Independent Research: because they’re worth it?

Vince Heaney
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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Published by
Centre for the Study of Financial Innovation (CSFI)

Email: info@csfi.org
Web: www.csfi.org

ISBN: 978-0-9570895-6-3

Printed in the United Kingdom by Heron, Dawson & Sawyer
Preface

No sooner does the independent research sector “come of age” – as we reported last year – than the market for research is threatened by the latest wave of cuts at financial institutions. As Vince Heaney reports, commission income from fund managers is shrinking hard and investment banks, which produce sell-side research, are fighting hard for whatever revenues remain.

The independent research sector has enjoyed some better news, helping to level the playing field. The Financial Services Authority, prompted by last year’s report, has investigated whether the provision of corporate access – as organised by investment banks – should count as a research service. The answer is apparently not. In addition, aversion to both universal and investment banks has grown through a combination of self-inflicted wounds, such as the Libor scandal, and the unpopularity of the too-big-to-fail format.

But this is no excuse for the relatively small and fragmented community of independent research providers to rest on its hard-won financial independence. Cost-conscious investors increasingly want to see results – ie measurable outperformance of peers and/or a benchmark.

This report considers how researchers in general – and independents in particular – can prove they are worth it. The question is almost as difficult as asking my old employer, the Financial Times, whether it can prove that its readers make more money for their clients. My former FT colleague, Vince Heaney, has had to tackle the tricky argument about subjective versus objective judgments of value. With the help of both an original survey of users of research and a series of interviews, he explains how technology will provide part of the answer – but never all of it.

The conclusions of the report are provocative for the independent sector – which is a good thing since its representative body, Euro IRP, commissioned it. The author then worked independently on it. We at the CSFI do not take a position on any of the issues, but we do support competition and the debate of controversial issues within financial services, including those parts that mind our savings.

Jane Fuller
Co-Director, CSFI
Independent Research: because they’re worth it?
Vince Heaney

Foreword

CSFI’s 2011 inaugural report into independent research - Has independent research come of age? – outlined how the independent sector’s product is clearly differentiated from the sell-side competition, playing a critical and value-added role that is highly prized by its buy-side customers. But the report also identified that the environment in which the independents supply their services is not a level playing field, with the use of dealing commissions to pay for corporate access one of the areas of particular concern.

Following the success of the report, particularly the interest it garnered from the regulator, it seemed appropriate for Euro IRP to commission a follow-up. This time the focus is on the people best placed to give useful independent insight into the value created by IRPs – the fund management end-users.

Once more, Vince Heaney has produced a very insightful piece of work, but more importantly he has also been able to report on the fruits of last year’s labour, with action by the FSA against the use of commissions to pay for the classic corporate access ‘concierge service’ provided by investment banks.

Euro IRP remains committed to supporting the needs of investors in helping them access the very best un-conflicted research - and to improving the position of our membership to help them achieve this important goal. We very much appreciate the substantial efforts of the institutional fund management community in their continued support and assistance as well as the tremendous contribution of Vince and the CSFI through these invaluable reports.

Peter Allen  Co-chair Euro IRP
Elaine Mulcahy  Co-chair Euro IRP

Euro IRP was set up in 2005 to represent the interests of the independent investment research industry in Europe. With some fifty member firms, its goals are:

- 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; and
- to improve the regulatory and fiscal environment in which independent research firms operate
Introduction

The 2011 report, “Has independent research come of age?”, commissioned by Euro IRP (the European Association of Independent Research Providers) and published by the CSFI, assessed the development of the independent research sector in the decade after Eliot Spitzer uncovered sensational evidence of tainted research by analysts working at US investment banks. The main conclusion of the report was that the independent sector had become an established part of the research market and was highly valued by its buy-side customers. In a world overloaded with electronically distributed, commoditised research, true insight that delivers a market edge is sought after – and the independent sector is well placed to provide that.

Last year’s report also found that the environment in which the independents supply their services is not yet a level playing field. Use of dealing commissions to pay for corporate access services provided by investment banks is evidence of continuing market distortions that legislation, in the wake of the Myners report, sought to eradicate. Our findings prompted the Financial Services Authority to look into payments for corporate access, leading to its recent announcement that this activity does not count as a research service. This should remove the justification for directing dealing commissions towards corporate access [see box on page 4].

A more level playing field would represent significant progress for the sector, but ultimately it is the quality of the product that will underpin growth in independent research.

A further conclusion from the 2011 report was that the independent sector, in general, had not come of age in terms of scale because of the niche nature of its output. With sell-side research still often considered a free commodity, the challenge faced by independent research providers (IRPs) is to demonstrate and get paid for the value they create. This year’s report – also commissioned by Euro IRP and published by the CSFI – turns to the question of value and asks: are the independents worth it? The report considers the question of creating and measuring value and looks at recent developments within the research market to address this issue.

Measuring added value is not easy. The judgment involved is inevitably at least partly subjective. It depends on the diligence of those involved, and the process cannot be wholly insulated from commercial pressure or personal influence. A further complication is that the independent input may be just one of a variety of sources that a fund manager draws on before making an investment decision. Assessing the value of analytical material will never be a wholly quantitative or objective exercise.

1. A summary of the 2011 findings is given in Appendix I.
Many independent research providers (IRPs) track the success of their investment ideas, although this is easier for those providing recommendations related to specific securities than for top-down, or macro, analysis. Some also run paper portfolios based on their recommendations, although such arrangements have the potential to create conflicts of interest with an IRP’s independence. A lack of common metrics for assessing research is another part of the problem, and last year’s report supported the development of more objective measurement techniques.

From the buyer’s perspective, the main tool in most jurisdictions for assessing the value of research has been the fund managers’ voting system. This system of periodically ranking research providers, and allocating commissions accordingly, is not standardised and can prove opaque, haphazard and manipulable. For larger fund management groups, the process can be quite rigorous, while for smaller firms it is often informal. It relies on the diligence of busy fund managers in assessing periodically a product they may have used several months previously.

As well as these inherent difficulties in valuing analytical output, the market environment in which research providers are attempting to create – and get paid for – added value continues to be harsh. Buy-side commissions remain under pressure and the investment banking industry is rationalising its business to suit a structurally lower level of activity.

The best people to give an independent insight into the value created by IRPs are the users of that research. This year’s report focuses, therefore, on the views of fund managers. The CSFI, with input from Euro IRP, devised an original survey that was distributed to a broad range of fund managers in the US, Europe and Asia, using a database provided by Thomson Reuters Extel. The survey results are based on the views of 156 buy-side users of financial markets research. Two-thirds of the respondents were UK-based, a quarter were from continental Europe and the balance from the rest of the world. It should be noted that a significant proportion of the respondents based in London work for overseas firms.

The results were supplemented by interviews with fund managers, IRPs and third-party information providers (see the list of contributors on page 33). The conclusions drawn are the author’s own and are not necessarily endorsed by the CSFI or Euro IRP.

2. The survey questionnaire is given in Appendix II.
FSA takes action on corporate access.

The fund management industry is expected to stop paying for corporate access services with dealing commissions after the Financial Services Authority in November published a letter outlining its opinions on the issue. This represents a significant leveling of the playing field for IRPs, which typically are not in a position to provide fund managers with access to senior company management in the same way as sell-side side brokers and investment banks.

