standard & Poor's 500 is weighted according to its components' market capitalization. As a result, brokers' results aren't strictly comparable to the S&P 500's. In order to help readers get a better perspective on relative performance, our tables show the S&P returns on an equal-weighted basis as well.

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