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Clear Reporting a Key for Hedge Funds Evaluating Stocks

Thursday, September 23, 2004
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NEW YORK (HedgeWorld.com) – About 20% of Rate Financial's clients are hedge funds, but the company expects the number to grow as equity hedge fund managers add the firm's services to their risk management regiment.

Long/short equity strategies, distressed debt and other U.S. equity-focused money managers more closely are monitoring the role corporate financial reporting plays in the overall equity markets, according to Victor Germack, founder and president of Rate Financial.

Rate Financial is finishing up reports on all the Standard & Poor's 500 stock index stocks, with reviews of more than 200 companies done so far. Some of those received a rating of one to two stars, a range that might signify a serious quality-of-earnings problem.

"We take out all the noise," Mr. Germack said of the service. Exploring beyond one-time gains and losses, Rate Financial's analyst team digs into the working capital and cash flows of each company. In too many cases, he said, no one looks at the transparency and completeness of company reports, yet these attributes can be a good indicator of how well a company is run, he said.

According to a study recently completed by Rate Financials, one-third of publicly traded companies that file financial statements do not accurately represent their financial conditions.

A detailed look of more than 120 companies in the S&P 500 shows that more than 30% had performed poorly in the area of reporting, harboring a high risk of existing or future financial problems and low overall quality of reported earnings. A total of 27% had aggressive revenue recognition techniques, while 48% had poor governance, Rate Financials found.

About 75% of companies used complex financing tricks to shift long-term financial obligations off their balance sheets. When added onto the balance sheet at a later date, such amounts can force significant shifts in a firm's debt-to-equity ratio. Such devices compounded with unrealistic pension plan assumptions can make for a dangerous combination, the study authors found.

Only 4% of companies were rated "outstanding." Included in that group were: BMC Software, Family Dollar Stores and Microsoft.

Ratings are based on a company's: quality of earnings; accounting policies; clarity and completeness of notes to their financial statements; management discussion and analysis; and governance issues.

A company is given a rating in each of the five criteria, and the scores are compiled to produce an overall risk rating. Back-testing of the firm's risk ratings has shown that highly rated companies have outperformed the lower-rated companies and also that these companies have had lower stock price volatility.

According to Fabian Babich, managing director at Rate Financials, a number of hedge funds have begun to build similar ratings systems. He said that his firm's services would cost hedge funds much less than if the funds built in-house stock analysis teams.