Corporate access was brought onto the regulator’s radar following the publication of last year’s CSFI/Euro IRP report “Has independent research come of age?” The report concluded that “use of dealing commissions to pay for corporate access services provided by investment banks is... evidence of continuing market distortions that legislation in the wake of the Myners report sought to eradicate.”

National press coverage of the report picked up on the call for corporate access to be scrapped from the list of activities that dealing commissions are able to cover. Following the call for the FSA to take action, Peter Allen and myself, as the author of the report, met with the FSA to discuss the issue of corporate access. It was clear from these meetings that the FSA intended to investigate the issue with market participants.

As part of a thematic review of conflicts of interest, over the last year the FSA has discussed use of commissions with a number of buy-side firms, and corporate access was a part of those discussions. The FSA has now published a letter giving feedback to the fund management industry on use of commissions, but it will not issue guidance.

The regulator has defined corporate access in the letter as follows: “Access to company management, (sometimes also referred to as ‘corporate access’), means, in this context, the practice of third parties (typically investment banks) arranging for asset managers to meet with the senior management of corporations in which the asset manager invests, or might subsequently invest, on behalf of customers. It does not refer to any research services that might be provided by the third party alongside providing access to company management.”

The FSA said that all the buy-side firms it spoke with believed corporate access is a valuable service and that they pay for it with dealing commissions. The FSA, however, has written in its letter that the buy-side firms it spoke with were unable to demonstrate how brokers arranging for access to company management constituted research or execution services.

The implication that can be drawn from the FSA's letter is that spending dealing commissions on corporate access, as defined by the FSA, may not fall within the rules and needs to be explicitly justified with reference to the regulator’s evidential provisions. While the letter does not constitute guidance, it can be expected to prompt the fund management industry to assess its use of dealing commissions and to stop paying for corporate access through commissions.

That, however, is unlikely to be the end of the issue. The provision of corporate access by sell-side firms may be accompanied by genuine research as part of a package. The sell-side may choose to provide more of the research element in future, although the regulator would require a mixed use assessment to be carried out – the research component could be paid for with commissions, but the corporate access would have to be paid for out of the firm’s own resources. Alternatively payments for corporate access may go ‘underground’ – dropping off broker voting services and being bundled in other ways. The FSA, however, intends to conduct a further round of reviews of buy-side firms next year and is likely to look at how buy-side commission payments have evolved once the significant proportion which goes to corporate access is removed.
Executive summary

The market environment

- Fund management commission pots continue to decline. On some estimates, commissions are now 40 per cent below the pre-crisis peak.

- The sell-side is contracting again. While trading staff have borne the brunt of recent headcount reductions, the investment banking industry still has a long way to go to downsize to a level appropriate to a structurally lower level of business.

- Competition is fierce among research providers to maintain or expand their share of the declining commission pot. Fund managers are under pressure to allocate shrinking research budgets efficiently, while maintaining access to the services they value.

Main points of the 2012 survey...

CSFI/Euro IRP Survey highlights

- 47 per cent of the institutions taking part currently pay for independent research and the majority of those expect at least to maintain their expenditure in 2012-13. Almost three-quarters of the respondents who are paying for independent research expect to maintain or increase their use of it over the next three years.

- 87 per cent of those surveyed expect that the independent sector will maintain or gain market share against the sell-side over the next few years.

- The most popular type of research consumed is macroeconomic/policy, with 54 per cent of survey respondents taking this category, while 40 per cent also use strategic/tactical asset allocation research.

- Almost three-quarters (72 per cent) of those using independent research believe that quality has improved over the last decade.

- Independent research is seen by users predominantly as a complementary offering to in-house research. The independents are perceived as supporting and filling in the gaps in the fund manager’s own output.

- A significant minority (28 per cent) view independent research as an alternative to the sell-side.

- Despite the introduction of Commission Sharing Arrangements (CSAs), the dominant payment model remains fixed fee/subscription.
Only just over a quarter of survey respondents said that exclusive access to research was important to them – contrary to anecdotal evidence.

Nearly half (48 per cent) believe that a common metric for valuing research – both independent and sell-side – should be developed.

Conclusions

The CSFI/Euro IRP Survey 2012 confirms that the independent research sector has become an established part of the research market that is highly valued by its buy-side customers. Based on this positive picture it would, in many cases, seem appropriate for IRPs to adopt a “carry on as you are” strategy.

However, independent research does not operate in a vacuum. A secular contraction of the financial services industry is under way, tighter regulation is here to stay and many banks still have an operating model geared to historic volumes of activity and will need to continue to downsize their businesses.

Sell-side contraction does not imply an easier ride for the independent research sector. Banks will fight to gain a larger share of the business areas left open to them, while the buy-side has a smaller amount of money to allocate.

The nature of the market is changing. High-frequency algorithmic trading and low-cost ETF passive investment strategies have no need for research. In a market where passive investment is cheap, there is a greater need to generate market-beating returns to justify the cost of active management.

Implications for the independent research sector

IRPs need to demonstrate value creation and shift from being “nice to have” to “need to have” in an environment where end-users are increasingly being required to justify – and minimise – their costs.

It will never be possible to remove all subjectivity from the assessment of the value added by independent research. Value is, to some extent, inherently qualitative.

There will continue to be a healthy market for research that is not linked to specific trading recommendations and with a longer-term investment horizon. Buyers are happy to part with cash for good ideas and they express their satisfaction in repeat subscriptions.
The qualities that buyers value – genuine independence, a degree of exclusivity and a fresh approach compared with the sell-side competition – are what help differentiate independent research and provide the key to building a long-term value proposition.

Nevertheless, there is an emerging trend towards greater rigour in the measurement of value. Alpha capture systems, which track the performance of trade ideas as well as filtering and organising the welter of information fund managers face, offer one possible tool to allow a more rigorous measurement of value.

Quantitative value measurement, however, will not displace qualitative assessment. So business models based on either fees for consultancy services or subscriptions for good published ideas remain valid. Quantitative and qualitative approaches are likely to flourish side-by-side in a twin-track model.

Increased rigour is likely to become a growing part of the way fund managers, the sell-side and independent research providers manage their relationships. Additional compliance requirements regarding the handling of sensitive information will be an important driver of this trend.

The bulk of the fundamentally-based fund management industry still operates on subjective and informal assessments of the value-added by research. However, the direction of travel towards increased rigour appears clear.

While currently focused on short-term trading ideas, alpha capture is being developed to incorporate longer-term investment themes, particularly those based on global macro strategies. As these systems develop, and given the appetite for macroeconomic/policy research revealed by the survey, more IRPs will convert their research into trading ideas or investment themes. An expanded alpha capture range will be available to measure performance quantitatively, as a means of generating revenue, servicing client relationships and attracting new customers.

The market environment

The market backdrop that IRPs face continues to be very tough. Trading volumes in equity markets remain subdued, which means that commission pots are declining and the buy-side has less money to spend on research. Integrity Research Associates, an information provider specialising in the investment research industry, estimates that commission pots are 40 per cent smaller than at their peak in 2007. In April of this year, TABB Group, the financial markets research and strategic advisory firm, estimated that for US markets, long-only fund manager equity commissions would fall by at least 5 per cent in 2012.
With less money coming into the system, sell-side providers of research are feeling the pain. After a reduction in headcount in 2008-09, the sell-side started investing in research again, but because the hoped-for recovery in business levels has failed to materialise, investment banks are shedding staff once more.

