A Level Playing Field for Investment Research?

Challenges facing the buy-side, sell-side and independents

Jane Fuller

Euro IRP
The European Association of Independent Research Providers

CSFI
Centre for the Study of Financial Innovation

C S F I / New York CSFI

The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field – particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open markets.

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Foreword

Euro IRP – the European Association of Independent Research Providers – broadly supported the reforms of MiFID II. However, throughout the MiFID II consultation process we have expressed concerns about the unintended consequences of these far-reaching changes. The conclusion from this thorough report – by an independent body with the stature of the CSFI – that the playing field may not be level for some time, should cause concern for regulators, asset managers, independent research providers and the end investor.

While MiFID II has clearly been driving headline research prices down for asset managers, predatory pricing, continuing cross-subsidy of investment banking research and the related conflicts of interest undermine one of MiFID's goals: to ensure a fairly priced and transparent market for research in order to improve investment outcomes.

In the short term, asset managers need to ensure they are not creating potential compliance and performance liabilities for the future. As banks race to the bottom on the pricing of written research – using premium-priced access to analysts and cross-subsidies from other activities – objective and thoughtful written research could become scarcer. Buy-side clients will ask of bank research: who else is footing the bill? Is it an inducement? Have you resolved your many conflicts?

As the price war rages, the flight to quality in investment research has yet to play out. MiFID II will ultimately lead asset managers to reflect more fully on what they need, what they value and what they will pay for. Our clients know the value of objective and independent research, and they see independent providers as partners – critical elements in their decision-making processes. Those asset managers that value rigour and objectivity will continue to access best-in-class research. We are here to help them through this process.

At Euro IRP, we are optimistic about the medium-term prospects for independent research. This report rightly highlights both the short-term challenges and the future opportunities for our sector. Despite the lack of a level playing field for research, and the stubborn persistence of conflicted research, we are positive that independent firms, working in partnership with our clients, will play a key role in providing objective insights, fresh thinking and assistance in generating ideas and ensuring transparent business models. Together, we need to ensure that the market we are creating serves the end investor and not the old vested interests.

Chris Deavin
Chairman, Euro IRP

The European Association of Independent Research Providers represents the interests of independent investment research firms which are based in Europe or which have clients or activities in Europe. It was founded in 2005 with the following four goals:

- To enhance the awareness and reputation of independent research
- To change the perception that research is free
- To work with regulators and investors to promote the awareness and acceptance of payment structures
- To improve the regulatory and fiscal environment in which independent research firms operate

C S F I

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A Level Playing Field for Investment Research? Challenges facing the buy-side, sell-side and independents

By Jane Fuller

Preface

This is the third report that the CSFI has carried out into the market for investment research. The first two (in June 2011 and November 2012) were written by Vince Heaney and they focused on the emergence of the independent research sector. This is written by my colleague, Jane Fuller, who spent 19 years at the *Financial Times*, latterly as financial editor, before joining the CSFI. It takes a wider view of the research industry, focusing in particular on prospects for making research provision a more 'normal' industry.

I want to emphasise that this is a CSFI report. We are enormously grateful to Euro IRP for its support, both moral and financial. But we are also grateful that Euro IRP allowed us to write what we wanted and to draw conclusions that, in some cases, may make uncomfortable reading for independent research providers. As Jane's report makes clear, the sector was facing considerable challenges even before MiFID II rose up out of the Brussels fog; now, things may well be even more difficult – at least in the next couple of years.

The problems are not limited to independent providers. There is a wider issue of downward pressure on asset managers' fees and on dealing commissions which will hit everyone. But the fact that there are clear conflicts of interest when research providers also serve corporate clients and run trading desks means that there is an obvious need for a robust (and profitable) independent sector. There is also a need for greater transparency when it comes to fees – and, here, the independent sector clearly sets the pace.

In the medium term, we are confident that the best independent research providers will survive – indeed, thrive. But the next couple of years may be tough, and the independent sector may well not find itself on the level playing field that the authorities want - and that MiFID is supposed to provide.

I think this is an important and timely paper, and I am delighted that we have been able to publish it. I am also immensely grateful to Jane for all the work she has put in, and for her wide knowledge and wise judgement.

Andrew Hilton
Director
CSFI

Introduction

This report is prompted by regulatory changes in the market for investment research that come into force in January 2018, under the Markets in Financial Instruments Directive of 2014, MiFID II. As with previous CSFI reports in 2011 and 2012, which focused on the emergence of an independent research sector, structural change in the industry is just as important as the new rules. Both the consumers of research – asset managers – and the producers of it – investment banks/brokers and independent firms – have experienced much more than cyclical pressure in the wake of the financial crisis. Independent research providers (IRPs) have established themselves, but are not immune to the upheaval.

MiFID II completes the separation of trading from research

MiFID II both completes the separation of payments for research from trading fees and insists on it being priced. The aim is to combat the perception that research is provided by investment banks and brokers to asset managers as an inducement, or bribe, to trade with them – and to over-trade. Detailed requirements have helped tip the balance towards asset managers paying for external research as an operating cost, rather than passing the charges on to asset owners alongside trading fees.

The industry environment in which these changes are taking place is harsh. Nearly all the pressures are downwards: banks have been cost-cutting to restore profitability; low interest rates have depressed savers' returns; criticism has mounted of asset management charges; and so have doubts about the value of active investing compared with the much cheaper passive approach.

What sort of market will emerge now that regulators have insisted that (a) payments for research are fully unbundled from trading and (b) asset managers control this cost rigorously? Overall, the aim is that research should be bought because of the value it adds to investment decision-making on behalf of hundreds of millions of savers across the European Union. This should take place in a "normal" market, with research priced transparently and fair competition between providers. Legacy arrangements and relationships, plus some conflicting US regulation, are among the obstacles to be overcome.

The CSFI's previous reports, *Has Independent Research Come of Age? (2011)* and *Independent Research: because they're worth it?"* found that this sector had reached viability in a niche (or a series of niches spanning the investment process). It was valued for its independence, but it faced an unlevel playing field both because its competitors could cross-subsidise research from banking and trading activities, and because the definition of research allowed commissions to be spent on corporate access. The Financial Conduct Authority (FCA) clamped down on the latter being defined as research, although it can still be procured.

The first two chapters of this report look at the regulatory catalyst for the next wave of change and the market trends that provide the context. The next three chapters are based on interviews with about 20 senior people from the buy- and sell-side, independent firms and regulators. They cover their experience of the past 3-5 years; what they think the main drivers of change are; how research is – and should be – paid for and valued; and what they foresee over the next five years. For convenience, a summary and the conclusions come first.

Terminology and the industry eco-system:

The asset management industry is also known as the **'buy-side'** because it decides what to invest in, which entails buying equities, bonds etc to populate the funds that make up their clients' investment portfolios. It manages the investment process from macro-level asset allocation to micro-level stock-picking. To support its internal operations, it buys in market information, software and research. Asset managers pay for external research either directly as an operating cost (like rent and media subscriptions), or indirectly via dealing commissions collected on market transactions.

The investment banking/broking industry is also known as the **'sell-side'**. It acts for companies and other issuers of equities and bonds, advising on fund raising and marketing the stock. It also employs the traders (mostly automated systems) that execute a myriad of daily transactions in the equity and fixed income, currency and commodity (FICC) markets. Like journalists, but far from all investors, it thrives on activity. Research is paid for via the dealing commissions that the sell-side collects, which are then split between trade execution and research.

There is some buy/sell-side blurring. The insurance element of the European banc-assurance model, for instance, acts as a buy-side institutional investor. In universal banks, investment banking and broking can sit in the same group as asset and wealth management subsidiaries.

Research paid for by dealing commissions

Independent research providers, or IRPs, are standalone research firms, owned by neither buy- nor sell-side. Their clients are mainly asset managers and their USP is their independence, which avoids the conflicts of interest that come with serving corporate clients. They receive most of their payments directly, in the form of subscriptions, payments for bespoke research and consultancy, although some receive a sizeable amount via dealing commissions. The sector is fragmented – the research ranges from macro to micro and includes technology-driven modelling and analytics. Most are niche operators. The advantage is their focus and depth of knowledge; the disadvantage is the lack of diversified revenues and of a big balance sheet to tide them over in tough periods.

Summary and Conclusions

Conditions created for a price war

The short answer to the question of whether MiFID II will level the playing field for the providers of investment research is: not much, initially. The conditions for a price war have been created by an over-supply of research and by asset managers' desire to cut costs. Incomplete pricing information and imperfect ways to assess value are causing anxiety about predatory pricing and unfair competition.

MiFID II does, however, help create the conditions for a more normal market for research after the initial upheaval. The normality will come from transparent pricing of different types of research service, so that asset managers can rationally weigh up price versus quality, with the latter firmly focused on the contribution to investment decision-making.

Fair competition is more difficult to achieve because the players are intrinsically different. Sell-side research has the support – call it cross-subsidy – of other investment banking/broking revenues, but conflicts of interest and heavy compliance costs go with the territory. The USP of independent firms is their independence and uncompromised specialist knowledge, which enables them to focus on the buy-side's needs. But their resources may be limited.

These competitors, along with consultants and other information providers, have different business models. MiFID II will concentrate asset managers' minds on choosing the best sources of information, analytics and advice from top to bottom of the investment process. That will be as level as this playing field can get.

Regulation

Previous reforms led to soft unbundling

Regulation has long played a central role in the market for research, linking payments for research to trading fees and allowing them to be passed through to clients on top of the annual management charge. Previous reforms have focused on transparency, leading to the 'soft' unbundling of execution and research via commission sharing arrangements (CSAs). MiFID II promotes a hard version, whereby asset managers either pay directly for research, or agree spending up front with their clients and run it through research payment accounts (RPAs). Complex rules surrounding RPAs essentially sever the trading link. This means:

- Payments for research should no longer be influenced by trading volumes. The key consideration is whether the research service aids investment decision-making.

- Many asset management firms have decided to pay for research directly, as an operating cost (see Appendix II for the Financial Times list). The regulatory complexity of RPAs has helped prompt this.

- Asset managers are in the driving seat. They will scrutinise not only the cost of external research but also the quality of the service bought in.

- To do that, research needs to be priced transparently and coherently. Both are incomplete: the former because of insufficient breakdown of sell-side services; the latter awaits a shake-out of the over-supplied market.

Market context

Asset managers decide to pay for research directly

Compared with the roughly $70 trillion of global assets under management, spending on external research is a tiny fraction of a percentage point. It may be material in terms of asset managers' profit/loss accounts, but by no means big enough to prevent absorption into the P&L of the average firm.

Commission revenues and sell-side head count have been shrinking for years. This is linked to declining revenues in cash equities, yet that market segment is dwarfed by activity in fixed-income, currencies and commodities. Demand for external research in these markets focuses more on macro-economic and geo-political themes and risks. A model of direct payments, notably via subscription, already exists but its extension under MiFID II is leading to fierce price competition between research providers.

The European market for research, measured by its share of commission payments, is estimated at $3bn-$4bn. Independent research providers (IRPs) have a small slice of this, although the sums involved may well be significant for individual firms. IRPs earn the majority of their revenues directly from subscriptions, bespoke research and advisory or consultancy fees.

- This report strongly supports the move by asset managers to pay for research directly, out of their own P&L accounts. This is a crucial step towards establishing a normal market.

- However, a normal market is not the same as a level playing field. It is "normal" for an over-supplied market to see intense price competition.

- IRPs are relatively well positioned for MiFID II because they already price transparently and are often paid directly.

- Their chief concern as competition intensifies for all types of research – macro-economic and fixed-income as well as equities – is that their sell-side rivals will continue to be cross-subsidised by corporate and trading income.

Structural pressure on asset managers

Regulatory change is coinciding with structural pressures on asset managers, exerting downward pressure on their fees. These include the switch from research-intensive active investment towards the much cheaper use of passive, index-tracking, funds. Charges for active investment (still the approach adopted for the majority of funds) are also under pressure from regulatory scrutiny, notably the FCA's critical Asset Management Market Study. These pressures have created conditions for consolidation of the industry – witness the Standard Life Aberdeen combination.

- Nervousness ahead of MiFID II's implementation centres on the assumption that the squeeze on asset managers' fees and profit margins will lead them to cut spending on research, further fuelling price competition between providers.

Profit squeeze will lead to cuts in research spending

- Since the unbundling of research budgets from trading fees is newer to continental Europe than the UK, there could be fresh opportunities to bid for business there. The difficulty lies in attempting to do this as asset managers are cutting their lists of research suppliers.

- To attract attention from potential customers, the fragmented independent sector needs to raise its profile – a challenge for both individual firms and the European Association of Independent Research Providers (Euro IRP).

The past 3-5 years

Interviewees for this report observed that payments for research had already fallen due to doubts about active asset managers' performance and "passivisation". In the UK, prompted by the FCA, asset managers have largely unbundled research from execution.

