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Reshaping research, reshaping the industry

Unbundling shows clients what they are paying for bought in research

Recently introduced rules, Bundled Brokerage and Soft Commission Arrangements (FSA PS05/9) require the reporting of how commission charged to client funds and paid to brokers for equity trades has been spent, split by execution and research. The rules that make it clear that managers are spending client money on research will fundamentally change the relationship between buy-side and sell-side firms. Now investment managers are more accountable for the research they buy, they will be more considered purchasers (roughly translated as: 'they will probably want to pay less and buy less').

Unbundling enables clients to ask how research is chosen

Investment managers will have to be able to answer client questions such as; "please list the services paid for by commissions.... and explain how you evaluate the benefit these generate for us relative to the costs incurred." Some managers with their own research will be able to answer that they are only spending commission on execution. Others who said in their sales pitches that they mainly do their own research but are paying for a lot of sell-side input are now out in the open.

This and 13 other questions are prompted by the NAPF and informally endorsed by the FSA. To arrive at answers to these questions, managers need more rigorous processes to decide what to buy and how to evaluate research bought with client funds.

More has been 'bought' than was used

This will affect a profitable business for sell-side firms where it is now generally acknowledged more research was bought than was usefully consumed.

What are clients buying?

So, what constitutes research? It's not simply Earnings Per Share or earnings growth forecasts. 'Research' includes access to analysts, bespoke research, use of financial models and, importantly, written company research. The importance of routine written research is played down by investment managers; in practice it is clear few will want to do without it entirely. More controversially brokers have organised meetings for companies and their investors. This is a service both have valued (and paid for). However, it is not obviously 'research' within the meaning of the regulations and there are some who say it is more akin to a specialist sort of travel agency.

Buyers and suppliers suffer mutual incomprehension

Currently the procurement process is often little more than a beauty contest based on a buy side analyst's or fund manager's vote, with little evidence to support the value received. Managers have to develop this process now so they understand what they need and what they can pay for. The renegotiation with sell-side firms has already begun.

The problem from the brokers' side is that they say fund managers do not understand their own approach to investment well enough to ask for what they need. Sell side researchers are struggling to understand what winning research will be like. An EPS forecast can be judged for accuracy. The rest of the research product needs to be honed to attract what research budget is left once managers become more discriminating.

From the point of view of the fund managers it is not clear how broker research is differentiated. What makes a piece of Morgan Stanley research different from something from Deutsche?

What does the future hold?

Unbundling of commission legislation has led to more commission-sharing agreements, where one broker executes the trade and another shares the commission and provides research. This enables clients to benefit from best execution and the chosen research. This is also benign news for many independent research firms; there is now a mechanism for them to be paid via commission.

Not such good news for the fund managers who are used to a variety of cross-subsidies from clients and competitors. The larger firms who believe they have been providing those subsidies are privately quite happy that they may no longer be supporting competitors.

The flip side of this is in an increase in brokers conducting execution only business. The debate about whether execution will all gravitate to a few market makers or to a plethora of cheap crossing services is underway.

The regulators will step in if the market for research does not change

If some clients do not ask the questions proposed by the NAPF perhaps investment managers will take more notice of this quote from the FSA: "There are signs that the market is moving in this direction and we think we should encourage an evolutionary approach to unbundling. **But, if this does not happen, further intervention may be necessary.**"

A solution?

Evaluating research is a complex problem, and one that will not go away now the issue has been raised, whoever is buying it. Right now fund managers need to be able to explain to researchers and clients what they value. The original recommendation from the Myners Review in 2001 that indirectly led to the new rules suggested the matter is much less of an issue between end client and fund manager if the manager is paying for research (in-house or bought-in) out of the revenue from a clean fee.

About the author

Richard leads the Investment Process practice. He works with clients on the beliefs that drive their investment processes (and the consequent construction of portfolios) and how the whole is translated into a coherent marketing message.

He began manager assessment in 1989, selecting funds for manager of manager's programmes for Schroder and FPAM. Richard ran funds for Friends Ivory & Sime before going on to develop products and marketing messages with Flemings and as UK Marketing Director at AXA.

Since joining Investit he has successfully completed projects analysing and developing investment processes and delivering evidence-based marketing messages for Fixed Income, Equity, Property and Multi Asset products.

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