In June of this year, news emerged that Credit Suisse planned to shed up to one-third of the senior employees in its European investment banking department. In July, Deutsche Bank announced that it would cut 1,500 jobs in its investment bank, having said only in April that it saw no need to reduce headcount. Deutsche’s new co-chief executive, Anshu Jain, said profit expectations had moved “closer to our grim scenario” and that difficult economic conditions and financial markets, increased regulatory oversight and litigation were all creating headwinds for the bank and the industry.

However, other press reports citing headhunters claimed that traders and sales staff were feeling the brunt of the job cuts and that research functions had been better protected. Banks with a pipeline of equity capital markets business are believed to be retaining their research divisions so as to be in a position to support deal activity when the market recovers.

Market participants’ assessment of future prospects is qualitatively different this year when compared with a survey carried out in 2011 by Euro IRP. There is greater awareness that the downturn in investment banking has a structural element to it, as well as a cyclical one. As one headhunter puts it, “the industry has a long way to go to right-size the model to a sustainable level of business”.

“At the beginning of this year, across the whole brokerage community, two thirds of firms thought the market was in a cycle – not a good point in it, but still a cycle – while one third were saying the model is broken”, says one provider of broker voting services. “Over the course of the year those proportions have switched round.”

In what could be taken as an illustration of the tough environment, in August Goldman Sachs announced the closure of its Hudson Street Services business, which offered independent research and data to its institutional clients. Goldman made minority investments in the research firms that joined the platform and received a commission on every sale it made on their behalf, but the investment bank admitted that “weak demand from our clients did not warrant continuing the effort”.

Reuters reported that “Hudson Street's failure is the latest sign of how difficult it is for smaller research houses to thrive in a market where everyone from the big Wall Street banks to major mutual fund firms are seeking to cut costs”. It added that this was “also a sign that major investors may no longer be prepared to pay for a diversity of opinion about the markets”.

An equally plausible explanation for Hudson Street’s demise is that it was not perceived as being truly independent. The same Reuters article goes on to quote Barbara Steiner, founding partner and head of institutional sales at the independent
research firm Portales Partners: “If you're going to be independent, you want to really be independent. As an adjunct to a bank, or another very large broker, whether you say you're independent or not, you're not perceived to be.” This alternative explanation is backed up by surveys carried out by Thomson Reuters Extel, which have found that independence is the most highly valued characteristic of research.

This pressure on both the buy-side and the sell-side affects the independent research sector in several ways. On the one hand, competition to gain or retain share of a smaller commission pot will ensure that the market remains intensely competitive. On the other, pressure on the buy-side commission pot can have positive implications for independent providers. According to one European fund management group, which currently does not pay for independent research: “With less market turnover and less commissions our importance to the sell-side has decreased. We’re not happy and the brokers are not happy, so we may have to look at other ways of getting research, such as the independent sector.”

In addition, headcount reductions create a potential pool of new entrants to the independent sector. One IRP interviewed for this report had been laid off in 2009 and started his own research company. He says: “My horror would be to fail at this and have to go back into a bank.” Moreover, the quality of the pool of potential new entrants is probably improving. “Headcount reductions have gone way beyond chopping out the dead wood. In the current round of restructuring very good people will be let go”, according to one headhunter.

Results and analysis of the 2012 Survey

“Relatively positive”...

![Graph showing budget for independent research]

Given this mixed backdrop, the results of the CSFI/Euro IRP 2012 Survey paint a relatively positive picture of prospects for the independent sector. Among those surveyed, 47 per cent of institutions currently pay for independent research and the majority of those predict they will at least maintain their expenditure in 2012-13. Just over 45 per cent of users expect their 2012-13 budget for independent research to be flat, while nearly 8 per cent see it rising. With 40 per cent of respondents unaware what their budget is, only 6 per cent expect it to decrease in the coming year.
A similar picture emerges when respondents comment on their expected use of independent research over a three-year time horizon.

Almost three-quarters of respondents expect to maintain or increase their use of independent research over the next three years. Individual institutions’ predictions for their own usage of independent research are consistent with their forecasts for the sector as a whole. 87 per cent of those surveyed expect that the independent sector will maintain or gain market share against the sell-side.

As one survey participant says, “overall it feels like a fight for survival, but there are pockets where firms are doing well”. On the basis of the 2012 survey at least, it would appear that independent research is one of those pockets.

What is underpinning this positive outlook?

Creating added value

No 1 is macro... followed by equities

60 per cent of those using independent research take it from up to five providers, although more than a quarter use up to 15. The most popular category of research is macroeconomic/policy, with 54 per cent of survey respondents taking this category, while 40 per cent also consume strategic/tactical asset allocation research. This result might in part reflect the current uncertain economic and geopolitical outlook, with many fund managers feeling they need additional help in getting to grips with the broader picture. The second most popular category, more predictably, is equities research (53 per cent).
“After 2007-08, macro research changed from being a ‘nice to have’ to a ‘must have’”, says one research provider. “In the current uncertain market environment, you have to have an informed global macro view. Our experience as a provider echoes the results of the survey.”

A significant proportion of those surveyed are unaware of their average annual expenditure per firm. Of those who do put a number on their outlay, a quarter reckon they are spending less than $25,000 a year per firm, but 10 per cent pay between $75,000 and $150,000, and a further eight per cent exceed $150,000. Clearly, for the right product, the buy-side is prepared to pay very well for independent research.

Almost three-quarters (72 per cent) of those taking independent research believe that quality has improved over the last decade. Detailed responses include the following:

- “Research is more specific and encompasses a wider variety of aspects, markets and securities.”
- “More focused and bespoke specialist consultants.”
- “More refined due to increased competition.”
- “The market for independent research has enlarged and the funds flowing into independent research have grown. As a consequence the quality has improved.”

The point about a consultancy role is important. “One US investor said to us that he did not see us as equity analysts, but as consultants – we are more a trusted sparring partner”, explains one European-based IRP who took part in the follow-up interviews. “If you establish that perception with the client you can differentiate yourself and display added value.” Part of the struggle for the research provider is to avoid being viewed simply as part of the cost base.
“Ultimately, research is sold and not bought, so how it’s sold is critical”, says one IRP. “A subscription model with relatively low fees is a great way to get established, but if the fund manager is paying more for your product they pay more attention to it and you get paid more by becoming a valued consultant.”

Perception is also important in other ways, given the recent spate of scandals, such as the manipulation of Libor. “Since the financial crisis we have taken less research from the large banks in favour of smaller, more specialist firms”, says one fund manager. “This has paid dividends with our investors, because when they ask us if we are doing business with banks tainted by the recent scandals, we can say that we are not.” Whereas independence is often viewed as desirable because it avoids the conflicts of interest inherent in much sell-side research, it has additional value as a point of differentiation from the activities of large banks/brokers.

Independent research is seen by users predominantly as a complementary offering to in-house research. The independents are perceived as supporting and filling in the gaps in the fund manager’s own output. For example: “We add value by saving the fund manager time”, says one IRP whose firm focuses on background research on companies’ US regulatory filings. “The sell-side firms are not looking at regulatory filings in any great detail.”

For larger fund management groups with big in-house research teams, it is rare to find gaps in their coverage of large-cap stocks, but lower down the market capitalisation scale there is scope for independent research to add value. “With large cap stocks we are using external research to test our in-house view against the opinions of the market”, says one large fund manager. “But our small cap teams take more of a ‘tell us your good ideas’ approach to external research.”