- The buy-side is managing spending on external research more rigorously.

- Over-capacity is a feature of the research market eg only 5% of reports received are read, while more than 40 analysts cover the biggest companies.

- Cross-subsidies of research on the sell-side may enable these providers to undercut their rivals and to sustain losses in the cause of gaining or keeping market share.

- While sell-side research teams have the balance sheets of diversified groups behind them, IRPs may have less ballast to weather a price war.

Another feature of the past 3-5 years is the growth of the "issuer pays" (a non-independent) model for research on smaller companies. Whether it be Edison, which specialises in commissioned research, or smaller brokers such as Numis Securities, opportunities to serve neglected companies have increased. The question is to what extent the buy-side will be prepared to pay for alternative, independent views.

Market will be just another set of direct costs

The market for research is moving away from payments linked to dealing commissions and towards the direct purchase of services that feed into investment decisions. Once absorbed into asset managers' accounts, the "research" market will be difficult to measure. It will be just another set of subscriptions, consultancy fees and ad hoc payments.

How should research be paid for?

In a normal market, research would always have been an operating cost for asset managers. The first question would be: 'how much do we spend in-house and how much do we buy in?' In the 'new normal' market, the more respected the individual experts, the more bespoke the content or the more limited its availability, the more it will cost. Freely available information may qualify for MiFID II exemption as a "minor non-monetary benefit". But if valuable resources have been employed to provide free or low-priced research, it could fall foul of the directive.

In any case, research is never really free. Asset managers already pay for it via CSAs and direct payments. Research that appears to be free, in that it is unsolicited, is paid for mainly by banks/brokers' corporate clients and by trading. This output will be curbed by MiFID's anti-inducement thrust since recipients must assess its value and either pay for it or turn it away.

- Asset managers will focus on the balance between internal investment in research and spending on external sources. Where they are rationalising, opportunities could be created for external providers.

- The most expensive research will entail access to the leading analysts in the field. But this is unlikely to cost $5,000 an hour, as reported for some opening negotiations. More likely, such access will be part of a premium service.

Access to analysts part of premium service

- Annual subscription levels will range from thousands to millions of dollars, depending on the range of assets and sectors covered and whether access to analysts is included. But the bigger amounts will be subject to breakdown as asset managers use pricing information to choose different providers for different purposes.

- Free, or unsolicited, material will still arrive – or be accessible – because issuers will use the loophole that exempts generally available material. This could apply to economic and political commentary, or to reports on the small- and mid-cap sector paid for by those companies.

- Macro-economic and top-down market research is experiencing intense price competition as some investment banks offer commentary at a low price, or even free. If valuable resources are employed to produce it, however, this may breach ESMA's implementation rules.

- As the buy-side cuts costs and the sell-side fights for market share, there is a risk that predatory pricing could threaten the viability of some research providers, including independents.

How might research budgets be cut?

Intense price competition for top-down research

One way to reduce spending on external research is to limit the number of suppliers. A few big continental asset managers have announced they will halve their lists. The fear among smaller research providers is that the cuts will be indiscriminate – driven by finance directors rather than fund managers – and that the "tail" will be easier to cut than the "bulge bracket" providers.

The counter arguments include:

- The axe will fall on previously unsolicited material and "me too" commentary, as it should. Some free or cheap suppliers will be cut because their service looks like an inducement.

- Budgets can be cut most easily by reducing the number of high-cost providers and negotiating the largest bills downwards.

- Asset managers with healthy profit margins can afford their current research budgets.

- Since external research costs were previously passed on to clients, a dramatic cut would imply previous over-charging.

The danger is that in the time it takes for prices to stabilise and for "bad competitors" to drop out, some smaller firms will go to the wall. However, assuming asset managers do not turn into dumb organisations that know the price of everything and the value of nothing, price will not be the over-riding factor in deciding who wins research business.

Forms of payment

This report supports the move to P&L absorption of research costs:

Subscriptions have many advantages

- Some CSAs will become RPAs, but the MiFID II red tape is designed as a disincentive. RPAs will gain some traction where they solve the clash with US regulation or tax issues.

- Subscriptions have many advantages as a form of payment: they are agreed up front and predictable. They are the main form of payment for IRPs.

- Ad hoc payments (expertise x time) will include bespoke research and consultancy for specific projects.

- Distribution channels have multiplied, via new platforms and stock exchanges. This has added ‘pay per use’ as another option for the sale of research.

How should research be valued?

How can quality be assessed? The 2012 CSFI report thought alpha capture systems (measuring whether trading ideas pay off in a limited time frame) might offer a way to measure value added. But these systems have not captured a significant market share because many investors have a medium to long-term view, and most investment decisions require a variety of internal and external inputs.

The broker-vote system has provided a means to assess quality, but regulators do not like its non-monetary and retrospective nature, or its link to trading commissions. MiFID II will help focus evaluations on the contribution made to achieving asset owners’ objectives.

The buy-side wants less noise

The buy-side wants less noise around news announcements and more ideas about where to find value over the next two years, or more. Independence is important but it must add to the depth of knowledge and variety of opinion. There is evidence that active management, including stock-picking, can add value – but not at historic fee levels. Asset managers are wary of ‘buy’ recommendations: the surfeit of ‘buy’ over ‘sell’ notes is a reminder of the conflicts of interest in banking/broking research.

- It is not feasible to put an exact monetary value on the ‘success’ of many research ideas.

- However, the buy-side will monitor how ‘calls’ turn out, as well as recognising contributions to investment decision-making.

- The detachment of research from trading will help switch attention away from instant news reactions and towards multi-year views.

- Independence is important but so are stimulating opinions and original analysis based on deep sector knowledge.

- The buy-side makes the investment decisions: recommendations are of limited value, especially if from analysts connected to the stock.

- One way of mitigating sell-side conflicts is to put research at arm's length via a joint venture (eg Exane BNP Paribas).

The next five years

The next 1-2 years will be tough.

Asset managers are in the driving seat, but they are experiencing downward pressure on fees and margins, and sector consolidation. Coupled with MiFID II, this will make them difficult customers and there might be some indiscriminate cutting of research budgets and research providers.

Excess supply fuels price competition

Over-supply has led to forecasts of further cuts to sell-side research teams, but meanwhile excess supply will fuel price competition. The trigger for retrenchment is likely to be falling returns on equity, leading investment bank boards to challenge the wisdom of carrying expensive teams of analysts.

The shake-out may lead to some buy- and sell-side leavers joining the ranks of the independents. Not all will survive – and there could be consolidation of this segment too.

- Regulators will receive complaints about predatory pricing. A key point will be whether the output qualifies as a minor non-monetary benefit. The argument will be 'no' if valuable resources are allocated to producing it.

- Competition may also be threatened, eg if independent firms are driven out of the market. But regulatory action will take time as evidence needs to be gathered.

The 3-5-year outlook is better

Once asset managers use the new pricing information to deploy budgets more discriminately, spending on external providers could rise. Price transparency will make the playing field more level, but this does create losers as well as winners. The pluses are:

- The buy-side will be choosing providers on the basis of the value they add to investment decisions.

Cross-subsidies will not disappear

- This will help IRPs to compete in a market no longer distorted by trading volumes.

- Sell-side research providers that lose market share are likely to refocus on strengths in corporate banking and trading. Those that remain should price their research on more of a standalone basis, leading to fairer competition.

- Helping asset managers make better decisions is easier when there are no conflicts of interest.

- All will stand or fall on the quality of their people and their service.

Cross-subsidies will not disappear altogether because research teams have internal value for banks and brokers. Yet, the research skills needed to support corporate finance and trading are not the same as those required to serve asset managers in their investment decision-making.

The end-game is a 'normal' market where asset managers buy research, which is priced transparently, in the same way that they do other professional expertise. Importantly, savers will get better value for money, especially where a premium is charged for active investment.

Other opportunities for external research providers

Research to be bought like other professional services

<u>The sell-side could become a customer</u> for, or distributor of, independent research. One example would be for thematic research aimed at FICC investors. Or, a provider pulling back from waterfront coverage might seek to plug gaps in content. This could look like a revival of the bulge-bracket distribution of independent research ordered by New York Attorney General Eliot Spitzer's 2003 Global Analyst Research Settlement.

<u>Coverage of smaller companies</u>: if international firms pull back from this sector, it leaves a gap to be filled not only by more focused banks and brokers but also by IRPs. For investors with a long-term horizon, liquidity is less of an issue, and original investment ideas are more likely to be found here than in the heavily analysed large-cap segment. There may even be scope to extend coverage to private companies.

Technology-led investment still needs research – witness the rise of quantitative analysis. As ETFs (exchange-traded funds) become more sophisticated, their design requires research to work out, for instance, which factors to incorporate in a value screen for “smart beta” products. Index providers need research to support definitions and methodology.

Join forces with other independents. The Redburn and Wolfe Research umbrella business models support analysts across a range of sectors. This allows economies of scale in shared costs and for much-needed profile-raising. Such a model, or looser partnership, can combine macro and micro research – very helpful in cyclical sectors such as banks. There may be scope for further mergers of IRPs, as with the 2016 combination of Trusted Sources and Lombard Street Research to form TS Lombard.

Quality of service will be crucial

FICC research, like asset allocation and market strategy, lends itself to subscription-based purchase of macro-economic and themed research, as well as market data analysis. While pricing of FICC research may be particularly competitive initially, asset managers will continue to seek a range of opinion, coupled with access to experts. Again, quality of service will be a crucial factor in research providers’ ability to charge a premium.

Chapter 1: Regulation

> *"The review recommends that it is good practice for institutional investment management mandates to incorporate a management fee inclusive of any external research, information or transaction services acquired or used by the fund manager rather than these costs being passed on to the client."*
>
> *Myners Review of Institutional Investment in the UK (2001)*

'An industry born of regulation'

If you were devising a market for investment research, you would not start with the one that grew up in the last century and persisted into this one. It would be, as Paul (now Lord) Myners, indicated, more logical for asset managers to incorporate the cost of research into the annual management charge. Internal spending on research is covered by that charge, but legislative and behavioural incentives have conspired to link spending on external research to trading.

As a report on *"The future of Equity Research"* (October 2016), by research firm, Edison, Frost Consulting and Bloomberg Intelligence, said, this is "an industry born out of regulation". The 1934 Securities Exchange Act provided a safe harbour from breaches of fiduciary obligations if equity commissions were used to purchase both execution and research services. This has provided a lasting incentive to ensure that these payments can be seen as 'ancillary to trading'. In the UK, before the Big Bang de-regulation of 1986, execution fees were fixed, so a key way for stockbrokers to differentiate themselves was via the provision of research. The practice of collecting payments for research as part of dealing commission became embedded.

Continuing incentives for this include that asset managers can pass on dealing costs to clients, who – in Europe at least – have not scrutinised this additional bill in the way they do the annual management charge. And barriers to unbundling remain: in the US direct (hard dollar) payment for research amounts to procuring investment advice, so the provider needs to be registered as such and subject to the related rules. VAT is not payable on fees linked to financial transactions, but it is on the direct provision of research services.

VAT payable on direct provision of research

The use and abuse of 'soft credits'

As a convenience, collection of payments is easy via transactions. Requirements for 'best execution' have enabled the non-execution commissions, mainly for research, to be identified and put in a separate pot. Commission sharing arrangements (CSAs), or client commission arrangements (CCAs) in the US, have allowed the pots for research to accumulate at the collecting houses, with the asset manager periodically asking for the funds to be distributed to its preferred research providers.

Amounts in excess of execution costs are also known as ‘soft credits’. Regulators have relied on disclosure of the sums involved and the way they are allocated to enable the clients of fund managers to judge whether their money was being well spent. US asset owners have been more active scrutineers than those in Europe.

But the system has been prone to abuse, lack of transparency and complexity. Abuse has included the way soft credits have been utilised: from the provision of computer hardware in the 1990s to the more recent controversy over payments for access to company executives. Conflicts of interest have included investment banks using research analysts to drum up support for IPOs or, more generally, the incentive for research ideas to stimulate trading rather than offer more fundamental analysis.

Short of misuse, the process of building up credits and then reclaiming or re-allocating them has spawned complex mechanisms such as ‘commission recapture’ and ‘directed commissions’, and now CSAs and CCAs. While the administration of those accounts might be relatively easy, the system by which asset managers have divvied up the pots – mainly via the broker vote – has remained difficult to follow.

FCA’s doubts about broker votes

On average, IRPs' fees lower than banks'

Asset managers employ the broker vote to rank research providers: the higher the ranking, the greater the allocation from the CSA pot. But the FCA has continued to be concerned (see DP 14/3, July 2014) that “broker vote processes often lacked detail in recording what the fund manager was valuing when voting for a particular research provider… [A]broker could provide the same research in two periods and receive the same amount of votes, but be paid a different amount because trading volume had varied.”

