HILLCREST ASSET MANAGEMENT

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The Next Step in Behavioral Analysis: The Hillcrest Management Sentiment Indicator

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"But reason always cuts a poor figure beside sentiment; the one being essentially restricted, like everything that is positive, while the other is infinite."
- Honore de Balzac

We recently read a presentation by a well-known behavioral portfolio manager. This manager has been involved in behavioral finance for many years and is an undisputed expert in this field. What struck us was that the presentation was virtually unchanged from ten years ago. When we talk to prospects, many want us to explain our behavioral "model". We let them know that behavioral insights are not just a series of models, but an approach to investing that starts with philosophy, permeates stock selection and continues all the way to portfolio construction. The only specific behavioral sentiment models that have been developed, earnings revision and earnings surprise, have been with us for many years. (For a history, see Brian's book *Analysts, Lies and Statistics*, co-authored with former Harvard professor Mark Bradshaw). That has now changed. Hillcrest is at the leading edge of the newest innovation in behavioral portfolio management, the use of non-database information to create indicators of sentiment. A leading data vendor has begun to use this approach with news feeds. Hillcrest is now using this new approach by utilizing a proprietary analysis of the sentiment of the management team of each company.

The quest for an accurate understanding of all types of sentiment has long been an alluring goal of investors. Whether a company is cheap or expensive, growing or declining, sentiment is a prominent determinant of the direction of stock prices. An accurate analysis of sentiment can make or break an investment strategy. Our desire at Hillcrest is to determine the sentiment of investors outside the company, as well as the more elusive sentiment within the company.

Since Doug and Brian built the first global earnings revision models at State Street in the early 90's, earnings revision has become a factor in virtually all model-driven strategies. This model is the most popular method of determining investor sentiment. No new behavioral sentiment indicators were created until recently. A recent study published by UBS, "Online Search Frequency, Information Asymmetry, and Market Liquidity," uses a new sentiment tool from a leading data vendor. According to the data vendor, their new tool analyzes news providing improved buy/hold/sell signals within milliseconds of the news event. They anticipate that users will be traders, market makers and quantitative hedge funds. The problem with news sentiment indicators is the ever changing nature of news, which can turn from positive to negative multiple times daily. Using this type of factor would cause significant turnover in a portfolio. Hillcrest believes it is impractical to incorporate such short-term information into a long-term strategy, such as Hillcrest's, that has a holding period measured in years.

Hillcrest Research into Internal Company Sentiment

Our goal when starting this research was to find a method of measuring the highly elusive sentiment within the company, or, to put it in the format of a question: do the people working there have a strong belief in their products, personnel and leadership? Without working at a company, it is difficult to ascertain the morale of the people developing, producing and marketing the products sold. But, as any reader of the Dilbert comic strip knows, the morale of the people working at a firm is one indicator of its long-term success or failure. And, it is the long-term results in which we are interested.

Finding a source of insight into companies led us to considering Earnings Call Transcripts. The transcripts had all of the necessary ingredients: transcripts are produced on a consistent basis, follow a standard format (review of financials, new products, problems and Q&A) which allows for comparison between companies, and were not over-analyzed by the investment community.

For our initial investigation, we created a proprietary scoring system to compare the number of positive phrases in each Earning Call Transcript to the negative phrases. Companies where the executives were nervous, apprehensive or concerned have a higher percentage of negative statements. Text reading transcripts was showing positive results, when we discovered, because of exposure to academic papers and actually reading the transcripts, a way to know when management has information they are not sharing. .

The Art of Deflection

One of our favorite quotes is, "Never answer the question you are asked, answer the question you wish you were asked." Our business leaders did not get to the top of the business world without being able to deftly focus on those aspects that make them look good.