When it comes to comparisons with sell-side research, while the role of supporting and filling in the gaps is still important, there is a significant minority (28 per cent) who view independent research as an alternative to the sell-side.

IRPs themselves were not part of the survey, but discussions with them confirm anecdotally that some buy-side managers use independent research as an alternative to bank research that is perceived as conflicted. “We have a number of fund management clients who use us as a second opinion instead of the sell-side”, says one European IRP. “This is particularly the case ahead of rights issues, because the opinions of the banks are often coloured by their other interests.”
Somewhat surprisingly, only just over a quarter of survey respondents say that exclusive access to research is important to them. One of the conclusions of last year’s report was: “Independent research is valued partly for its exclusivity and, therefore, by definition is a niche rather than mass-market product. It is doubtful, therefore, that the sector will ever be more than a relatively small proportion of the market.”

These views are echoed by some fund managers interviewed for this year’s report, when asked why they buy independent research. “Independents come at issues with a fresh angle and their views are not available to everyone”, says one fund manager. “We are always looking for new independents to work with, who are not working with our competitors.” As another European-based manager succinctly puts it, “exclusive access is always what fund managers want”. For an IRP, however, the downside of having a small number of clients who are paying for exclusivity is a lack of diversity in sources of revenue.

The disparity between the survey and the interview evidence might be explained by differing interpretations of the word “exclusive”, or by the type of strategy the fund manager is following – quantitative strategies, for example, would not rank exclusive access to research highly.

There will always be a fine line to tread between exclusivity and ubiquity. But if the results of the survey are taken at face value, the implication is that the potential client universe for independent research may be larger than some providers think it is:

Drilling down below these high-level findings, a consistent theme emerging from interviews with both providers and users of research is that the quality of ideas forms the bedrock of the research value proposition. “The market for ideas is as good now as it’s ever been; it’s all about how compelling what you have to say is”, says one contributor who has been both a fund manager and a research provider. “The problem is that there aren’t that many people who are genuine idea generators.”
The buy-side is happy to pay for the best ideas. As one IRP puts it, “one of the biggest London hedge funds is prepared to pay us $80,000 for two ideas a year that make them money. For example, in January 2011 we told the client to short the French banks, at levels 50 per cent to 80 per cent higher than today.” This view is echoed on the buy side. “We’re looking to find out the long-term drivers of a business”, says one fund manager. “What could change, either in the market or within the company itself? That’s not the sort of information you get in maintenance research after quarterly results announcements.”

Translating added value ideas into payment, however, is not always straightforward because value lies in the eye of the beholder. “A hedge fund might want six deeply researched short ideas a year, while a long-only manager might want something broader based, backed up by quantitatively oriented forensic balance sheet analysis”, says one contributor. “The difficulty in these different situations is that the recommendation doesn’t capture the full value of the service being provided – often management access, quant models or access to analysts will be rated more highly than the trade recommendation.”

Also, given that a single piece of research represents just one input into an investment decision it may be difficult to separate out the value added. “If an outside firm gives you the idea then it’s possible to separate out the value added”, says one fund manager. “But we rely most on our in-house research, so when we have used external research for a second opinion it’s tough, other than subjectively, to decide what the added value has been.”

From added value to payment

“The subjective nature of value”...

The subjective nature of value explains why there is so much variability in the ways and amounts that independent research firms are paid.

Following the findings of the 2001 Myners report, which decided that the bundling together of research and trade execution was an “unacceptable market distortion”, the Financial Services Authority introduced new rules at the start of 2006, which limited investment managers’ use of dealing commissions to the purchase of “execution” and “research” services. In practical
terms, the mechanism adopted by the industry to implement the new rules has been Commission Sharing Arrangements (CSAs), which are designed to allow firms to choose a broker for execution, and to direct the research portion of the commission to another broker or independent research provider.

Despite the introduction of CSAs, the dominant payment model remains fixed fee/subscription, based on responses to the 2012 survey. Two-thirds of independent research providers are paid, at least in part, through fixed fees/subscriptions. The durability of this payment model suggests that users view independent research firms as information providers in a broader sense, comparable to Bloomberg or the Financial Times, rather than narrowly linking their output to trading activity.

The subscription model has the advantage for the research firm of providing some certainty of payment, which can be particularly beneficial for smaller and new providers. One IRP, which has been in business for only 18 months, explains: “As a small fish in a big pond it’s a case of what the buyer wants, but I would prefer a fixed fee because it’s clear, it gives me certainty and there’s less administration involved.”

However, from the fund manager’s perspective the fixed-fee model means that payment may be less tied to performance. “Sometimes a research provider will effectively be under-charging because they are providing good profitable ideas”, says one fund manager. “But on other occasions, if we are not using their research, we are overpaying.”

One potential solution is to use the functionality of third-party electronic delivery platforms, such as Bloomberg and Reuters, to move towards a “pay per download” model. “We have a shorter version of our research output available free on Reuters and Bloomberg, but to access the full report the client has to pay”, says one IRP. This model, however, could put downward pressure on providers’ revenues compared with the annual subscription model. A busy fund manager may like the research being delivered, but might not always have the time to download it.

A good reason for moving away from the subscription-based model is the evidence that those who are paid through trading commissions earn more than those paid through fixed fees. An analysis carried out by Integrity Research Associates compared the price per client consultation when paid through subscription and through trades, and found that firms charging via trading commissions could earn up to five times as much per consultation.

To get paid by trading commissions, however, independent research providers must first sign a CSA agreement with a broker. The fund managers who use their research must then allocate commissions to them through the fund manager voting system (also known as the broker vote, given its use to rank and pay sell-side providers).
The broker vote

In principle, the broker vote is straightforward but, given its inherent subjectivity, it can be hit-and-miss and susceptible to pressure from vested interests. At regular intervals, a fund management company’s portfolio managers, analysts and in some cases traders assess the services they have received from sell-side and independent providers and allocate commission income to those they value. In practical terms, however, the process can become complicated and varies considerably across fund management groups. The first point of differentiation is the degree of formality, which will largely be determined by the size of the firm. “We only have eight portfolio managers”, says one European-based fund manager. “So we get together and talk about it, we’re not that analytical, and at the end we vote as a group.”

This informal approach is not unusual. The 2012 survey results show that where payment is made to independents by commission-sharing, in 46 per cent of cases payment is decided by a formal vote, but in the remaining 54 per cent the vote is an informal one. “Smaller fund management groups don’t have the budget to establish a more formal process, so the result is that many are just paying lip service to the idea of unbundling research and execution commissions”, says another fund manager. This can potentially create a problem for IRPs. “For us the voting system is very important, but for the fund manager it’s just an administrative hassle”, says one provider.

At the other end of the spectrum, a large UK-based fund management group has operated a fully unbundled formal process on a quarterly basis for the last five years. “Every quarter we send a report to all our brokers, ranking their analysts and telling them which ones we have paid for. We speak to our research providers to let them know what we are paying for and what we expect to receive.”

Last year’s “Has independent research come of age?” report highlighted that some asset management groups will only pay for research from their top 50 providers, thus excluding niche operators who may add considerable value but are not rated by enough managers to get paid. Voting is carried out retrospectively – at best at quarterly intervals, but often less frequently – further weakening the link between payment and services provided. Others highlight that not all managers are diligent about voting, or that they overlook the smaller providers when allocating their votes.