The FCA found that while asset managers were requesting more detail over the price of research, “most brokers appeared to be unwilling or unable to provide this, which hindered the price formation process”. Brokers were instead insisting that a minimum amount of commission had to be paid to gain access to written research, with tiering of additional services also linked to trading revenues.

IRPs have supplied a pricing benchmark, and survey evidence has indicated that their output is significantly cheaper. Quinlan & Associates, in a report published in June 2017, entitled “*A Brave Call: is it time for investment banks to explore alternative research models post-MiFID II*,” said: “On average, fees being charged by IRPs were considerably lower than those charged by global banks” (see chart), albeit for waterfront coverage. The strategy consultancy did, however, acknowledge that banks were responding to “push back from the buy-side”.

Annual Subscription Fees

	MIN	AVG	MAX
IRP	USD 20,000	USD 40,000-60,000	USD 250,000+
REGIONAL	USD 60,000	USD 150,000-250,000	USD 350,000+
GLOBAL	USD 300,000	USD 500,000-1,500,000	USD 5,000,000+

Source: Quinlan & Associates analysis

MiFID II

Live from January 2018, MiFID II bans inducements from bankers/brokers to asset managers, which might lead them to act against asset owners' best interests (eg by over-trading). This completes the regulatory drive to insist that payments for research are unbundled from fees for executing trades.

The reforms make payments for research much clearer to the ultimate asset owners and call for upfront agreement of budgets. The latter is a challenge to the broker-vote model for retrospective allocation of commissions to pay for research, since it means a price should be agreed in advance for a specified service.

Controversial loophole for 'minor' benefit

Asset managers will be expected to turn unsolicited, or free, research away unless it is a minor non-monetary benefit, such as where the material is generally available. This loophole is proving controversial as some investment banks make macro-economic research available cheaply, or even free. The European Securities and Markets Authority (ESMA), in a Q&A on the regulation, has pointed to recital 30 of the MiFID II Delegated Directive, which says: "any non-monetary benefit that involves a third party allocating valuable resources to the investment firm shall not be considered as minor and shall be judged to impair compliance".

Research with anything other than a minor benefit will have to be paid for by asset managers either directly, as an operating cost, or from a separate research payment account (RPA) where the costs are passed on to the asset owner. While the RPA resembles the current CSA, the rules have been ratcheted up. An important requirement is for a rigorous assessment of research quality, based on its ability to contribute to better investment decision-making. (See Appendix I for more detail on MiFID II.)

The regulators want to see a research market develop with transparent pricing. MiFID II is supposed to level the playing field between research providers. These currently fall into two broad camps:

a) The 'sell-side', which sits within investment banks or broking firms, where the researchers or their colleagues work for corporate clients and other issuers of securities, and where trading is integral to the business model.

b) Independent research providers, or IRPs, whose clients are asset managers – the 'buy-side'. While they can be paid via CSAs, they are more likely to be paid directly by subscription or on a consultancy basis.

FCA's asset management study

One last point about the regulatory context for MiFID II: the FCA and its peers in Europe are in scrutiny mode over the asset management industry. The leading example of this is the FCA's Asset Management Market Study. The final report, published in June 2017, found:

Regulators in scrutiny mode

- weak price competition and price clustering, especially in active management of retail funds (ongoing charges at around 1.6% pa);
- high levels of profitability: average margins of around 35% for 2010-15;
- no clear relationship between charges and performance of retail active funds;
- around £109bn in 'active' funds that closely mirror the market but are significantly more expensive than passive funds; and
- investors increasingly focused on charges and large institutions negotiating effectively.

The suggested remedies include strengthening the duty on asset managers to act in the best interests of investors, and increasing the transparency of costs and the clarity of performance reporting. The FCA also makes clear its support for a single all-in fee to investors, ie one including research costs.

Chapter 2: The Market

Shrinking on every measure

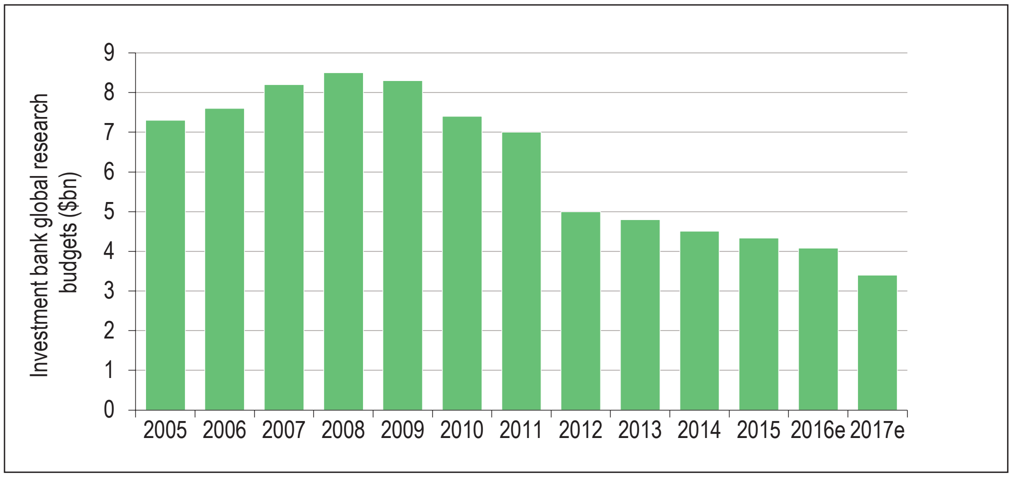
Exploring the investment industry is like opening a Russian doll. The large outer layer represents the roughly $70 trillion globally (2016 estimate) in assets under management (AUM). The UK industry alone manages £6.9 trillion of assets, according to the FCA's market study. Fees for managing all this run from a tiny fraction of a percentage point of AUM for passive funds to 2% or more for specialists, such as hedge funds.

European market at $3bn - $4bn

To arrive at figures for the research market, based on commissions, you have to go a few layers deeper. BCA Research puts the global market at $15bn, with IRPs taking 15%. Integrity Research Associates last year estimated the global number at $12bn. North America is estimated to account for at least half of the market, with the rest split between Europe and Asia/emerging markets. This leaves the European market at $3bn-$4bn, with the UK as the biggest constituent. In 2014, the FCA estimated that UK investment managers paid about £1.5bn via dealing commissions for research.

Dealing commissions fell dramatically in the wake of the financial crisis. Frost Consulting estimated that equity commission payments had declined 43% by 2012, and that investment banks (as part of widespread cuts to restore profitability) responded by allocating about 50% less capital to research by 2015. According to Coalition, the business intelligence provider, the number of analysts at the 12 biggest banks fell from more than 6,600 in 2012 to fewer than 6,000 in 2016.

c50% decline from peak to 2015 in capital allocated to producing investment banking research



Source: Frost Consulting

Anecdotal evidence suggests that banks have also been cutting the cost per head by replacing experienced analysts with younger, cheaper ones – an ugly word has been coined for this, "juniorisation". New homes for seasoned leavers include mainstream fund managers, hedge funds, corporate investor relations and the independent sector.

Leavers join fund managers, IR and independents

Independents have a bigger share of the shrinking pie

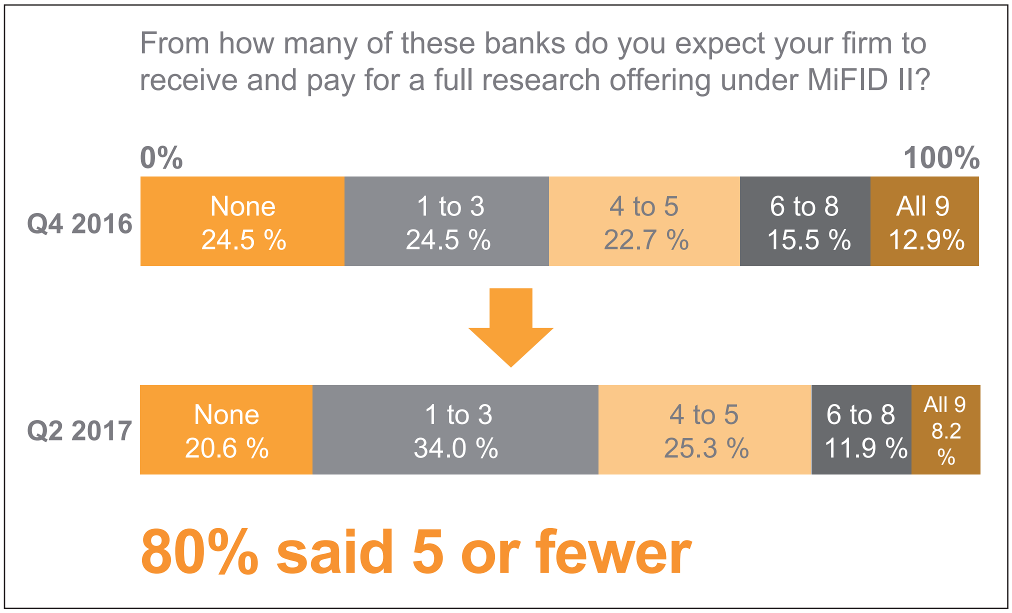
For the independent sector, predictions made in the CSFI's 2012 report have largely played out. A survey of fund managers indicated then that most intended at least to maintain their use of IRPs, and this has helped independents to increase their share of a shrinking pie. According to figures published in June 2017 by Integrity Research, IRPs in the US were earning about 20% of all spending on research (including an estimate for direct payments), up from 17.4% in 2011. In Europe, they had doubled their share of revenues to about 11% last year.

The mood is gloomier now than in 2012. MiFID II is one source of that because of the emphasis on research budget discipline. In June 2017, McKinsey put the spending of the top 10 sell-side banks on research at $4bn and forecast a fall of 30%, or £1.2bn. Quinlan & Associates' survey, published in September 2016, found that asset managers intended to cut their external research budgets by 30 per cent globally.

Big asset managers halve suppliers

This view has been borne out by the actions of individual fund managers. Germany's third-largest asset management company, Union Asset Management, announced plans in June to halve the number of external research providers, meaning more than 100 would be culled. It was echoing Amundi, Europe's biggest fund manager, which said in the spring it had halved the number of external providers. The question is whether it is easier to cut the tail, or whether more savings bang can be achieved by reducing the number of expensive full-service providers? Just over half the respondents to a survey in June 2017 by RSRCHXchange, the research distribution platform, said they planned to pay for a full-service offering from a maximum of three of the top nine investment banks. They had pared down the expected number since the Q4 2016 survey.

Firms expect to receive research from fewer banks



The banks referred to are: 1 - JP Morgan Chase;2 - Goldman Sachs;3 - Bank of America Merrill Lynch;4 - Morgan Stanley;5 – Citigroup;6 - Deutsche Bank;7 - Credit Suisse;8 - Barclays Capital; 9 – UBS.

Source: RSRCHXchange

Most research spending done in-house

As direct payments become the norm in Europe, new ways will need to be found to assess the size and growth of the market for research. In any case, the Russian doll has always had other layers. Most of asset managers' spending on research is done in-house, where it blends into investment decisions from asset allocation to stock-picking, alongside mining market data and listening to a spread of internal, and external, opinions.

Other factors bearing down on equity commissions

The switch from active to passive management: Assets managed in passive mutual funds grew 4.5 times faster than active in 2016 to reach $6.7trillion, according to figures from Morningstar, the data provider. But the active segment remained much larger at $23.9tn. ETFGI, a research firm focused on exchange-traded funds and products, reported that assets invested globally in ETFs/ETPs had increased 35.5% in the first eight months of 2017 to reach a record $4.8trillion at the end of August.

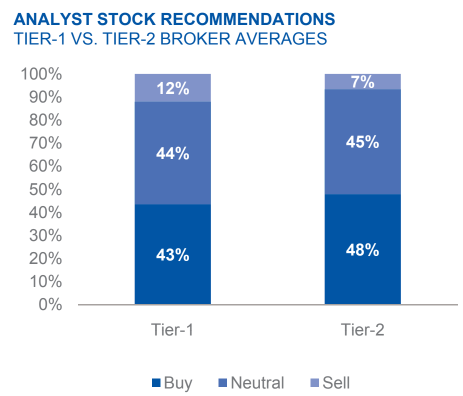
Active funds' bad press: Studies on both sides of the Atlantic have failed to provide evidence that active funds perform better than passive funds net of fees – ie any higher gross returns are absorbed by higher charges. The FCA's Asset Management Market Study put the average charge for active fund management at 1.6%. Passive fund providers charge institutions as little as 10bps for the most commonly used index trackers.

Investors aware of the way charges erode savings

Investors are becoming much more aware of the way that charges, compounded over many years, erode the size of their savings pot. Since performance is difficult to predict, it is easier to cut costs and present this as a way to secure better net returns. Hence the 75bps cap on charges for the UK's auto-enrolled pension funds.