The second phase of our research focused on determining when the managers are consciously or subconsciously hiding lingering doubts about potential problems. Whether these are problems such as an inventive new competitor, or an internal problem that they hope will find a solution by the next quarterly report, they don't want to talk about it so they hide it by talking about something positive. To determine if we could find these situations, we developed "Deflection Phrases;" where the manager is deflecting attention away from something they don't want to talk about, or deflecting blame so that they will not be implicated. Below are some samples of Deflection Phrases, as well as Positive and Negative Phrases.

Sample Word and Phrases Used in Earnings Call Analysis

Positive Phrases	Negative Phrases	Deflection Phrases
Great	Collapse	Unexpected
Innovation	Breakdown	Mostly Positive
Leading Edge	Decreasing Market Share	Do Not Wish to Comment
Profit Growth	Below Expectations	Previous Management Policies

The Deflection Phrases fall into two major categories. The first is the use of qualifying statements: things aren't described as simply "good" they are instead described as "mostly good". These qualifiers allow management to focus on the "good" while ignoring the parts that don't qualify as "mostly". Of course as investors we are interested in the information that management is ignoring. The second category of Deflection Phrases is blame avoidance, where management has lingering doubts about the future and is trying to limit the amount of blame that is attributed to them personally. In blame avoidance, you see such words as "unexpected", which we translate into "it is not my fault, it was unexpected".

Deflection Performance

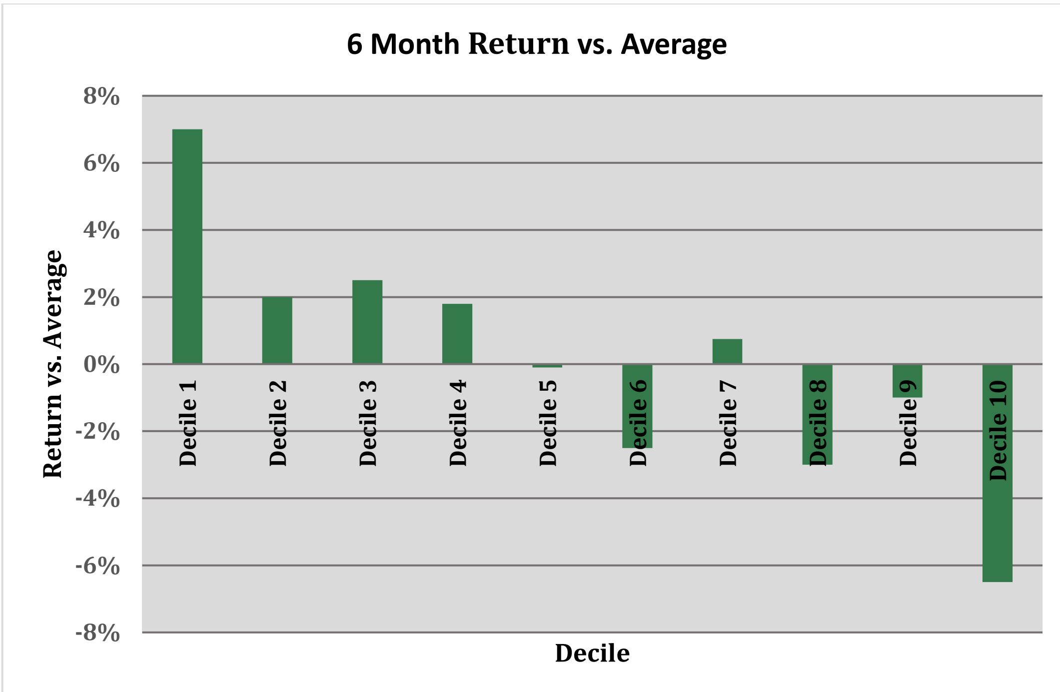
Deflection Phrases, by their very nature, are expected to have significantly more power on the downside than the upside. At Hillcrest, we expect that because Deflection Phrases look for unseen problems that have not surfaced, the returns will be delayed into future quarters as the problems start to become noticed. This delay is perfect for our long-term investment strategy. The results of our research confirms what we expected, as is shown in the following graph which looks at the bottom two deciles (the worst scoring companies in our Deflection Score). The data continues to show power, even 12 months after the Earnings Call Transcript was analyzed.