The second point of differentiation in broker votes is who gets to vote. For a 2011 report “The broker vote – complexities of the buy side ballot”, TABB Research Group interviewed 20 European and US buy-side companies, brokers and providers of broker voting tools. The report found that the biggest disparity in voting processes is who is included – specifically whether traders are involved or not. The question is whether this is in effect double-counting, as the trader has already made a “vote” by choosing a broker. The distortion may affect payment levels in other ways. “If I’m a research provider to a fund manager, I could have a number of loyal clients among the firm’s
analysts, but may not be paid as well as someone servicing the traders. Getting paid for research can still be an arcane process”, says one information provider.

Despite the shortcomings of the voting process there is a lack of impetus among fund managers to change the system. Based on the results of the CSFI/Euro IRP survey, over half of respondents are indifferent – and a further quarter are comfortable – with the way research is currently rated through the voting system.

This indifference probably reflects the fact that research and execution commissions are paid for by end-investors, rather than coming out of the fund manager’s fees. The original vision of unbundling, contained in the initial FSA proposals in the wake of the Myners report (FSA CP 176, April 2003), would have required fund managers to pay for research out of their own fees, rather than from clients’ commissions. Instead, the final rules required only that fund managers provide adequate disclosure of these costs to their clients under industry-led guidelines developed by the Investment Management Association and the National Association of Pension Funds.

There remains, however, a significant minority who are not happy with the current regime. The responses of those surveyed who provide more detail on their dissatisfaction with the voting system focus largely on the subjective nature of the process:

- “There is too great a reliance on the bulge-bracket firms, and the commissions they receive are disproportionately larger than the value they add.”
- “The amount of lobbying done by some firms should be cut down.”
- “The system is too arbitrary and personalised. It’s very easy for strong or physically attractive broking personalities to shortcut the voting system.”
- “Putting more emphasis on the performance of the recommendation would be an improvement.”

One research analyst at a mid-tier sell-side firm describes the feedback from fund managers as “like a flimsy primary school report”. “There is a wide variety of ranking systems, from 1 to 5, or 1 to 10, or from A to E and you might get the occasional qualitative comment”, he says. “Quantitative assessments rarely happen.”
In some instances there is also the problem that larger organisations are not even aware of which services they are taking, let alone measuring their value. “We met with the head of equities at a big buy-side firm recently”, says one information provider. “He had no idea that 12 people in his firm were already using our economic consultancy service.”

There is clear evidence, however, that the buy-side is gradually becoming more rigorous about the evaluation of research and other services provided by the sell-side. In part, this is being driven by necessity. With commission pots shrinking, fund managers must allocate a smaller budget more efficiently while retaining access to the services they value. In addition, in a market environment where returns are under pressure, fund management groups have to justify the expenditure of clients’ money. Where regulation feared to tread, harsh economic reality is starting to have an impact.

There is also a compliance requirement underpinning the process. TABB Research Group’s 2011 Broker Vote report notes that, in the US, under new Securities and Exchange Commission (SEC) rules, many hedge funds will have to become registered investment firms. Once regulated by the SEC, they will be required to justify their broker selection under the terms of the 1934 Securities Exchange Act. In the wake of the Galleon insider trading scandal, buy-side firms realise they need to document contact with third-party providers of research and trade information to create a clear audit trail.

The main way in which the broker voting system is becoming more rigorous is through the application of customised software to formalise and standardise the process. Whereas in the past, the main tool for fund managers to assess their research and execution providers was a manually updated Excel spreadsheet, now third-party vendors of commission management programs have added broker voting functionality to their product. State Street, for example, offers a broker voting and relationship management system called Broker Select, while in November 2011 Instinet added broker voting functionality to its Plazma Commission Management Suite. Markit and ConvergEx also offer these tools.

Broker voting software is generally included in an off-the-shelf version for smaller firms, but customisation is available for larger users. Buy-side groups will use a mixture of qualitative commentary and quantitative rankings to assess the value of the services received. Specialised software, by allowing the user to rank interactions and research as it is received, can help overcome the reliance of voting processes on the memory of the fund manager.

The use of software can ease the administrative burden of the voting process and help manage information flows feeding into the vote. The decision itself, however, remains based on qualitative criteria, such as the knowledge of specific individuals employed by the research provider.
The extent to which IRPs become part of the trend towards greater use of broker voting platforms could be hampered by charges introduced by some US software providers. “Previously, the fund manager would pay the software platform provider and the research firm wouldn’t”, says one IRP. “But in the last six months we have been asked to pay fees of $4,000 per year, per voting fund management firm, by one of the main software providers. They have 80 buy-side clients and 790 research providers using their platform, so their incentive is clear. Some of the buy-side firms say they are not happy with research providers being squeezed in this way, but they have no economic incentive to fight it and are going along with it.” Simple arithmetic suggests that multiplying $4,000 by many clients adds up to a large potential cost.

Some fund managers allow IRPs to be part of their voting procedure without being on the software platform, but others use broker voting software for compliance reasons and expect their research providers to use it too. If an IRP expects to earn, for example, $50,000 a year from a fund manager, then the additional $4,000 can be absorbed. If, however, the IRP expects only to earn $5,000 then pursuing that business is marginal. If this charging model were to become the norm, it would not only squeeze IRPs’ profitability, but also create an additional hurdle for smaller firms trying to gain access to large fund managers.

The challenge remains to measure the value of research on a more objective, quantitative basis. Among survey respondents, 48 per cent believe that a common metric for valuing research should be developed. Of those who provide detail on what such a measure should look like, the emphasis is on quantitative measurement:

• “The following measures should be used to evaluate independent research: independence, thoroughness, technical valuation (for security-specific research), 6 or 12 month post-report validity (i.e. was the call correct?).”

• “The performance of the recommendation.”

• “It should capture how well independent research performs in reality.”

Given the diversity of research produced by both the independent sector and the sell-side, establishing common metrics will not be easy. Even if a specific piece of research is measured quantitatively, it is only one input into a fund manager’s decision to change his or her allocation to or from a particular asset. The problem remains of attaching weight to that particular piece of the jigsaw. Despite these obstacles, the recent wider adoption of alpha capture systems in the equity markets points towards a possible solution that could have wider application.
Alpha capture

Alpha is a risk-adjusted measure of an investment’s return in excess of a benchmark index, whereas beta is commonly used to describe the returns from the benchmark. In short, alpha is a measure of market-beating returns and beta is used to describe the market return. An alpha capture system provides a way for fund managers to track the performance of potential alpha-generating ideas provided by sell-side and independent research firms. At present these products concentrate on short-term trading and are often used by algorithmic traders. But systems are being developed to focus on longer-term investment ideas, particularly ones based on global macro strategies.

Marshall Wace, a hedge fund specialising in global long/short equity strategies, introduced the first alpha capture system in 2001. Called the Trade Optimized Portfolio System (TOPS), it collects trade ideas from sell-side firms, tracks their profitability and rewards them accordingly. Its success has led others to enter the market. TABB Research Group in 2011 estimated that there were close to a dozen fund management groups running similar quantitative strategies to TOPS. Third-party providers have also developed alpha capture platforms, including FactSet and TIM group, which is the market leader. Some banks have developed their own proprietary systems – for example, Deutsche Bank’s Raptor and Morgan Stanley’s TIDE.