Sell-side independence issues: Investment banks are in the business of providing corporate finance and broking services, so their analysts are more likely to be positive than negative about clients, and potential clients. According to Quinlan & Associates' June 2017 report ("A Brave Call"), a heavy bias remains towards the provision of positive ratings at integrated banks/brokerages, with 'buy' recommendations greatly outnumbering 'sell' (see chart). A key question is whether MiFID II will prompt the buy-side to place a greater emphasis on internal research and independent external sources.

Broker Stock Recommendations



RATIO OF BUY-TO-SELL RECOMMENDATIONS
TIER-1 VS. TIER-2 BROKERS

	MIN	AVG	MAX
Tier-1	2.0	3.6	15.5
Tier-2	1.4	7.2	51.0

Tier-1 banks are global bulge bracket and Tier-2 are regionals and global non-bulge brackets.

Source: Investar, Quinlan & Associates analysis

Reduced scope of trading activity

Falling liquidity in equity markets: The regulatory clampdown on proprietary trading at investment banks, via the Volcker Rule in the US and a general increase in capital requirements, has reduced the scope of trading activity. The rise of passive investing in some ways resembles buy-and-hold behaviour by investing institutions, militating against stock churn. As research teams are cut, the coverage of small and mid-cap companies tends to suffer, reducing the stimulus to trade in them.

Don’t forget FICC

The sharp end of the debate about research lies in active equity management. But this is dwarfed by fixed income investment and activity in currency and commodity markets. Credit and foreign exchange markets have a far greater array of liquid trading instruments available. Trading skills are to the fore, but research needs range from micro inspection of arbitrage opportunities to 30,000ft views of macro-economic and geo-political trends. Funding for research and trading comes from the bid-offer spread on millions of daily transactions. MiFID II transparency applies to bought-in research for this, too, and direct payments are well established in subscriptions for macro commentary, consultancy fees and data analytics.

Pinch point in macro subscriptions

However, research that feeds into fixed-income investment is experiencing intense price competition as the buy-side starts to pay for it explicitly for the first time. Macro-economic research delivered by subscription could be a pinch point as some investment banks make this high-level commentary generally available as a low-price entry point to their service, or even free. The question then becomes whether it is really a “minor” benefit for recipients.

Chapter 3: Changes in the past 3-5 years

Downward pressure on charges

CSFI interviewees confirmed the downward pressure on dealing commissions. One commented: "The biggest driving factor has been performance problems for asset managers and the passivisation of investment." So even absent MiFID II, downward pressure on charges has prompted tighter scrutiny of anything that costs an asset manager, or its clients, money:

> "Ours [payments for external research] have come down substantially and will continue to do so."

> "Commission rates have been under pressure and so there has been pressure on revenues across the industry and some cuts in capacity."

On the sell-side, although US investment banks have led a recovery in profitability, pressure on revenues from cash equities has persisted. This has led to withdrawals: the Edison/Frost/Bloomberg Intelligence report includes a non-exhaustive list of 26 names that had exited the cash equities business in the UK, significantly scaled down their operations or merged with others. This provides further evidence of shrinkage in sell-side equity research, with some paring down coverage of sectors and stocks.

On the buy-side, increased regulatory scrutiny – notably the FCA's 2014 wake-up call – has prompted asset managers to take more care over research budgets and the destination of commissions. One simple outcome has been that some asset managers have cut off payments once those budgets have been spent. Trading houses have emerged that offer no research, focusing on best execution for asset managers. On research spending, tougher negotiations have set in "as there is more pressure on the allocation of that wallet and to decide who is essential to the investment process, or not". And so, in the UK, soft unbundling is well under way. MiFID II will extend the harder form, which the UK has advocated, across the EU:

> "In the past two to three years there has been quite a steep increase in the extent to which clients would say they want execution only because they have spent what they want to on the research side."

> "A lot of clients are thinking about research in an unbundled way."

Who is essential to the investment process?

The impact on behaviour has not been straightforward. The logic is that "the compressed wallet is going to those that add value". But this desirable outcome cannot be reached in the absence of transparent and coherent pricing on the sell-side and sound measures of quality, or value added, on the buy-side (see Chapters 4 and 5).

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Buy-side power

With the buy-side flexing its muscles, there is anecdotal evidence of large firms putting pressure on the sell-side to provide bespoke research in return for broker votes. This plays on investment banks' desire to see their analysts in the top five in high-profile rankings, such as the Extel survey. While the broker vote should be linked to research quality (some fund managers attempt to be rigorous in this judgment), it remains something of a popularity contest.

In the absence of monetary amounts, it looks as though investment bank/brokerage research is being distributed as a loss leader. Indeed, while the anti-inducement regulation and the roll-out of transparent pricing should reduce cross-subsidy, it will not disappear. Research departments have internal value for investment banks and brokerages in their service of corporate clients, and to their trading desks. Indeed, in the pre-MiFID II world, one interviewee suggested that larger clients had effectively taken advantage of sell-side cross-subsidies: once trading commissions were stripped out, "research was being provided for free":

Plenty of evidence of over-supply

> "Clients are keen to emphasise the importance of whether you are in the top five – ie their vote is helping to put you there."

But while some banks have withdrawn from crowded sectors, there is still plenty of evidence of over-capacity: the torrent of written research that is mostly unread; more than 40 analysts covering stocks such as AstraZeneca and Daimler. One manager had counted 77 conferences hosted by the sell-side in London in September, at which research would be distributed and access to analysts – and maybe corporate clients – arranged.

The overall impression is that although the market has evolved in the past 3-5 years, MiFID II will ratchet up the rate of change. One interviewee described it as "the lull before the storm". For UK asset managers that have responded promptly to changes in regulation since 2006, the impact should be limited – "we have unbundled for 11 years so there is nothing new for us". Others, however, have been waiting for MiFID II to seal unbundling and set out clear rules on how to do it.

On the European continent, where the bancassurance model has remained common, there has been far less unbundling of research payments than in the UK. This presents both an opportunity for external research providers – in particular, those not linked to a rival bank – but also a challenge to compete for a place on a list of suppliers that is being cut.

Those with activities in the US have already experienced a changed environment prompted by more pro-active asset owners (thanks to better governance). One said: "There will not be much impact on us because unbundling of trading and research, along with all-inclusive [management] fees, has been imposed on big asset managers by US pension funds and other institutional investors for the past 10 years." This interviewee has felt uncomfortable when, in Europe, investment banks have suggested that "they offer us services in exchange for higher brokerage fees, which are passed through to clients, and I thought: 'this is illegal'."

IRPs have less financial ballast

Tough competition from recovering banks

On the sell-side, trading initially bore the brunt of cost cuts in the wake of the crisis, then the squeeze moved on to research. But with profits recovering at investment banks, the sense of urgency may have receded. Will this mean that they hang on in asset classes and sectors where they are weak, stoking cut-throat pricing competition? This could present a particular threat to IRPs, which have less financial ballast to weather the storm.

Some banks have invested in research in the past couple of years to better position themselves for a more discriminating world. After all, there will still be winners from the expected shake-out in capacity, including the small handful of large banks seen as best-value providers of global 'waterfront coverage':

> "One or two organisations are trying to upgrade the quality of their people on the basis that if we are not top three, we are at risk of not being paid very much."

Yet, once the winners emerge, so will the losers. Investment banks are vigilant when it comes to returns on equity, which affect executives' bonuses. So where and when RoE heads downwards,"stronger voices will challenge the wisdom of carrying an expensive sell-side function," as one interviewee put it. The research needed to support corporate finance and trading is not the same as that required to serve investment decision-making, and internal purposes have lower compliance and sales costs, he argues.

'Challenge to carrying expensive sell-side'

Independent sector growing

The independent sector has continued to grow. Membership of Euro IRP has doubled from about 40 in 2012 to 80 in September 2017. In the past two years, according to a recent survey of the association's members, overall staff numbers have gone up 12%. The majority of respondents had more than 50 clients, but many remain small. IRPs operate across a wide variety of functions: macro-economic, portfolio construction and quantitative analysis as well as industry specialists. So the fragmented sector faces both a collective and individual challenge in raising its profile.

CSFI interviewees from the buy-side have become more aware of this alternative to the sell-side. One said: "I'm more aware than I was of the existence of independent consultants, especially in macro and market strategy." And another: "There have been some specialist research firms and individuals who have emerged and they are quite good."As expected, the sector has benefited from asset managers' efforts to seek value for money and the regulators' push for transparent pricing. But some doubts remain about the viability of a pure research business model:

> "We do buy some services ex-ante from IRPs on a subscription-type basis, which gives us a sense of how much stuff costs eg research reports, time with an analyst, annual service."

> "There has been a gentle rise of independent research shops, but not to the extent expected because it is difficult to get paid."

Research quality

It might be easier to cut costs

A tricky question is whether research quality has improved. After all, that should be the key factor in negotiations with asset managers. The environment has been unhelpful for this, however. After fees, active equity fund managers have, on average, failed to outperform their benchmarks. So, research providers may face the same doubts about their worth as their clients. Asset managers may find it easier to cut costs in the value-for-money contest:

> "If I don't know how good you are, at least I know how cheap you are."

A few interviewees from larger buy- and sell-side firms had invested in in-house research to improve quality both for internal purposes and to improve the chances of being a winner in a more competitive world. In the context of overall cost cuts, however, some perceived this as musical chairs. Comments included that fund managers had been poaching good people and that "good seasoned analysts have moved to hedge funds and other buy-side firms". But as asset managers consolidate, research spending overall is being squeezed:

> "It strikes me the real world is catching up with the buy-side and is putting it under increasing pressure: to perform; to justify fees; to justify active management; to justify paying for research."

On the sell-side, while one stressed that it had been investing in research to improve its chances of being a winner, another indicated the selectiveness of its approach: "We have reduced coverage of large cap European companies because we don't think we will be paid for it. We are consolidating around UK small and mid-cap, niches and corporate-facing work."

Lack of a wide spread of opinion

Overall, concerns remain about quality. One investment strategist commented on the lack of a wide spread of opinion: "Actually, there are not many provocative views and few are sending stuff on trends or areas we have not seen. There's very much of a 'me too' flavour and we are less willing to pay for it." He said the comfort zone remained "short-term noise, eg a decimal point on GDP" designed to stimulate trades.

Similar comments were made about "bottom up" equity market coverage. The persistent focus on tweaking the investment story in the wake of corporate news is puzzling. Passive and index-hugging investing effectively make large institutions follow a buy-and-hold strategy (apart from automated rebalancing), and it reduces the attention paid to individual companies (other than for stewardship purposes). Even ignoring the criticism thrown at 'short-termism' in recent years, why would trading on small items of news still matter so much? It suggests a lack of differentiation despite the potential for something different:

> "There are more ideas away from large stocks. But the voter base is focused on big liquid stocks…Liquidity is driving the fund manager's focus."

The perception remains that equity research is cross-subsidised at investment banks, which leverage it to gain other business, from equity and bond trading to M&A and IPOs. While there have been some tough negotiations over the amounts paid for written research and contact with analysts (see Chapter 4), a crucial factor in opening the door to competition is that there should be a breakdown in the pricing of services offered, notably between sectors. Asset managers should use their negotiating clout to obtain this:

Negotiations tough over written research

> "There has always been a mismatch between how revenue is earned and the costs within a broking business. At the big banks 25-40% of the cost is still born internally. Good analysts give more credibility for mandates for M&A and IPOs."
>
> "Analysts are used as links between the bank and the buy-side – good for IPOs etc."
>
> "Few firms have instituted what needs to be done ie transparent pricing structure for products and services, and a rationale for how they are pricing services."

What are the main drivers of change?

The structural drivers are clear:

- downward pressure on costs at investment banks, with recovering profitability easing that pressure on some;

- downward pressure on buy-side fees driven by poor performance of active managers and end-investors focusing on charges; and

- a fall in dealing commissions that first hit trading desks and has rolled through to the research side.

In Europe, asset owners have not barked

However, regulation remains the biggest catalyst for change. Lord Myners said, in an interview for this report: "I would like to say there are other factors driving change but it's primarily regulation. It's a highly conservative market where people are very comfortable with the established way of doing things." In Europe, asset owners have been the dogs that have not barked, whereas in the US, pension funds have been more demanding. "It's close to shocking that the owners have not been asking questions and they will now be obliged to. It's more work for everyone," he added.

The regulatory aim is to see both a mindset change across the asset management industry and a higher level of scrutiny by asset owners. The onus is on the buy-side to choose external research providers according to the value they add for those clients. While it has taken a long time to see improvements in the way the research market works, regulatory and structural drivers of change are now reinforcing each other:

> "There is lots of regulatory change, massive pressure on costs and for cost transparency, and pressure everywhere to unbundle and be transparent. Even without MiFID that will continue."

