THE 2011 ALL-AMERICA RESEARCH TEAM: BOUTIQUES

SMALL FIRMS, BIG AMBITIONS

The research boutique business model entices top-notch talent from bulge-bracket firms.

BY CAROLYN KOO

Edward Wolfe remembers how Bear, Stearns & Co.'s decision to merge derivatives coverage into its equity division wreaked havoc in his career as a publishing analyst. If Wolfe had a trip scheduled to present his research in Denver and Kansas City, he might well be told to cancel it and "instead go see one client who I'd never known was a client before but is a big derivatives client of the firm and wants to talk about one private name," recalls Wolfe, 45. "I had to change my whole day, and then I'm in debt to all those clients in Denver and Kansas City, and I'd have to make it up to them another day."

That experience encapsulates the challenges of being an equity research analyst these days at a bulge-bracket firm, he says. It's also part of the reason Wolfe left Bear Stearns in early 2008 — shortly before its forced merger with JPMorgan Chase & Co. — to start his own boutique. He had garnered quite a following by then, having appeared on the All-America Research Team ten times since 1999, including seven appearances in the winner's circle, in Airfreight & Surface Transportation and related sectors. He has continued to rank every year since launching his New York–based boutique and is the sector's No. 3 analyst this year.

In 2010, Wolfe welcomed as chief investment strategist his former Bear Stearns colleague François Trahan, then an eight-time veteran of the All-America Research Team who ranked six times in Portfolio Strategy (including four appearances atop the sector) and two in Quantitative Research; he finishes in second and third place, respectively, this year on behalf of Wolfe Trahan & Co.

Working at a smaller firm with a primary focus on research appeals to many top analysts, especially at a time of heightened regulation and increased collaboration among analysts covering various asset classes. When Wolfe started at Bear, in 1999, "you didn't have the bureaucracy of private client services that wanted your attention and compliance that wanted you in meetings all day, and you weren't being told by the product manager that you had to do this product with the rest of the industrial team," he says. "It was just getting to be very draining."

Jeffrey deGraaf can relate to that. A veteran of Merrill Lynch, Lehman Brothers and ISI Group, he launched his own New York–based firm, Renaissance Macro Research, in March. "In the big shops the reality is that the banking business and the trading business drive the direction of the firm and research is always considered a cost center," says deGraaf, who captures the crown in Technical Analysis for a seventh straight year and has appeared on the All-America Research Team 11 times since 2001. "We think it's important for our business to be run by research and research people, because that's what we do and what we focus on."

The 43-year-old likes the fact that the boutique approach allows him to provide an all-macro, all-the-time message. His firm holds a half-hour meeting every morning on macro-only issues, whereas "at the big banks you're given a three-minute slot, maybe five minutes, Monday morning. That's how you get your message out to the world, in that five-minute slot on a Monday morning."

Another advantage: Smaller firms don't usually suffer from the conflicts of interest that can exist at a large investment bank. "We're not trading, we're not handling anyone's money, we're not banking," says Jeffrey Sprague, who left Citi in February 2010 to start Vertical Research Partners, a Stamford, Connecticut–based boutique targeting capital goods companies. Sprague, 50, was inducted into the All-America Research Team Hall of Fame in October, having amassed 18 appearances on the team since 1994, including 11 times at No. 1 in Electrical Equipment & Multi-Industry and affiliated sectors. "When something happens we can respond immediately. We're not tied up in compliance reviews — are we doing an investment banking deal for this guy or that guy. Sometimes it's the next day, or maybe it's days — or weeks, in some cases, if somebody is truly restricted on the sell side — before the competition can even say anything," he adds.

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Chip Dillon, who worked with Sprague at Citi until 2008, when he moved to Credit Suisse, joined VRP in July. He has been voted onto the All-America Research Team 18 times since 1994 and has been top-ranked in Paper & Packaging and predecessor sectors eight times. He captures third place in the sector this year.

Analysts who leave big banks need not create their own operations or join start-ups; there are plenty of established specialty firms looking to acquire talent. James Crandell, who has made 21 appearances on the All-America Research Team since 1984 and led the Oil Services & Equipment sector eight times (he is currently ranked second), became global head of oil field services research at energy-focused boutique Dahlman Rose & Co. in New York in February.