In a May 2011 report “Alpha Capture: The What, Who and How Much”, TABB reckoned the alpha capture market would grow “in the range of 20 per cent to 30 per cent in incremental revenues globally in the next few years” and that, by the end of 2012, it would account for a 10 per cent share of commissions. The following comment is made on the potential for alpha capture to alter the way in which research is valued and remunerated:

“Not only does the technology enable the highest conviction ideas to bubble to the top, it also allows the star salespeople and broker-dealers to rise as the technology tracks and monitors industry performance. As a result in the not so distant future, the performance metrics within alpha capture systems could be used universally to determine which brokers get paid and how much.”

The report focuses on the relationship between the buy-side and the sell-side, but some of its conclusions are applicable to independent research providers.
The advantages and drawbacks of alpha capture systems for IRPs

Pluses...

Alpha capture has a number of advantages for the independent research sector:

• The playing field is relatively level. The systems track the performance of all ideas equally, irrespective of whether they come from a bulge-bracket bank or a small independent research group. Several Euro IRP member firms already contribute to commercial alpha capture systems.

• Running a portfolio of trade ideas in an alpha capture system allows a research provider to showcase the value it can create and provides a potential introduction to new fund management clients. Some IRPs market themselves based on their presence on alpha capture systems. “When we start marketing, people say they don’t want to receive even more email and research, so we can limit the client contact to showing them the trade idea – it’s a way of cutting through the information overload”, says one IRP.

• Idea contributors pay a single annual fee to put their trades into an alpha capture system. The cost is reported to be in the region of “several” thousand dollars, but on a one-off basis this is not prohibitive. Contributors can determine which fund managers see their ideas. They must then agree with the fund manager how they will get paid for the ideas, depending on performance.

...and minuses

The most obvious drawback to the wider applicability of these systems is that alpha capture, in its present guise, is designed to track the performance of specific trading ideas in equities against a benchmark, for example, the S&P500. The main users have tended to be quantitative fund managers.

This raises fundamental issues regarding the value created by research. The critical importance of “good ideas” has already been highlighted, but they are not limited to trading recommendations on specific stocks, or to the time horizon of a typical “alpha capture” trading idea. “Many of the big fund management houses have investment horizons of two to three years”, says one IRP, which uses alpha capture systems. “How can I demonstrate value to someone like that with trading ideas of three to six months?”

Not all IRPs would feel comfortable with providing trading ideas based on their research. By entering ideas on to an alpha capture system the research provider is effectively running a dummy portfolio. One issue raised in the 2011 report, “Has independent research come of age?”, is the potential for paper portfolios to create conflicts of interest with an IRP’s independence. “Let’s say I’m running an asset allocation model with an exposure to fixed income”, said one IRP, interviewed
last year. “If I were to have a conversation with PIMCO, the world’s largest bond investor, during which they tell me they are changing their view on the bond market, this might influence the decisions I take on my own portfolio. How much of the performance would be down to PIMCO and how much down to me?”

Potential exists for other conflicts of interest. A focus on short-term trading ideas may conflict with the aims of a more long-term fund’s end-investors, whose returns will be diluted by the trading costs. Regulators have increasingly criticised signs of buy-side bias towards trading, as opposed to creating more fundamental, or sustainable, value without the friction costs of constant churn.

The focus on the performance of assets relative to a benchmark is also not relevant for pension funds following a liability-driven investment strategy, which focuses on pension assets in the context of the long-term payment promises made to scheme members.

More than just short-term trading ideas

Fundamental research supporting long-term investment may not lend itself to being reduced to specific short-term stock recommendations. Nevertheless, fundamentally-based fund managers are increasingly looking at alpha capture, not to develop a quantitative strategy based on an aggregation of trade ideas, but to use the systems’ capabilities to manage the information flow from the sell-side and help make decisions on individual trades. Just as broker voting software helps rank interactions with research providers, alpha capture systems help fund managers filter out the “noise”. As one platform provider puts it, “it helps you decide who’s good and who’s bad”.

As more fundamental fund managers adopt the technology, the demand for longer-term trade ideas is increasing. Systems are being developed that are tailored to the foreign exchange and commodities markets, as well as ones that deal with macro themes. “Macro is an area of particular interest as, particularly for the larger sell-side houses, macro research is often tied up with the structures they want to offer”, says one industry insider. “For example, the idea might be that the market has under-estimated the risk of a rise in the euro if the European Central Bank gets its act together. From that macro idea you build a structure that takes account of that tail risk.” So the developers are working on bringing global macro strategies, which involve being able to invest at a high level across all asset classes, on to their platforms.

Since the CSFI/Euro IRP survey indicates that the most popular category of independent research is macroeconomic, with strategic/tactical asset allocation not far behind, this emerging market trend could be of particular interest to independent providers. A macro economic and political analysis provides the core building blocks of a global macro strategy for trading in fixed income, currencies, commodities and
equity indices. So, in the context of greater pressure for quantitative measures of value added, there will be increasing demand for global macro ideas to be translated into trading strategies. Once this happens, the broader development of alpha capture systems will allow the outcome of these strategies to be measured. This will not apply to the whole market, but the potential to measure outcomes is there.

Regulatory compliance concern

The transparency of the audit trail is an issue that has grown in importance in recent years. The insider dealing trial of Raj Rajaratnam, founder of the Galleon Group, turned on whether the hedge fund’s trading was based on a “mosaic” of research and publicly available information, or inside information provided by investment banks and corporate insiders. Following his conviction, the buy-side is acutely aware of the need to document how and when it receives information from the sell-side and other parties.

“Compliance requirements around price-sensitive information will become more stringent both for us and for our counterparties”, says a large fund manager. “The cost of that compliance will create a relatively larger burden for small firms, which cannot spread the cost over as large a business as we can.”

Compliance is, therefore, another factor pushing the fund management industry towards a more rigorous assessment of its relationship with both the sell-side and independent research providers. “I would expect the fund management industry to become more rigorous in future about handling counterparty relationships”, says one fund manager.

Financial market trends drive focus on alpha

The greater emphasis on the creation of alpha in a competitive marketplace means research providers may have to become accustomed to being judged more quantitatively. A June 2012 report from McKinsey & Company, “The mainstreaming of alternative investments”, highlights the resurgence in assets under management (AUM) in alternative asset classes, including hedge funds, private equity and investments in real estate, infrastructure and commodities. Between 2005 and 2007, it says, AUM in global alternatives nearly doubled and, after stalling during the financial crisis, have resumed their growth to reach a record high of $6.5 trillion by the end of 2011.

“Money is flowing into alternative assets because they are alpha-driven asset classes”, says one fund manager. “Traditional asset managers will have to get in gear to compete and will need to strengthen their alpha engines.”
Meanwhile, looking at the market from another perspective, the growth of exchange-traded funds (ETFs) has brought down the cost of passive investment strategies, which aim to match the return of the benchmark (delivering beta). “Assets under management with passive ETF investment funds have grown very rapidly over the last five years”, says one fund manager. “If the likes of BlackRock are producing pure beta at a very low cost, as an active manager you have to prove you are adding value by creating alpha.”

The growing trend towards sourcing the best trade ideas electronically and ranking them quantitatively makes sense for fund managers who are under pressure to deliver returns in a low interest rate environment. It appears quite plausible that while the trend is at an early stage for fundamentally-based fund managers, the market will move towards a more rigorous assessment of research firms’ capabilities.