Internal vs external

With MiFID II finally breaking the link between trading and research, the model should be that the demand for external research is driven by the investment needs of the buy-side. That, in turn, will depend on what the asset manager can, or cannot, do in-house. Some large asset management firms have made a considerable investment in internal research, resembling the 100-plus teams and the 2,000-plus stock coverage of a large investment bank. But they still value challenge or confirmation from external providers.

Others specialise in a few sectors and pay ad hoc for external research on others when their interest is piqued. One interviewee commented that this meant "the concept of buy- and sell-side research is breaking down. If you have a big enough portfolio, you run it internally, otherwise you run it externally - especially as the analysts are going to be much better, with a wider set of experience."

More asset management mergers expected

The impact of buy-side mergers, such as Standard Life Aberdeen, also needs to play out, but it will lead to rationalisation of activities and that means cuts to overlapping teams. More mergers of asset management groups are expected, and there is also scope for product rationalisation. One industry insider commented: "There are far too many funds – it's ridiculous."

Another factor affecting equity market coverage is the limited liquidity in small and mid-cap stocks. "There is a big debate about how broad coverage needs to be because there are more ideas away from large stocks." But the value of the idea is limited if it is difficult to execute it. "Large companies are easier and cheaper to trade, so portfolios will become more concentrated in larger names." This narrowing of focus makes life more difficult for research providers since clients have less time to discuss individual stocks.

While some investment banks see an opportunity to generate revenue from their research coverage, others are cementing the traditional link between research and capital markets activity. "They want to make sure they focus research where the money has economic benefit for the whole bank… You need to show research expertise to attract new issuance." Another interviewee commented that commission and research payments had come down to a level where they were "less relevant". The firm's revenues in corporate client retainers, primary broking and M&A were "considerably greater than commission revenues". This should create opportunities for IRPs to appeal to the buy-side.

Issuer pays and stockbroking models

Commission payment now 'less relevant'

How can smaller quoted companies get a hearing from more patient investors, who are less hung up on liquidity? This conundrum has fuelled the growth of an issuer-pays model in equity research, as happened many decades ago in the credit ratings sector. Firms such as Edison and Hardman, which carry out commissioned research for companies, are benefiting although they are not regarded as independent. Edison's website says it aims for objectivity and rigour, but recognises potential conflicts. It says these are limited because it does not carry out corporate finance work or equity sales and trading.

The traditional broker, sitting between companies and investors, obviously has a role here. Peel Hunt, for instance, describes itself as a "joined-up" broker offering corporate broking, research, sales and trading. Steven Fine, chief executive, spoke in a recent video on its website of companies being the "last to know" of MiFID II's impact. They would (as ever) need help in navigating the public markets. That meant being relevant to the buy-side. Consumers of house brokers' research have to discount for the inherent bias, so there should be opportunities to provide alternative, independent opinions.

Some independent firms, such as Autonomous and Redburn, provide agency broking services, capturing additional dealing revenue to complement payments for their research. They stick to their buy-side orientation and protect their independence by avoiding corporate work.

The impact of technology

Research sector's version of 'big data'

A structural change that has attracted less attention in the context of MiFID II is the automation of research, pioneered by quantitative analysis of market data. This could go much further, especially where linked to trading on news. "Instead of an analyst with 20 years' experience, there'll be an AI program and machine learning that can adapt the model. When a press release comes out, the information can be scraped off and used to populate charts and tables. Comparing with internal models is automated." This means that new recruits' ability to design and manage software will be as important as the traditional skills of fundamental company analysis. The trend can also be seen in the increasing number of IRPs offering technical analysis and data mining systems.

A further twist to the technological story comes via the passive industry. Through 'smart beta' and even so-called 'active ETFs', it is in the market for clever screens that can capture different aspects of performance within a variety of asset classes and sectors. This builds on the established role of quantitative analysts whose programs screen stocks for positive investment factors, such as value (with dividend and balance sheet inputs) and momentum (share price trends). Effectively this is the research sector's incarnation of the 'big data' and data analytics trends seen in many other parts of the financial and corporate world.

Chapter 4: How should research be paid for?

The first thing to say about research is that it is not free. This is like saying that mail is free just because some junk mail lands on the mat every morning. Unsolicited information about markets, sectors and individual companies may be freely distributed to a wide variety of recipients, but it is paid for ultimately by the issuers of shares, bonds and their derivatives. Widely distributed economic commentary burnishes the brand of the organisation employing the experts, so it is prepared to fund the cultivation of their personal reputation.

Research is not free

Some research, including subscriptions and consultancy fees to IRPs, is already paid for directly by asset managers. Where the payments are passed on to asset owners, some buy-side firms have been rigorous in handling unbundling and in allocating payments from CSA pots:

> "We have been paying for research on an unbundled basis for 11 years. It is not free and we have a mechanism whereby we can pay brokers, IRPs etc for substantive research as defined by the FCA – no corporate access, no data, no Bloomberg."

MiFID II exempts generally available research as a minor non-monetary benefit. If the service does provide valued input to the investment process, however, it will need to be paid for specifically, otherwise it looks like an inducement. So some supply will be turned off because it has monetary benefit but is not being paid for. Asset managers need "a policy to delete it and inboxes are examined by compliance staff".

The sort of research that might be made generally available is high-level economic commentary – effectively free journalism as a marketing ploy – and reports on smaller companies funded by those companies. In other words, some unsolicited mail will keep coming.

Pile it high, sell it cheap

Contentious $10,000 for access

Perhaps the most contentious pricing issue is the relatively low tag being put on access to written research. Integrity has reported "sources" saying that JP Morgan is charging as little as $10,000 per legal entity for read-only access to its research. Contact with research teams is additional: "high touch services are priced higher, so the bank's all-in fees can be comparable to competitors," according to Sanford

Bragg, a principal at Integrity. He cites others as charging a fee per so-many heads – eg $6,000 for the first 10 users, $5,000 for the next 90 and so on. Meanwhile, others seek subscriptions of up to $150,000 for equity reports (“Research Fees Update: Downward Pressure On Equity Research Pricing”, 11 September 2017). A point of comparison might be Bloomberg’s service at about $20,000 per terminal or per user – note how tightly it controls usage.

A low price could be justified by relatively loose limits on access to routine output. In some cases, this might be the reports sent to journalists, who never pay but provide a wider means of distribution. As with the online revolution in journalism, it will take a while to work out what should go behind the pay wall, what is part of a commoditised information service and what can be restricted to premium customers.

What price an equity rock star?

At the other end of the spectrum from ‘pile it high and sell it cheap’ reports are the “rock star” prices reportedly demanded for one:one meetings with top-rated analysts. One buy-side interviewee said: “Some are asking 4-5,000 an hour in pounds, dollars or euros for an analyst’s time. What are they smoking?”

'What are they smoking?'

Another interviewee said that the spread of suggested charges for meetings was “wild”, from $500 to $10,000. It is a short step to compare the high opening bids with the rate paid for other professionals: “I could get Freshfields’ most senior lawyer for £1,500 an hour.” And the consultation with a lawyer would definitely be bespoke, whereas it is not clear who else might get the benefit of the analyst’s expert views. Indeed, if he or she delivers exclusive price-sensitive information that is apparently very valuable, a question might be raised about its legality.

Bearing in mind the annoyance caused to buy-side clients by these high opening shots, what lies behind them? Take the sum paid for research in a previous year by a big client, say $10m. If the investment bank charges $250,000 for access to all its written content, that leaves a $9.75m gap – divide that by an estimate of the number of one:one meetings that might be held with a select group of analysts. You want them to be earning about $800,000 a month between them, while still finding time to do the research that their reputation depends on.

An alternative is to seek an all-in fee of $10m for access to all written material and analysts, but that takes up a chunk of the asset manager’s budget and compromises flexibility. One buy-side interviewee commented: “You buy upfront on the basis of using all the services all the time, but you will pay vastly over the odds – like a 24-programme washing machine when you only need two programmes.”

The relative value of written research and one:one meetings is not as clear-cut as it appears. Although perhaps only 5% of research received is read, fund managers spend a lot more time reading than they do in meetings. And if the latter become very expensive, the former can fill much of the gap:

> "Customers are pulling back from meetings, they think the price is incorrect and they want to see the market move in the right direction."

This is not just for one:one sessions. One buy-side interviewee shocked one investment bank by threatening not to send any representatives to a conference it was holding – one example of many that supports the conclusion that the buy-side has the whiphand in these negotiations. In other words, the big banks may have started out with aggressive bids, but that phase has faded and the perception now is more that they are price takers:

Big banks become price takers

> "People are going back and saying it's not worth $1m but half that. We thought that was what we paid last year and that is what we will continue with and we expect the same level of service. The banks will say OK and then try to adjust cost."

> "The main challenge is that banks say you have access to all this and we want $5,000-$10,000 per head for access to the research library. If I did that, there would be no money to pay for access to analysts and I don't want the whole library."

> "$50,000 to $150,000 for global banks, to have access to all their documents. Is this commoditised or under-priced? For access to analysts it could be millions of dollars – it's finite."

'Not a healthy client industry'

A key constraint is that most asset managers do not have tens of millions to spend on external research. One respondent with about $200bn of assets under management in Europe had a research budget in the £5m-£10m bracket. Bear in mind that big asset managers tend to spend much more on internal than external research. One rueful sell-side comment was: "It would help if our clients spent more money – it's not a particularly healthy industry as a client industry." As any journalist who has lived through the online revolution could tell him, that is a legacy of the perception that information is provided free. In the investment world it has, of course, been cross-subsidised by the banks.

In-house or buy in?

Opportunities for external providers...

One of the impacts of MiFID II's insistence on clear pricing for research, separate from trading fees, is that asset managers will be in a better position to decide whether to cover an asset class or sector in-house, or to buy in coverage. After a period of internal investment, a few buy-side firms have their own waterfront coverage. But short of that, and prompted by cost-cutting and consolidation, some rethinking is bound to be taking place that could create opportunities for external providers.

The sell-side might also think about – and have better evidence for – which sections of their research departments are most in demand:

> "Big firms have some good analysts and a tail. Will they be forced to make a more selective offering? What happens if a star analyst leaves?"

Shake-out affects all sides

In human terms, the earlier shake-out of sell-side firms provided a supply of seasoned analysts to the buy-side and the independent sector. Now the shake-out is hitting the buy-side. The MiFID-induced element of the cost-cutting is the growing wave of asset managers deciding to pay for external research out of their own resources, from their P&L accounts, rather than passing fees on to clients. With the finance director imposing discipline, the assumption is: "Where research is paid for out of P&L, the budget is cut."

The danger is that "the buy-side does not know what the real value is, so they will drive prices down until something happens". They could be aided in this by cut-throat competition on price among all suppliers. This includes among the ranks of IRPs, if their numbers are swelled by analysts leaving the sell- or buy-side.

...but some could be driven out of business

The "something" that might happen is that research providers are driven out of business.

Regulators could take action on two counts. Very low prices might look like an inducement, or bribe, in which case supervisory action should be taken under MiFID. If predatory pricing leads to a reduction in competition, it could also be looked at on those grounds. But how much evidence of predatory pricing will supervisors need? And how much blood on the carpet is necessary to show that competition has been impaired? Either way, there will be a lag before any action is taken. Meanwhile, it is a buyer's market for asset managers.

A couple of factors may restrain the buy-side from making quick and deep cuts in spending on external research. One is comparisons with previous payments. If the amount paid to an investment bank for research comes down from $500,000 last year to $10,000 this year, it could arouse suspicion of accepting an inducement from the bank. Looked at from the perspective of an asset management client, one interviewee said: “If you cut a lot, it implies you were previously over-charging.”

Long way to go before prices are clear and coherent

The reaction of those asset owners in Europe will be interesting. So far, while they might have questioned execution fees, they have not been pro-active on research spending. “We have been reporting semi-annually on research costs for the last 10 years,” said one manager. “We have never had a client question research costs, nor have we had a big pat on the back for cutting it.”

Overall, there is a long way to go before prices for research are both clear and coherent. As one put it:

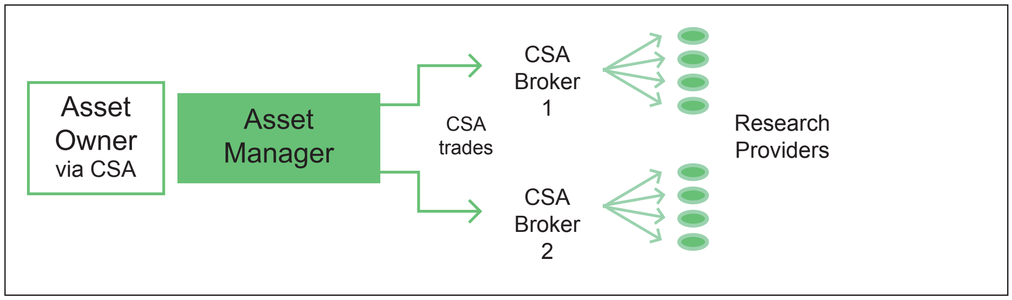
> “The nascent pricing of research in the bank/broker market is currently all over the place. There needs to be greater consistency in pricing before asset managers can buy services with confidence that the price is right.”