"The way I want to organize things is different from the way most firms are organized," explains the former Barclays Capital analyst, noting there's a strict geographical division at many bulge-bracket firms when it comes to coverage, with analysts based in London covering only the European names, and so on. "I want to have everybody based in New York, and I want the same person to cover a particular subsegment of the industry, whether the company is based in Oslo or London or Brazil or New York or Houston. It doesn't really matter."

Crandell's plan is to build a team of four analysts and six associates — currently, the team employs two analysts and three associates — and to cover 80 companies, which is more than the 55 stocks BarCap's U.S. and European analysts track, he observes.

Sprague is embracing a similar global model at VRP and is adding coverage of European names. "I've known these companies for years, but I was never able to follow them because there was some guy sitting in London who did," he notes. "So what happens is your client at whatever buy-side firm has global responsibilities for the sector. If they want to talk to big bank X and get a global view, they talk to the U.S. analyst and the Europe analyst. As ironic as it sounds, we can have an edge with these international names by being small."

DeGraaf is thinking broadly too. In October RenMac announced that it is partnering with Scowcroft Group, an international business advisory firm managed by former National Security Advisor Brent Scowcroft, and eventually plans to add an economist and a Hong Kong– or London-based global strategist. The Scowcroft collaboration reunites deGraaf with his former ISI colleague Thomas Gallagher, who will provide political insights for the firm's macroeconomic research; Gallagher led teams that ranked 18 times in Washington Research, with nine appearances in the No. 1 spot.

Similar expansion is under consideration at Strategas Research Partners in New York, the macro research boutique Jason Trennert co-founded in 2006 after leaving ISI Group. "We don't have an analyst who's specifically focused on either Europe or Asia, although we're doing more and more work particularly on China and continental Europe," says Trennert, who has ranked in Portfolio Strategy six times since 2004. "That may be an area of growth for the firm."

Like many boutiques, Strategas saw an unexpected boost from the global downturn. Before the meltdown many investors "didn't feel like they needed to know a lot about money supply or the central bank or all of these things that we spend a lot of time on, but with the financial crisis some of those old lessons became important again," explains the 43-year-old.

The struggles many bulge-bracket firms experienced have helped make the boutique model more appealing, Wolfe believes. "Big banks are having a lot of turnover and a lot of restrictions and constrictions," he says. "People have been paid down and paid in stock that's worthless, and they're busy watching the new regulations and wondering if [the debt crisis in] Europe is going to affect their banks." At his firm "there can't be a mortgage issue or a derivatives issue or an issue where somebody else at the bank does something stupid and blows us up," he adds.

Jeff deGraaf (left) of Renaissance Macro Research and Tom Gallagher of RenMac's Macro Policy Team at The Scowcroft Group

Sanjay Sakhrani, who worked at Citi and Calyon Securities (USA) before joining New York–based financial services boutique Keefe, Bruyette & Woods in 2006, agrees that smaller can be better. "The business model is more simple here," says the 36-year-old, who debuts as a runner-up this year in Consumer Finance. "We're an advisory firm first. We do equity trading. We don't have a huge balance sheet where we're taking on a lot of risk, so I think that's helped in terms of the stability of the firm."

And because boutiques are more specialized, their clients tend to be more specialized too — and more knowledgeable, analysts say. For example, at a larger platform like Citi's, "there is definitely a second audience that you have to consider. We had a big retail distribution, so we had to be able to be more clear and concise in the way we explained things to the broad-based audience," recalls Sakhrani. At Keefe Bruyette the audience is "institutional investors, for the most part, and they are more familiar with the language."

There's also an opportunity to spend more time with clients. "I have great knowledge now of every single customer — who cares, who needs my time," says Wolfe. "We've really been able to focus on the client in a way that we've never done before and weren't able to do at the large banks."

There is a downside to having a smaller team, however. "There are certain big firms that are just not doing business with us because they require a broad research effort that we don't have," observes Crandell, 58.

Even so, with the smaller firms' focus on research, there's also an ethos that's a counterpoint to what's happening at the big firms. "There's a certain nostalgia for the way Wall Street used to be in terms of its role of acting as a fiduciary," explains Trennert. "We're providing research to the benefit of the client. Sadly, I think that in a lot of large investment banks and public companies, that idea has unfortunately been lost." ●●