Regulatory update on corporate access

This section provides the background to the FSA’s recent action on corporate access. Last year’s report “Has independent research come of age?” noted that:

“A growing proportion of commission income, however, is being allocated to corporate access. While not collecting precise figures on money spent, Extel monitors the proportion of commission the buy-side says it is spending on corporate access. Extel estimates that corporate access now accounts for about 25 per cent of commission dollars paid for research and advisory services, and that it has increased from between 15 per cent to 18 per cent over the last three to four years.”

Corporate access typically involves a sell-side broker arranging a roadshow giving fund managers access to senior management from a corporate client. Alternatively, the broker may organise a conference bringing together large numbers of corporate clients for the fund managers to meet at one time.

Last year’s report concluded that:

“Use of dealing commissions to pay for corporate access services provided by investment banks is… evidence of continuing market distortions that legislation in the wake of the Myners report sought to eradicate. While there appears no case for affirmative action in favour of the independent sector through subsidies or quotas, there is a case for pressing the FSA to re-examine the unbundling debate when the FCA becomes operational.”

The focus of press coverage when the report was published was on the corporate access issue. The Financial Times ran a story, “Call to ban ‘corporate access’”, on 5 June 2011 which said:
“Independent research houses are calling for asset managers to be barred from rewarding investment banks for providing corporate access via their commission payments.

The European Association of Independent Research Providers is to lobby regulators to push for corporate access to be scrapped from the list of activities that dealing commissions are able to cover, in order to tackle what it perceives to be an ‘uneven playing field’.

‘The rules are not being policed properly at the present time. We’re going to talk to the [UK] Financial Services Authority about what the legislation says it should be. We’re not asking for something new. This might be a classic situation where the banks are stealing more ground’, said Peter Allen, co-chair of Euro IRP.”

Following the call for the FSA to take action, Peter Allen and myself, as the author of the 2011 report, were contacted by the regulator and we met members of the FSA’s Wholesale Conduct Policy Team to discuss the issue. It was clear from these meetings that the FSA intended to investigate corporate access with market participants.

Fund managers interviewed for this year’s report commented on the FSA’s inquiry into the issue. “We have just had our FSA audit. The regulator was asking questions about corporate access and my sense is that they will take some action on it in the next 12 to 24 months”, according to one fund manager.

Corporate access continues to grow in importance. According to the Thomson Reuters Extel Survey 2012, the proportion of dealing commissions used to pay for corporate access has increased further in 2012 to 29 per cent, compared with 27 per cent in 2011 and 21 per cent in 2010. Also, corporate access is now the largest component of services provided by the sell-side, overtaking trading and execution (28 per cent) and research (26 per cent) for the first time. Among buy-side equity research respondents, 38 per cent ranked corporate access as very important.

In light of this, there is a perception among fund managers that if the regulator were to take too draconian an approach, valuable information would be lost. “We do value corporate access”, says one large fund manager. “We don’t consider that it adds as much value as our own research, but if, for example, a broker organised a conference with 50 Chinese companies attending, that’s a line-up that it would be difficult for us to put together ourselves. If you take the extreme example that there were no more such conferences then the whole industry would be worse off although, as a large fund management group, we would be relatively better off than smaller firms.”

Given the value the buy-side attaches to corporate access, these services are unlikely to disappear following the FSA’s action. What is likely to change, however, is that instead of being paid for out of dealing commissions the costs will have to be met from a fund’s own resources.
Conclusions

The picture that emerges from the CSFI/Euro IRP Survey 2012 backs up the conclusion from last year’s report, “Has independent research come of age?”, that the independent sector has become an established part of the research market that is highly valued by its buy-side customers. Almost half of those surveyed are paying for independent research – and a significant minority is paying substantial sums. The quality of independent research is considered to be improving and the majority of those paying for it expect to maintain or increase their consumption over the next few years. As a whole, the sector is expected to maintain or increase its market share relative to the sell-side competition.

Based on this positive picture, it would be tempting to recommend that IRPs adopt a “carry on as you are” strategy. However, independent research does not operate in a vacuum and it would be foolish to ignore the wider financial market backdrop and emerging trends within it.

The financial services industry has realised that, after the global crisis, it is not operating in a normal cycle. While there are some cyclical factors affecting investment banking revenues – the current low level of initial public offerings, for example – the bigger picture is one of structural change. The areas that banks operate in are more restricted and their activities will become more expensive in terms of the regulatory capital needed to support them. Tougher regulation is here to stay – a realisation that grows stronger with each successive banking scandal. The bottom line is that many banks still have an operating model geared to historic volumes of activity and are continuing to downsize their businesses.

However, sell-side contraction does not imply an easier ride for the independent research sector. As well as attempting to cut their costs to levels more suitable to their revenues, the banks will fight to gain a larger share of the businesses left open to them. That competition is likely to be even fiercer because the available pool of fund management commission income has declined markedly from its pre-crisis peak and is continuing to shrink. The buy-side is trying to allocate a smaller amount of money among banks, which are even hungrier for revenue than before.

The last piece of the background jigsaw is that not only are the participants facing a more difficult market, but the nature of the market is changing too. High-frequency algorithmic trading and low-cost ETF passive investment strategies, which have grown rapidly in recent years, have no need for research. In a market where passive investment is cheap, there is an increased need to generate alpha to justify the cost of active management.

Just as the application of technology has transformed equity trading, it is now being brought to bear in counterparty relationship management between the fund
management industry and those who provide research and trade execution services. The need for both sell-side and buy-side to allocate resources in the most efficient manner, while dealing with a proliferation of information, is prompting wider adoption of tailored software to manage broker relationships.

The need for greater transparency around price-sensitive information and broader regulatory trends provide impetus for the adoption of a more formalised approach. While much of the industry still operates informal broker voting processes, the direction of travel towards more rigour is becoming clear.

What are the implications of this emerging market structure for IRPs? A critical question is: How do you demonstrate value creation and shift from being “nice to have” to “need to have” in an environment where end-users are increasingly being required to justify and minimise their costs?

There are two competing elements to consider:

1. It will never be possible to remove all subjectivity from assessment of the value added by independent research. As one contributor to this report says: “The only metric that can be applied across all sectors and to all types of research is customer satisfaction. How happy is the client with the service?” This depends on several factors, of which the performance of any recommendations based on the research is just one – and not necessarily the most highly rated. Value is, in part, inherently qualitative.

2. Nevertheless, the trend towards greater rigour is present in the measurement of value. Alpha capture is one tool that allows more precise measurement of value. These systems act as a means both to track the performance of trade ideas and to filter and organise the information overload that fund managers face. While still predominantly focused on short-term equity trading ideas, alpha capture is evolving to include longer-term macro themes.

With these two very different aspects of value creation to reconcile, it is unlikely that quantitative value measurement will displace qualitative assessment in business models based on fees for consultancy services and subscriptions for good published ideas. The two approaches will flourish side-by-side. This means that there will continue to be a healthy market for research that is not linked to specific trading recommendations and that is longer-term in its investment horizon.

The continued dominance of the fixed fee/subscription model, and the fact that almost a fifth of those surveyed are spending an average of more than $75,000 per firm per annum, suggests that if you have good ideas buyers are happy to part with hard cash for them. Customer satisfaction will then be reflected in repeat subscriptions. The qualities that buyers value – true independence, a degree of exclusivity and a fresh approach compared with the sell-side competition – are what help differentiate this product and provide the key to building long-term value. For

...but more formal, more structured
example, according to the Thomson Reuters Extel Survey 2012, three-quarters of buy-side equity research respondents ranked independent thinking as very important.