From CSA to RPA or P&L

The alphabet soup indicates that payments for research via dealing commissions has remained different from payments for other services that have always been treated as simple business costs, such as media subscriptions and research paid for directly.

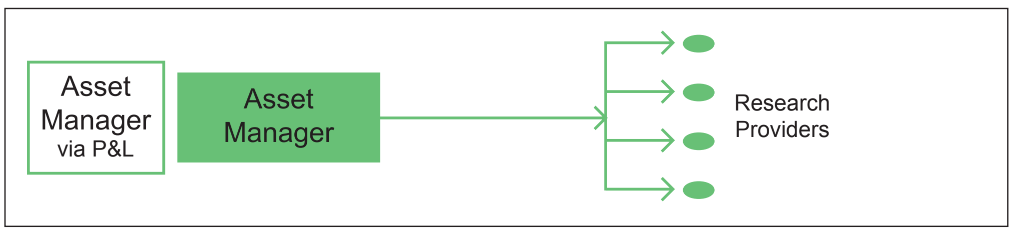
> MiFID II's Article 13 sets out how payments for research can be made:
>
> (a) direct payments by the investment firm out of its own resources;
>
> (b) payments from a separate research payment account controlled by the investment firm.

CSA models for research payments



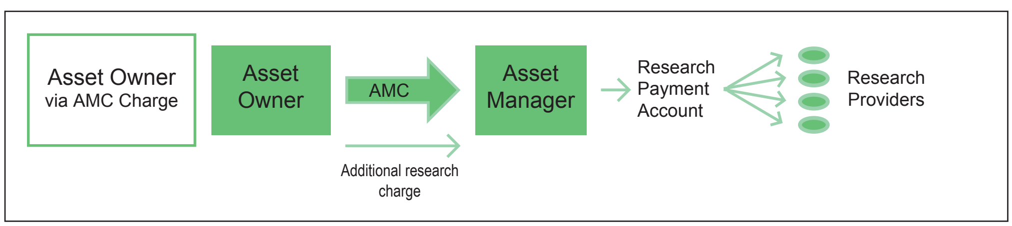
Source: Frost Consulting

CSA Payments directly out of asset managers own P&L



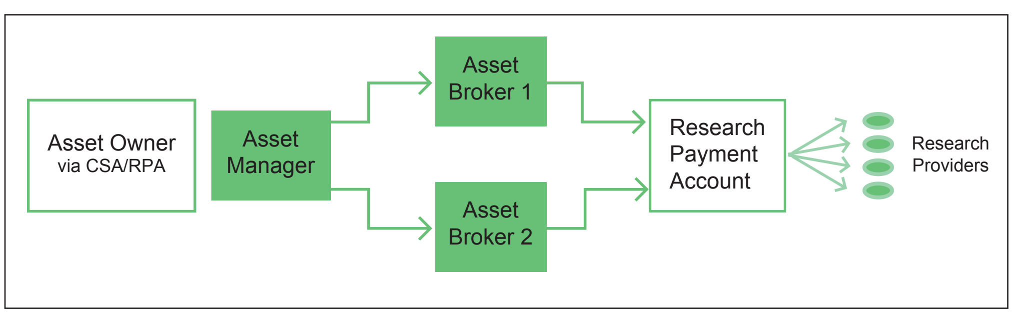
Source: Frost Consulting

The "Swedish model"



Source: Frost Consulting

Using CSAs to fund a RPA



Source: Frost Consulting

Asset managers bear the cost (P&L)

Strenuous requirements for RPAs

The approach gaining the most traction is to treat research spending like any other business expense. One interviewee said his firm had spent a lot of time trying to understand the RPA route, but had baulked at all the new requirements. In taking the decision to move to absorption in the P&L, he said: "The regulatory risk profile goes down because it's not audited, whereas RPAs will be. And there are very strenuous requirements to show that if Mr Smith pays for research that only he and other [paying] clients…benefit, and that no one else is to get a free ride." Overall the firm believed that the P&L approach "is much better for our relationship with clients and intermediaries".

This report supports the move to P&L absorption of research costs. This tallies with the regulatory push towards an all-in management charge. At the *Financial Times*, journalist Attracta Mooney has been tracking asset managers' decisions on how to pay for research. On 3 October 2017, the count for 'absorb costs' stood at 29 – nearly three quarters of the sample, with six saying they would 'pass on costs to clients' and four undecided. Of particular interest is that Henderson, Schroders and Union Investment had originally stated they would pass on research costs to investors, but had since changed to 'absorb costs'. (See Appendix II.)

Two serious barriers remain. The first is the clash with a US regime that incentivises a view of research as ancillary to trading. External providers of research who are paid directly – in 'hard dollars' – are liable to be classified as investment advisers, which carries its own weight of regulation. At the time of writing there was hope the SEC would provide comfort that it would take 'no action' over hard-dollar payments to research providers under the MiFID II regime. Meanwhile, the RPA can be seen as "an olive branch to the US" because it is deemed to be equivalent to CCAs, the American equivalent of CSAs. But it is complicated. One London-based sell-side research provider said:

> "We had a situation where a client was not unbundling in the US, but talking about sectors being paid for in an unbundled way for the London business."

'An olive branch to the US'

The second barrier is that charges related to financial transactions are exempt from VAT, which benefits banks and brokers. VAT is charged on direct provision of services – subscriptions, consultancy – as is typical for IRPs. With EU countries' standard rates ranging from 17% to 27%, this burden is heavy enough to make consumers of research services want to avoid it. One sell-side provider commented: "We ran an event and my client wanted to pay through the US broking unit to avoid VAT."

This playing field is likely to be levelled as payments for research are increasingly made directly, with VAT added. The impact is mitigated because VAT payments can be offset against VAT owed, reducing the net amount passed on by the asset manager to the tax authorities. But it is still an additional cost to the external research budget that will need to be absorbed.

Research Payment Accounts

MiFID II requires firms to set a research budget as an internal measure, based on the need for third party research "on robust quality criteria and its ability to contribute to better investment decisions". A "clear audit trail of payments made to research providers" is required "with reference to the quality criteria". Costs that are being passed on to clients must be fairly allocated and form part of a written agreement.

ESMA stressed in a "Q&A" publication in April:

- "Fair allocation could involve apportioning costs according to the expected relevance of research to particular investment strategies or the level of use by individuals or teams that manage or advise on certain portfolios or accounts.

- "The research budget should be an ex-ante estimate of forecast expenditure for research costs that can be charged to portfolios with similar strategies under management. This, in turn, will require that a budget is sufficiently granular to be able to be pre-apportioned by portfolio or client."

'The cost of the privilege of spending clients' money'

In other words, there is a lot of red tape, as interviewees pointed out:

> "The RPA route has a deep set of things you need to keep proving, recording and being checked out on."
>
> "What if you have a fund with 10 institutional investors and four won't pay?"
>
> "There are onerous conditions: it's the cost of the privilege of spending clients' money, when it should be their own."

How CSAs worked

Commission-sharing arrangements have their own complications, but have been made to work. One interviewee, with 70 in place with different brokers, explained that CSAs allowed "complete flexibility as to whom we paid for research and when we should move money from A to B". For example, the dealing commission collected for the transaction might be split into 3bps for execution and 9bps for research. "They keep the 3bps and 9bps goes to the CSA in our pot. If that pot is £50,000 and they have provided research worth £50,000, then nothing happens. If their research is £25,000, we will ask them to pay £25,000 to other providers that we owe money to…If it's £75,000 then we will get a cheque from another broker."

Under the RPA arrangement, which insists on the asset manager controlling the account, "we have to sweep money on a fortnightly basis from the broker to the RPAs, which is 6-7 times more frequently".

What the RPA allows is an indirect payment to research providers, getting around the investment adviser issue and potentially protecting the VAT exemption:

> "The way the SEC looks at it is that it is a way to distribute commission dollars."

Swedish model

Subscription model looks ideal

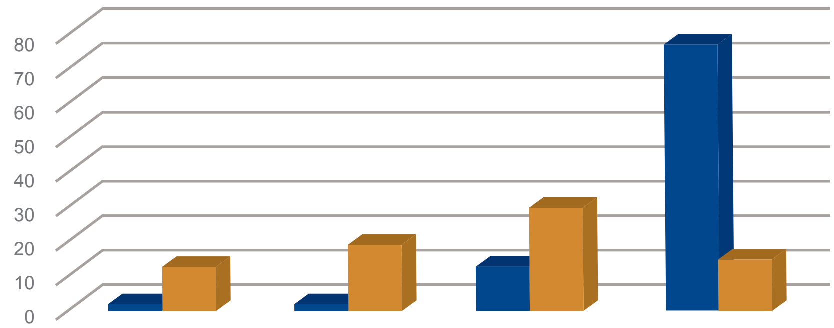
There is a way of charging clients directly for research without linking that charge to transactions. Known as the 'accounting method', or the 'Swedish model', it starts with the asset manager agreeing a specific research charge with each client eg 'it's 60bps to manage the fund plus 10bps for research'.The charge is withdrawn from client funds and put into an RPA, from which research providers are paid. This unbundles research payments from trading transactions and makes them predictable for asset owners, but inserts the RPA element that looks like a CSA. While it is hard to see how this will satisfy the US need to keep payments ancillary to trading, it may resolve tax issues in some jurisdictions.

Types of payment

Subscriptions

If payments for research are to become predictable, separate from trading and agreed upfront, then the subscription model looks ideal. It is already the dominant form of payment among IRPs. A recent Euro IRP survey of its members found: "Some 80% of IRPs [receive] more than half their revenue via subscriptions and 60% [see] that revenue coming via direct hard dollar payments."

How IRPs are being paid for Research Services



	None	Under 20%	20-49%	50%+
Subscriptions	2.2	2.2	13	78.3
Voted Basis	13	19.6	30.4	15.2

Source: Euro IRP

Subscriptions also suit the fixed income and currency markets. They are likely to be tiered, from basic access to written reports up to premium access – including to the leading analysts and commentators. Competition could be particularly fierce for basic access to written research, so the additional services – and the quality of them – will be of crucial importance in determining price:

> "If you look at fixed income marketing, the price for an overall service globally is between $50,000 and $500,000 depending on the amount of research the client takes. Lots of discussions in the low hundreds of thousands – for publications and service based on what they have done in the past."

Equity research costs more

Since FICC trading – and the holding of bonds and derivatives on balance sheets – is more important to many investment banks than cash equities, the funding of internal research (including any external support it needs) is an accepted and regular cost. Active equity management is higher profile, related to important corporate client relationships and regarded as a competitive weapon in pursuit of high but volatile fees for M&A and IPO work. So equity research costs more: on one estimate 4-7 times as much as fixed income research, depending on the bank's business model, hence the thirst to charge more for it:

> "How much do you want to profit from external clients? $1.5m in equities and $150,000 in fixed income?"

Consultancy/bespoke research

But subscriptions cannot take account of either ex-post performance or unpredictable needs. For additional research, providers can adopt a consultancy model and charge for specific projects. In the P&L model, this is a decision the asset manager can make on an ad hoc basis. In the RPA model, if it requires additional spending, that would need to be agreed with the clients whose portfolios are expected to benefit.

Need to disaggregate pricing

It is unpredictable which sector might reach a turning point – for better or worse – during the year. What this argues for is disaggregation of pricing, so that changing levels of demand can be accommodated. This would, in turn, help asset managers to decide which sectors they permanently wish to cover, justifying in-house investment, and which will come and go, where ad hoc purchases of external research would be better.

Pay per use

Research could also be distributed like publications or music, with customers just buying the items they want, singly or on a subscription basis. One buy-side interviewee was an advocate of paying "piecemeal". Having found that the quality was patchy from some of the macro-economic services his firm subscribed to, "I cancelled and then go back for specific pieces".

"My approach [to my research team] is: show me what's useful…Most people were not looking for stuff to help take decisions, they just felt part of a club."

'Show me what's useful'

Research can be bought via aggregators such as Bloomberg, which led the way in the Euro IRP survey with about 40% using this channel. Rival platforms have mushroomed. Clearly this is an area where fintech start-ups have seen an opportunity to automate both distribution and the related administration, including MiFID II compliance. RSRCHXchange is one challenger and more than a quarter of IRPs were using it as a distributor. The firm models itself on i-tunes. The customer buys the research and the platform deducts VAT and a distribution fee before paying the providers. Others, such as Red Deer, charge the asset managers as part of a back-office service that manages research consumption.

On RSRCHXchange, prices for individual pieces of research generally range up to about £3,000. Ad hoc payments can run higher. One example (sold elsewhere) was a heavyweight analysis of east European banks, priced at $50,000. One for the cognoscenti, maybe, but if it helped an investment manager make the correct call on a niche with big recovery potential, serious money could be made for clients.