Hillcrest Deflection Score - Performance of Bottom 2 Deciles

Source: Hillcrest Asset Management

Our analysis of the informational value of analyzing Management Sentiment is shown in the following graph. Our Management Sentiment Indicator shows power in both finding companies that will outperform, as well as companies that have potential problems and should be avoided.

Hillcrest Management Sentiment Indicator



Source: Hillcrest Asset Management

Our Hillcrest Management Sentiment behavioral factor confirms our belief that analyzing earnings call transcripts is a profitable way to determine the internal sentiment within a company, and that sentiment provides evidence of future returns. At Hillcrest, we continue to look for ways to exploit our unique knowledge of behavioral finance and the cognitive decision biases that affect executives, analysts and money managers. We use this information to make constant improvements to our investment process.

We have done significant back-testing of our behavioral ranking system with the Hillcrest Management Sentiment Indicator included as part of our Sentiment ranking. We have found that it adds value to both positive sentiment stocks and negative sentiment stocks. In its current form, it has proven especially useful in guiding us to avoid companies where management has negative information that is not yet visible in the financial data or the analyst estimates.

We have just skimmed the surface of this fascinating new sentiment tool and look forward to providing you with ongoing updates from our research over the next few quarters. We are available anytime to talk more in depth about how we can help you solve your investment problems.

References

Bruce, Brian R. and Mark T. Bradshaw. *Analysts, Lies and Statistics*. New York: Institutional Investor Books, 2004.

Brian R. Bruce, CEO and Chief Investment Officer

Brian is the CEO and Chief Investment Officer of Hillcrest and oversees all business and investment activities at the firm. Before founding Hillcrest, Brian was Chief Investment Officer in charge of equity management and research at PanAgora Asset Management. Previously, Brian was President and Chief Investment Officer of InterCoast Capital and worked at State Street Global Advisors, the Northern Trust Company and Stein Roe & Farnham. Brian received an MBA from the University of Chicago, an MS in Computer Science from DePaul University and a BS in Business Administration from Illinois State University. He is a member of the Illinois State University College Business Hall of Fame and is a recipient of the University of Chicago's Graduate School of Business CEO Award. Brian has published numerous scholarly articles and books including *Analysts, Lies, and Statistics*, which he co-authored with former Harvard Business School professor Mark Bradshaw. He is also the Editor of the *Journal of Investing* and the *Journal of Behavioral Finance*.

Douglas E. Stark, Managing Director, Portfolio Management and Research

Doug is a partner at Hillcrest and focuses on the firm's research and portfolio management. Prior to Hillcrest, he was a Partner, Senior Vice President, and Director of Research at Martingale Asset Management. Prior to joining Martingale, Doug was a Senior Vice President and Portfolio Manager at InterCoast Capital Company, where he developed a stock selection strategy and created a risk management process for an active U.S. equity portfolio, an active international portfolio, and an emerging markets portfolio. Doug started his career at State Street Global Advisors in 1990, where he was a Vice President and managed international stock portfolios and active currency overlays. He received an MBA in finance and international business from Columbia University, where he graduated with honors, and a BS in Business from Arizona State University. He is a CFA charterholder.

About Hillcrest Asset Management

The Hillcrest Portfolio Team utilizes their combined behavioral finance expertise to create all client portfolios. Hillcrest remains guided by a fundamental belief that stocks deviate from their fair value due to behavioral biases and stocks follow the behavioral cycle of stock movements. We combine model-driven behavioral analysis with traditional fundamental research to build on the strengths of both approaches. Our goal is to add value equally through both behavioral models and fundamental stock research. Results reflect Hillcrest's expertise in successfully utilizing these concepts in the portfolio management process.

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