Alongside this traditional version of independent research, for firms that can convert their work into trading ideas, qualitative assessment will increasingly be accompanied by quantitative measures based on the performance tracked by alpha capture systems. Some IRPs already contribute trade ideas to these platforms. As the range of strategies covered evolves, for example to include global macro, more IRPs will use these systems to generate revenue, service client relationships and attract customers.

For some IRPs this will mean making explicit trade recommendations for the first time. While the potential for conflicts of interest exists when running paper portfolios, this should be outweighed by the benefit of being able to demonstrate ability to create value to potential buy-side clients.

Of course, there will be an overlap between the qualitative and quantitative segments of the market. Even where there is no trading recommendation, the functionality of more automated broker voting and alpha capture systems will allow a more formal approach to the assessment of research used by fund managers. Increased compliance requirements regarding the handling of sensitive information will be an important driver of this trend.

Outside of the quant fund space, the quantitative assessment model is not yet established – this is only one vision of the industry’s future. The bulk of the fundamentally-based fund management industry still operates on subjective and informal assessments of the value added by research. The direction of travel towards increased rigour, however, appears clear.

The question asked in the title of this report was “Because they’re worth it?” The answer from the survey results and the interviews with research users is that IRPs are indeed perceived to add value. But if the challenge is to prove the creation of value – whatever the client’s investment horizon – the sector needs to embrace the new reality in financial markets and adapt accordingly.
Appendix I

Has Independent Research Come of Age?
Summary of CSFI/Euro IRP 2011 report

The Market Environment

• The independent research sector has grown considerably since both Eliot Spitzer’s action on conflicts of interest in 2001 and the FSA’s new regime on unbundling was introduced in the UK in 2006.
• The estimated annual revenues in Europe are £250 million, with the continent less developed than the UK.
• The market remains highly competitive: the sell-side is investing in research again after a reduction in headcount in 2008-09, and buy-side commission budgets remain under pressure.
• The independent sector still operates in an uneven playing field, with the sell-side combining commoditised research with corporate access.
• As research is required to contain ‘original content’, corporate access is not a legitimate use of dealing commission since it does not fall within this definition.

The regulatory arena

• Introducing market quotas for IRPs, or subsidising their output, would compromise the quality of research, which is the sector’s USP.
• Euro IRP should lobby for a stricter implementation of the UK unbundling regime, specifically the exclusion of corporate access payments.
• The FSA has accepted that payment for corporate access might not be a legitimate use of dealing commissions. The new Financial Conduct Authority will be pursuing the corporate access agenda.
• The idea of establishing a single clearing house for Commission Sharing Arrangements (CSAs) has a number of practical difficulties. Many of the proposed functions are performed by independent brokers.
• The best practice agenda for CSA payment mechanisms drawn up by Euro IRP in 2007 should be pursued.
• Euro IRP should support the development of research value metrics to verify its value-adding credentials, and develop its PR strategy to emphasise the importance of independent research.

Market structure

• The independent research market in Europe will continue to grow, but will remain a niche product because exclusivity is an important part of its value.
• Smaller firms have a regulatory disadvantage compared with larger firms when dealing with buy-side clients. Buy-side procedure and compliance requirements point to benefits of scale.
• To bring scale to some operations, there is a case for partial consolidation.
• A possible model to reduce the cost of regulatory compliance and make marketing more effective is for several providers to group together under a co-branded umbrella organisation. This organisation might also be able to offer execution services.
• This model could capture a greater part of the value chain as well as dealing with the VAT issue. Quality of research would not be compromised nor would a definition of independence that includes execution-only broking.
Appendix II

The questionnaire used for the CSFI/Euro IRP Survey 2012

**PART 1**

1. Name: 
2. Institution: 
3. Position: 
4. If you are willing to be quoted by name in our report tick here (please note that all answers will be aggregated and confidentiality will be respected). 

**PART 2**

1. As an institution, do you pay for independent research? 
   - Yes  
   - No

2. What types of independent research does your organisation use? 
   - Equities  
   - Credit  
   - Macro-economy/policy  
   - Commodities  
   - Quantitative  
   - Technical  
   - Expert networks  
   - Strategy/tactical asset allocation  
   - Other

3. If your firm does buy independent research, what is your average spend per firm? 
   - Less than $25,000/yr  
   - $25,000 – $75,000/yr  
   - $75,000 – $150,000/yr  
   - More than $150,000  
   - No idea

4. For 2012/13, is your budget for independent research 
   - Going up?  
   - Coming down?  
   - Flat?  
   - Don’t know

5. How many independent research sources do you use? 
   - Up to 5  
   - 5 to 15  
   - More than 15

6a. How do you pay for independent research? Tick all that apply: 
   - Tagged commission  
   - Distribution from commission pool  
   - Fixed fee/subscription  
   - Ad hoc  
   - Other (please specify)

6b. If you pay by commission, how is the distribution determined? 
   - Formal vote  
   - Informal vote
7. In your opinion, would there be a better way to pay for independent research?
- Yes
- No
If yes, please specify

8. Do you feel the quality of independent research has improved over the last decade?
- Yes
- No

9. If you feel it has improved, in what way do you feel it is better:

10. Does your institution have its own inhouse research team?
- Yes
- No

11. If yes, how is independent research seen?
- As an alternative to inhouse research
- As a support to inhouse research
- To fill gaps in inhouse research
- Other

12. Compared with sellside research, how is independent research seen?
- As an alternative to sellside research
- As a support to sellside research
- To fill gaps in sellside research
- Other

13. Do you expect to increase or decrease your consumption of independent research over the next three years?
- Increase
- Decrease
- Maintain
- Don't know

14. Does it matter to you whether a provider of research (independent or otherwise) can also provide execution?
- Not at all
- A little
- A lot

15. How important to you is exclusive access to research?
- Very
- A little
- Not much

16. Do you commission specific projects from independent research providers?
- Yes
- No
PART 3

1. Are you comfortable with the way that research is currently rated through the fund manager voting system?
   - Yes
   - No
   - Don't care

2. How, in your opinion, could the rating system be improved?
   

3. Do you believe a common metric for valuing research (independent or sellside) should be developed?
   - Yes
   - No

4. If yes, what might it look like?
   

5. Over the next few years, do you expect the share of independent research relative to sellside research to increase or decrease?
   - Increase
   - Decrease
   - Stay the same

6. If you think it will decrease, how damaging will that be to your business?
   - Very
   - Slightly
   - Not at all

Thank you for your time. Are there any other points you would like to make?

Please send your answers to the CSFI by July 30.

Address: 5 Derby St, London, W1J 7AB.
Email: sophie@csfi.org

If you have any queries about this survey, please get in touch with:
Vince Heaney: vince@heaney.com 0208 789 9209
Jane Fuller: jane@fulleranalysis.com 07980 305278
Appendix III

List of contributors interviewed for this report

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Investment Director, Scottish Widows Investment Partnership

Michael Woischneck  
Abteilungsdirektor, Lampe Asset Management GmbH

Two further interviewees wished to remain anonymous: one is a research analyst with a mid-tier sell-side investment bank and the other is a provider of third party alpha capture systems
Vince Heaney is a freelance financial writer, prior to which he was deputy editor of the Financial Times Lex column. Before becoming a journalist in 2000, Vince spent nine years as a proprietary trader in the banking and hedge fund industries and eight years as an agricultural commodities trader. He holds a degree in economics from Cambridge University.
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