Tools that track whether research is read can be part of these services, helping asset managers to value the research. And they can also encourage users to rate the piece, rather like TripAdvisor, giving feedback to other customers and the research provider.

Chapter 5: How should research be valued?

Contradictory conclusion may be valuable

What is 'substantive research'?

The FCA's definition of substantive research aims to ensure that asset managers only pass charges on to clients if the research adds value to investment decision-making. For example, there should be a "meaningful conclusion". This is not limited to a buy or sell recommendation. It can be a statement of opinion, or a reasoned deduction. The asset manager does not have to agree with it; indeed, it may be valuable "precisely because it reaches an opposite, contradictory conclusion to their own".

Corporate access does not count as substantive research. The FCA said in PS 14/7: "If the broker and investment manager agree that a form of arrangement or introducer fee is appropriate to compensate the broker, an investment manager may decide to pay this fee from their own resources."

Criticisms of the broker vote included that it did not represent a monetary amount; it lacked detail in recording what the fund manager was valuing; and the link to trading levels persisted. The process tended to reward "touch points" with fund managers and a broad relationship, rather than the specific quality of the research. The fund manager might also be influenced by keenness to secure other benefits, such as access to IPOs. Effectively the bundled mindset, which benefited investment banks, was alive and well.

The FCA supports the MiFID II approach of requiring an upfront agreement with research providers – as part of an all-in management fee. But not all agree. One interviewee said: "The FCA wants investors to come out with a value mechanism, in advance, for a product that can't be assessed clearly in advance. You don't know which calls will make you the most money and it's difficult to put a tangible value on it."

Quantity vs quality

According to Lord Myners, "there has been a change over the past 10 years in the way the buy-side evaluates the sell-side – keener appreciation of who really helps and matters, but it has not gone far enough."

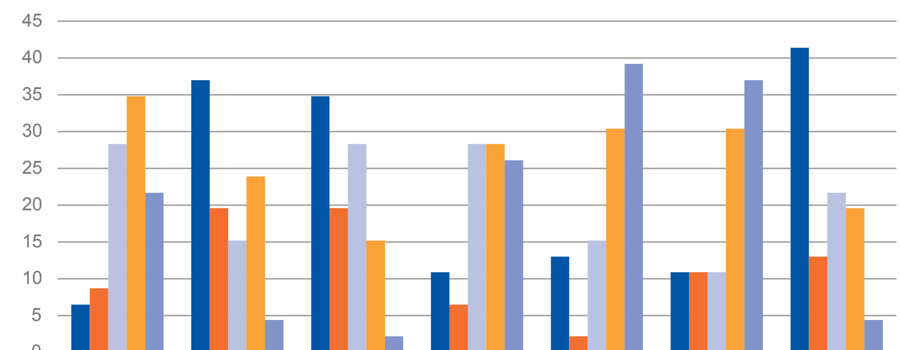
The 2012 CSFI report noted that the rise of passive investment was already intensifying the need to generate market-beating returns to justify the cost of active management. Qualitative factors would always be integral to judging value, but there was a trend towards a greater use of metrics, aided by software programs.

Limitations of alpha capture systems

To measure the success of 'calls' made by analysts, alpha capture systems can track the performance of trading ideas within a limited time frame. Research firm Tabb Group forecast, in May 2017, that spending on alpha capture would represent about 5.8% of total global paid commissions this year, up from about 4.8% last year. Yet the limitations are clear for valuing ideas either with a longer horizon or that feed into a multi-faceted investment process.

The recent Euro IRP survey looks at the way IRPs and their buy-side clients evaluate the success of their ideas. Nearly a quarter do not measure the success of research for fund performance as it is simply not feasible to do so. A third relate success to specific services.

Value of Investment Research Services



	Written Research	Group Discussions	Short-Term Notes	Long-Term Perspectives	New Ideas	Analyst Meetings	Models
Not at All	6.5	37	34.8	10.9	13	10.9	41.4
Infrequently	8.7	19.6	19.6	6.5	2.2	10.9	13
Sometimes	28.3	15.2	28.3	28.3	15.2	10.9	21.7
Frequently	34.8	23.9	15.2	28.3	30.4	30.4	19.6
Very Often	21.7	4.4	2.2	26.1	39.2	37	4.4

Source: Euro IRP

The fact that "new ideas" remain the most sought-after element of research confirms the intangible and human nature of the market. The survey also shows long-term perspectives as clearly favoured over short-term ones. Written research (other than short-term notes) retains a significant role.

New ideas are most sought after

Discernment is the key, and that should be easier if the "me too" research can be turned off. As one interviewee said:

> "You were reading 100 things to get three good ideas, ie find diamonds in a lot of coal. When you pay off the bottom line, you ask the guys to be very discriminating about what they read and rank."

What does the buy-side want?

Less is more

Research needs to inform and stimulate the recipient's thinking in a way that helps the investment process. One manager of analysts said: "I ask people to keep pieces of research that were useful in a file. Then I can go to clients and say this is what we paid and pass it on." This might be for "one excellent piece of research per quarter".

Whatever the delivery mechanism, quality costs since it involves an experienced person spending time digging, probably with support from statisticians and more junior researchers. The question is which research outfits can afford to provide the working capital for fundamental analysis, with less frequent output than the daily stimulants to trade? Investment banks are still seen as focusing on "changes to the story for morning meetings" to give the sales force something to work with. Yet they can also afford the ecosystem to support analysts and they can be patient about the timing of payments.

Greater focus on the long term

The past few years have seen many calls for fund managers to focus more on the medium- to long-term, especially if the end-investors have a long-term horizon, as in pension saving. This should de-emphasise the quarterly earnings announcements, which have also been discredited by the game of manipulating down quarterly earnings forecasts so they can be beaten on the day. In an investment environment less focused on transactions, value should be more orientated towards less transient decisions, including asset allocation and portfolio construction as well as old-fashioned stock picking:

> "Investors want three-year rolling numbers, they are moving away from quarterly reporting."

Importance of independence

An important aspect of quality is independence and investment banks' dependence on corporate relationships and trading flows diminishes this. In the US, the money earned from arranging corporate access for asset managers has thrown an unflattering light on this issue. A Wall Street Journal article entitled *"New Wall Street Conflict: Analysts Say 'Buy' to Win Special Access for Their Clients"*(19 Jan 2017) describes how some companies cut off access to analysts writing "sell notes". While corporate access is not defined as research in Europe, it can still be paid for directly by asset managers.

In the UK, the FCA has taken action to promote independent commentary on IPOs. Investors had complained that prospectuses were published too late and that 'connected' research, by analysts at banks involved in the process, was biased. In its consultation paper, "*Reforming the availability of information in the UK equity IPO process*" (March 2017), one of the FCA's main aims was to create "the necessary conditions for unconnected IPO research to be produced".

Operations put at arm's length to ease conflicts

It is possible that MiFID II will encourage banks to put their research operations at arm's length to ease the conflicts of interest. Examples of this include Kepler Cheuvreux, a European brokerage that is 34.5% owned by its staff but where other shareholders are the banks (including CréditAgricole, UniCredit, Rabobank and Swedbank) for which it provides equity research and distribution. BNP Paribas has a partnership with Exane in European cash equities and derivatives. While the banking or corporate brokerage links are not severed, it is easier for these more autonomous units to focus on the needs of the buy-side.

'Buy' and 'sell' not appreciated

It is commonly said that while external analysts provide essential information and stimulating ideas, it is the asset manager's job to make the investment decisions. Fund managers often deny that they pay attention to buy and sell recommendations. One said:

> "We are not buying recommendations, ie buy/sell Vodafone, and then measuring whether it was a good or bad decision. It's the process behind that."

'That's my job'

> And another: "Some want a clear investment conclusion, whereas others say 'that's my job'."

There needs to be some disciplined follow-up, however, to assess the value of the ideas. One asset manager's list of desirable analyst attributes included the efficacy of ratings, but also domain expertise and depth of knowledge. Its time horizon was two years, with monitoring along the way:

> "At the heart of the process is how effective they are. Does the price of the stock move as predicted over the relevant time period? Are they good long-term stock pickers? Are their recommendations adding value for the benefit of the clients ie safeguarding alpha for our clients?"

Different asset managers want different things depending on their mandate and the end-investors' time horizon. When it comes down to stock picking, what is helpful is "understanding of the business model, the competitive dynamics, why the company has higher margins… that's difficult research and requires real thought". An important component is access to analysts as trusted advisers.

Independent analysis should add to both the sum of knowledge and the spread of opinion. One consumer of macro research said he needed:

> "a) factual input telling me not just when things are published but who the policy-makers are, their views, political context…and b) I want someone to be provocative: show me data and things I have not seen before."

'I want someone provocative'

External research can help portfolio managers at both ends of the investment process. Expert screening and sifting can "break the bulk" for portfolio managers who may be covering hundreds of stocks. They are concerned with portfolio construction and do not have time to be experts. In the bond markets the task of helping the manager to zoom in on potential opportunities is particularly important because of the sheer number of instruments. One interviewee said: "There are too many stars and the analyst applies the telescope." At the other end, once a sector has been identified as of interest, experts on that sector can help with stock picking and monitoring trends.

A key question is the extent to which research services can be disaggregated so that asset managers can pick and choose providers for different asset classes, investment styles and sectors. A greater breakdown would help IRPs to compete as they tend to operate in niches:

> "The majority of the buy-side is already looking at it on a disaggregated basis, so they won't subscribe to the whole service. They will say 'who is the best auto analyst and I don't care where they work'."

Chapter 6: The next five years

Spending on research will fall further

Most CSFI interviewees expected asset managers' spending on research to fall further in the next year or two. This is based on the assumption that asset managers are now highly motivated to drive down costs, bearing in mind the trend towards them absorbing research spending into their P&L (see Appendix II):

'There are savings to be had'

> "Payments for research will continue to decline. A lot have not thought about this carefully and when they do they will find there are savings to be had."
>
> "The regulators don't want to have the underlying clients paying for research ie it goes to the P&L and costs are borne by the industry."

Fewer providers, fewer analysts

The expected impact is that asset managers will rationalise their research supply chains. The shake-out is expected to reduce the number of firms providing research as well as the number of analysts employed at many remaining firms, as they focus on the areas of expertise for which they can get paid. This will be informed by what one interviewee described as "a period of price discovery that never existed before".

Some predict further cuts in international banks' activity in the cash equities market in Europe, leading to a further cull of the dozens of analysts following large-cap companies. One estimate is that 25-30% of sell-side analysts will go. However, the recovery in US investment banks' profitability might stay their hands and feed cut-throat competition: "If business is pretty good, they are not too bothered about cutting 50 people in research in Europe. If there is a real downturn, then you get a sense of urgency."

The FCA's unflattering picture

The pain will not only be felt on the sell-side, where cuts date back to the financial crisis. Interviewees saw over-capacity across the industry. The FCA's unflattering picture of the asset management market, in reports published in November 2016 and June 2017, showed weak competition, price clustering for active management and eye-brow raising profit margins of, on average, 35%. The inference is that there is fat to be cut and scope for profit margins to fall – including by absorbing costs traditionally excluded from the annual management charge.

Add to this the pressure on charges imposed by unfavourable comparisons of active with passive managers. One response has been for asset managers to merge and prune overlapping activities – a consolidation of the industry that is forecast to continue. Compliance costs related to FCA action and MiFID II create another headwind:

> "On the buy-side: you will see further consolidation in the industry…eg Aberdeen/Standard Life and a lot more to come."

> "You need a certain minimum AUM to absorb all the regulatory costs."

> "The industry absolutely needs to consolidate."

1-2 years bad, 3-5 good

Complaints of 'low-balling' by banks

On prices, there is much nervousness about the next year or two. In the recent Euro IRP survey there were complaints of "low-balling" by investment banks in an effort to retain market share. Interestingly, one sell-side manager interviewed by the CSFI was also concerned about being undercut by banks with a weaker franchise, but which were not yet ready to give up.

While there is disagreement over how "chaotic" the next year or two will be, the perception is that capacity needs to be driven out before the market stabilises and starts to grow again. A more benign view is that spending on research has already become constrained in anticipation of MiFID II, and that the long decline in trading costs to a very low level has left more firepower for research:

> "Counter-intuitively, there will be an increase in budgets for research. People have been holding back because they are getting rubbish. There will be less spending on trading because that is increasingly run by technology and algorithms."

A key question is to what extent consumers of research will rebalance their attention away from quantity – the daily torrent of unsolicited reactions to news – and towards quality, actively seeking more fundamental analysis and fresh ideas, including contrarian ones. The fear is that the buy-side will focus on cost rather than value. One interviewee said:

> "The buy-side does not know what the real value is, so they will drive prices down until something happens."

