Equity analysts facing new quant challenge

Thu May 31, 2007 1:07PM EDT

By Dane Hamilton

NEW YORK (Reuters) - Wall Street equity analysts have had their share of problems in recent years, from regulatory heat to budget cuts to a loss of star power and prestige.

Now, with the growth of quantitative analysis, some are facing a worse possible fate: being supplanted by computers.

At an increasing number of Wall Street investment banks, hedge funds and elsewhere, computers are churning out investment analyses culled from enormous pools of data.

And some say they're more objective than human-based reports in determining which stocks, bonds or currencies to buy or sell. Increasingly, such programs are used to turbocharge traditional research.

"Given the same set of factors, it will always produce the same result," said quant industry veteran Tanya Beder of quantitative analysis. "Its signals are pure and systematic."

Beder, who built the quant trading division of top-performing hedge fund Caxton Associates LLC and was chief executive of Citigroup's (C.N: Quote, Profile, Research Tribeca Global Management in 2006, estimates that quantitative analysis and trading "drives one-third of the market" on any given day.

The trend has made quantitative specialists, or quants, among the most highly valued on Wall Street, with top players commanding seven-figure salaries, similar to stock analysts a decade ago.

"There's great demand for these rocket scientists," said Sandy Gross, managing partner at Pinetum Partners, a Greenwich, Connecticut-based executive search firm specializing in hedge funds. "They don't necessarily come out of financial services, but have a strong background in mathematics and statistics that can be applied to all asset classes."

Hedge funds, which are often early adopters of new investment methods, are spurring the development of quantitative strategies, which trade using mathematical, or algorithmic, models. Many such strategies were spawned at the internal trading desks at banks, notably Goldman Sachs (GS.N: Quote, Profile, Research.

"It's all about trying to create an artificial analyst," said a portfolio manager at a large quantitative hedge fund who asked to remain anonymous. "It may not do it as well (as a human analyst), but it makes up for it in terms of volume."

BUY OR SELL

Traditional fundamental analysis leads to buy or sell recommendations based on a security's price compared with the analyst's projections for earnings, cash flow, relative valuation to peers and other factors, including the personal judgment of the analyst.

Now complex computerized programs can do all that and more, including employing vast reservoirs of data on historic prices to project how stock, currency or other prices may move.

Overlay that security-specific information with macro-economic data, forecasts, demographics, industry statistics and other information, and you get a more efficient trading model, proponents say.

The evidence of quantitative success is exemplified by top-performing hedge fund groups D.E. Shaw & Co. and Renaissance Technologies Corp., which both were founded by former university math professors and hire heavily from the scientific community.

Such firms were never big users of Wall Street sell-side analysis, preferring to do their own. But the fact that leaders in the fast-growing, $1.5 trillion hedge fund industry don't rely on outside analysts is telling, experts said.

"It doesn't necessarily mean that Wall Street analysts are going to go out of business, but it does mean that there are other ways to be successful in identifying value," said Ron Papanek, director of strategy at RiskMetrics Group, a financial consulting firm.

"The mere fact that it's not only successful but represents the largest hedge funds tells you that this form of analysis has legs," Papanek said.

Brad Hintz, financial services analyst at AllianceBernstein (AB.N: Quote, Profile, Research, said quantitative hedge funds are only one factor that's eroding traditional sell-side research.

The biggest, he said, is declining trading commission rates at major Wall Street firms, which has forced them to cut costs and outsource research. Regulatory investigations into analyst conflicts, the technology stock crash and other factors also played a part.

Still, the commission revenue decline has caused major investment banks to boost resources to higher-margin quantitative trading and derivatives desks, further fueling the trend.

"There are lots of arguments as to why equity analysts are doomed," said Hintz.