The "something" would be a drop in service level, or a reduction in choice as providers drop out in the face of bad competition.

Reduction in choice if providers drop out

Asset managers' move towards paying for research out of a P&L account minded by the finance director might be a factor in this. "The big worry is that if they get it wrong, especially if they pay via the P&L, the service will fall." Another challenge mentioned was to ensure that the measurement of research activity did not create the wrong incentives "ie every time you meet a broker, it incurs $1,000 on the internal budget clock":

> "The aim should be to find the price you have to pay to get the external research that your strategy needs to deliver returns to investors."

As headlines about asset managers opting for the P&L route mount up, what is not clear is whether they will switch to an all-in management fee (also known as the ongoing charges figure) that is higher than the old annual management charge. The argument is that clients will see the logic of this as previous add-ons are added in. If the all-in fee is under pressure, a willingness to absorb research costs into the existing fee might help convince clients that they are getting value for money:

> "I'm confident managers will increase fees to recoup costs: adjust the add-ons downwards and the regular ones upwards. Yet there is quite low confidence among fund managers that they can pass these costs on as they have not 'fessed up' to other costs in the past."

Active vs passive

At the highest level, active decisions are constantly being made about portfolio construction and risk management. The area that has attracted most criticism has been active equity management. At present the weight of opinion is that, on average, active management does not pay off after charges. But there are reasons to believe that such pessimism has gone too far. An article in the Financial Analysts Journal (Gallagher, Harman, Schmidt and Warren, vol 73, no 1, 2017) examined the performance of 143 global equity funds 2002-12. They generated annual excess returns, over their benchmarks, of 1.2%-1.4% before fees.

Conditions improve for active managers

A light at the end of the tunnel is that this year correlations have diminished between markets and asset classes, and within them. Coupled with less Pavlovian following of "risk on, risk off" trades, conditions have been more favourable for active managers, and 2017 may see the majority beat their benchmarks for the first time in several years. And at the end of a long bull run in US equities, analysts who help asset managers position portfolios to weather a correction also have a chance to prove their worth.

Active managers that pass on most of the excess returns to clients should retain their appeal. That will mean lower fees for mainstream active management and/or a prompt to link fees to performance – hedge fund lite. At the start of October, for instance, Fidelity International announced plans to reduce its annual management fee for active equity funds and to introduce a variable fee linked to fund performance.

Losers would be 'closet trackers'

Losers in a value-for-money world would be "closet trackers", which charge active fees while hugging benchmarks. They are bound to under perform after charges. In its market study, the FCA identified "around £109bn in 'active' funds that closely mirror the market which are significantly more expensive than passive funds". It is also possible that passive investing will become more risky as it concentrates a greater weight of mindless money in popular funds (index-trackers and ETFs), embodying herd behaviour:

> "The shift to passive can only go so far. If everyone moves in the same direction it's easier for actives to outperform."
>
> "The ideal is that half a dozen analysts cover each company and they have an active debate about its merits."
>
> "The analysts [should be] paid as any other professional service provider, for their expertise and time, whatever the action taken."

Challenges on all sides

Buy-side

A few interviewees expressed concern about the future for small asset managers because of rising compliance costs and pressure to absorb research costs. However, it was interesting to hear these doubts expressed by people from large institutions. According to one interviewee who had met a wide range of market participants: "The smaller firms see it as an opportunity: they are more targeted."

Those that are clear about their internal strengths should find it easier to work out what sort of research services they need to buy in a) to support their internal teams and b) to allow some opportunities to be pursued in areas where they have fewer in-house resources:

> "What are the costs that a fund manager would incur to produce the relevant research for themselves?"
>
> "It is germane to the asset management model to generate ideas – either your own or from a healthy independent research market, which depends on a level playing field."

Economies of scale can help

Nevertheless, economies of scale can help cover the cost of regulation, investment in technology including data analytics and automation, and marketing. The last is particularly important for independent and smaller research providers if they wish to break into the continental market.

Sell-side and independents

It is assumed that demand for waterfront coverage of industry sectors across the globe will persist. But as this will be the single biggest item of expenditure on research, asset managers are expected to limit the number of suppliers:

> "Within the bulge bracket there will be clear winners in terms of positioning."

> "It will end up with fewer [waterfront] research providers and there are several banks in a weak position because of regional or asset class holes."

The concern among IRPs is that investment banks will continue to subsidise research. While it will be easier for a bank to see the revenues generated by research teams, will it actually aim to have a self-sufficient unit? MiFID II follows other regulation in erecting barriers between research teams and corporate finance and trading departments. Its requirements will shed more light for banks' boards on whether it is worth spending so much on research teams that do not earn enough to cover their costs:

> "Whether IBs continue to subsidise research is a key factor. If it becomes explicit that they have a business that makes no economic sense on a standalone basis, they are less likely to invest in it."

Subsidies for research a key factor

"Cross-subsidy" is a derogatory term, but it must be remembered that research has internal value for banks. In fixed income, they are big asset owners in their own right; while for their loan books, they need economic and market insight to inform lending decisions. On the equity research side, an indirect 'halo effect' can justify cross-subsidy, since it helps the bank to win corporate clients and advisory work on deals:

> "Research has been a loss leader for investment banks for as long as I can remember. It is only there because it can be subsidised through banking activity."

> "I think they [independents] will struggle because they don't have anyone else paying for research, whereas the big banks have corporate finance and possibly wealth management feeding the research department."

Recognition of these cross-subsidies, however, highlights the conflicts of interest that mar the objectivity of their research. Those that act for corporate clients are not seen as fully independent even when commenting on non-clients. After all, they are in the market for business from them.

It is up to IRPs to seize the opportunity

IRPs should be among the winners, so long as they can demonstrate their worth to asset managers, sector by sector and through the entire investment process. Regulators are keen to see a more diverse and rich patchwork of research providers, and the assumption is that severing links to trading and forcing investment banks to price their research will help level the playing field. It is up to independent firms to seize the opportunity, although their financial resources may be tested by price competition, and they will need to promote themselves:

> "The role of the independents will increase in importance in terms of payments for research and relationships with asset managers, but it will depend on the quality of what you provide. They become an extension of the investment process that is taking place."

Consolidation in execution

The other side of unbundling is best execution. Several interviewees expected further consolidation, with the winners being those with the fastest, smartest technology, namely execution only venues and bulge bracket firms. This presents a challenge to smaller and/or more diversified brokers, which could lose execution revenues to the highly automated "big flow shops", charging as little as 2bps. "So the only way of attracting equity revenue is if your research is good," as one interviewee put it.

Some IRPs, such as Redburn and Autonomous, have augmented their revenues by acting as agency brokers. The 2011 CSFI report pointed out the advantages of this in a CSA world: "Obviously, the ability to earn the entire gross commission rather than just the research portion significantly increases potential revenues." It also ensures prompter payment and enables services to be structured as ancillary to trading.

'High touch' execution has a place

MiFID II isolates the decisions asset managers must make about execution. For straightforward trades in liquid markets, the cheapest option will be best. But not all trades are like that. The potential market impact of some investment decisions can mean it is difficult to execute them at the assumed price. So 'high touch' execution services, coupled with specialist market knowledge and advice, will still have its place – via either dealing commissions or bespoke services paid for directly. As with research payments, it will depend on asset managers working out what will provide the best value for the end-investor.

Endgame: effective markets and better value for the end-investor?

Removal of perverse incentives

The creation of RPAs and the need to accommodate US businesses using CCAs means that full unbundling will not arrive on 1 January 2018. But it will create transparency of research costs, even if the prices revealed lack coherence. While there will be complaints about predatory pricing and cross-subsidised sell-side output, breaking the link with trading volumes and the ban on inducements should remove some of the perverse incentives:

> “One of the things that will change is that smoke and mirrors on either side is harder to get away with. You are banned from saying execution of trades pays for/covers research.”

> “Greater transparency is an excellent result whether it’s enhanced CSAs or hard dollars.”

> “The regulation should be fostering an effective market where previously we had an absence of transparency and misaligned incentives.”

The end-investor should certainly be better served, not only by greater transparency but also through greater value for money. The latter may arrive initially in a painful way for research providers, since asset managers may initially focus on cost-cutting. Ultimately, however, they will work out what it is worth paying more for in order to achieve the goals of their clients – Europe’s mass of investors:

> “Research should be paid for transparently ie on a view of value for money.”

> “You don't exist unless you help clients make money – and that is how it should be.”

'The real winners will be clients'

> “The real winners will be clients: they will know what they are paying for, how much, and they will get better value.”

Appendix I: MiFID II

The Markets in Financial Instruments Directive of 2014, know as MiFID II – or Directive 2014/65/EU – amends previous directives and continues their focus on investor protection. More specifically, the aim is to ban any inducement for fund managers to act in a way that is not in clients' interests. In the market for research, this means completing the regulatory drive to insist that payments for research are unbundled from fees for executing trades. The latter has, in turn, been subject to increasingly rigorous requirements to demonstrate that "best execution" terms have been achieved for the client.

A key section of the Directive is Article 11 on Inducements. The focus is on ensuring that any benefit received by the investment manager enhances the quality of service to the client (asset owner), and does not distort or bias the provision of services:

> "Investment firms shall hold evidence that any fees, commissions or non-monetary benefits paid or received by the firm are designed to enhance the quality of the relevant service to the client."

The "evidence" required includes keeping detailed records of the benefits received from a third party and how the investment manager intends to use them to enhance the quality of service to the client. An issue here is the need to disclose in advance what relevant service is and, in principle, how much will be paid for it. The emphasis is on a prior agreement, or disclosure of the method for calculating any future payments followed by information about the exact amount paid. At least once a year, "the investment firm shall inform its clients on an individual basis about the actual amount of payments or benefits received or paid".

There is an exemption for "minor non-monetary benefits" if the benefits are trivial, such as hospitality of a minimal value, or if the research is made generally available. This includes reports commissioned by a company, where the relationship with the research provider is clearly disclosed.

Article 13 sets out how payments for research can be made:

(a) direct payments by the investment firm out of its own resources;

(b) payments from a separate research payment account controlled by the investment firm.

The latter – RPAs – come with further requirements including that they must be funded by a specific research charge agreed with the client. RPAs form part of a research budget set by the firm, which it must regularly assess. The quality of the research purchased must be judged on robust criteria based on its ability to contribute to better investment decisions. It is emphasised that this assessment must “not be linked to the volume and/or value of transactions executed on behalf of the clients”.

Further, the “allocation of the research budget to purchase third party research shall be subject to appropriate controls and senior management oversight to ensure it is managed and used in the best interests of the firm’s clients. Those controls include a clear audit trail of payments made to research providers and how the amounts paid were determined with reference to the quality criteria.”

Appendix II: *Financial Times*

Mifid II: How asset managers will pay for research

Data as of 10.30 on October 3 2017

Pass costs on to clients	Absorb costs	Undecided	Declined to comment/ no response
Amundi*	Allianz Global	Ashmore	Credit Suisse
BNP Paribas*	Investors	BNY Mellon	Investec
Carmignac	Aviva Investors	Candriam	Morgan Stanley
Deka	Axa Investment	GAM	State Street Global
Fidelity	Managers	Legal & General	Advisors
International	Baillie Gifford	Investment	
Man Group	Barings	Management	
	BlackRock	Lyxor	
	BlueBay Asset	Natixis Global Asset	
	Management	Management	
	Brewin Dolphin	Nordea	
	Brooks Macdonald	Old Mutual Global	
	Canada Life	Investors	
	Charles Stanley	Pictet	
	Deutsche Asset		
	Management		
	Equitile		
	Evenlode		
	Fisch Asset		
	Management		
	Flossbach von		
	Storch		
	Franklin Templeton		
	Goldman Sachs		
	Asset Management		
	Hermes		
	HSBC Global Asset		
	Management		
	Insight Investment		
	Invesco**		
	Janus		
	Henderson***		
	JO Hambro		
	JP Morgan Asset		
	Management		
	Jupiter		

Pass costs on to clients	Absorb costs	Undecided	Declined to comment/ no response
	Kempen Capital		
	Management		
	M&G Investments		
	Majedie Asset		
	Management		
	NN Investment		
	Partners		
	Newton Investment		
	Management		
	Northern Trust		
	Asset Management		
	Pimco		
	Rathbones		
	Robeco		
	Royal London		
	Ruffer		
	Russell Investments		
	Schroders***		
	Seven Investment		
	Management		
	Standard Life		
	Aberdeen		
	Stewart Investors		
	SVM		
	T Rowe Price		
	Troy Asset		
	Management		
	TwentyFour Asset		
	Management		
	UBS		
	Unigestion		
	Union		
	Investment***		
	Vanguard		
	Woodford		
	Investment		
	Management		

* *Previously said it will charge clients, but now says it is still deciding*
** *Had said preferred approach was to pass on research costs*
*** *Originally stated they would pass on research costs to investors*

Source: FT research

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