Making MiFID II Work

Unbundling Research

November 2018

Canary in the Coalmine

Disclaimer

Liquidnet University

Foreword

The central aim of MiFID II has been to focus on improved transparency over costs and charges to deliver greater value to the end investor, an initiative Plato fully supports, however it is clear that the industry is still evolving as we adjust to unbundling research, particularly in different regulatory locations across the globe.

The need to separate the provision of research and execution has been under discussion since the Myners report in 2004. As we as an industry adjust to the regulatory changes, the true value in research is also evolving as the introduction of technology in the research process is leading to necessary changes in the production and consumption of research. The argument that research unbundling will lead to a decline in the number of analysts covering certain instruments or limit a company's ability to engage investors is one viewpoint in a complex debate. As industry participants seek to differentiate in today's competitive asset management industry, new alternatives are beginning to emerge which will challenge the traditional provision of research and construction of investment ideas, and the emphasis on supplier differentiation and move to quality over quantity is now firmly underway. Debating the benefits and potential pitfalls as the industry undergoes transition is the most effective manner for the industry as a whole to benefit from the opportunity regulatory change brings. We welcome the opportunity to engage in this debate and would encourage our peers across the globe to do the same.

Mike Bellaro
CEO Plato Partnership

PLATO

Plato Partnership is a not-for-profit company comprising asset managers and broker dealers who are collaborating to bring creative solutions and efficiencies to today's complex market place. As an organisation we support academic research to identify improvements to be made in building a better financial eco-system, and as such Plato supports the findings of this latest market structure commentary by Liquidnet.

This paper is part of *Making MiFID II Work*—our comprehensive content, learning, and resource programme about MiFID II and its impacts on the buy-side, both in Europe and around the world.

For more information about MiFID II, how Liquidnet can help you prepare, or to access more of Rebecca Healey's MiFID II research papers, insight, and workshops, please reach out to your Liquidnet coverage, email **mifid2@liquidnet.com**, or access the Making MiFID II Work app on My Liquidnet by:

1. Logging into **my.liquidnet.com** or **mifid2.liquidnet.com** using your Liquidnet 5, Commission Management, or My Liquidnet username and password.

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2. Clicking on the 'apps' icon from within Liquidnet 5.

Unbundling Research: Canary in the Coalmine

Executive Summary

Critics claim that unbundling research from execution will negatively impact research provision, particularly small and mid-cap companies, threatening listings and secondary trading volumes in Europe as a result. Proponents believe this offers an opportunity to open up the research market and challenge the status quo regarding the implementation and execution of investment ideas.

As the first year of MiFID II draws to a close, we spoke to 62 market participants in a variety of roles across the globe—PMs, traders, sell-side, buy-side and independent research providers to understand just how the provision of research has changed since the introduction of MiFID II and whether the outcome has been negative or as positive for European capital markets as previously supposed.

The ability to access value-add research continues to matter in an increasingly competitive asset management industry. Headlines regarding the slashing of research budgets and culling of broker lists detract from the fact that as price transparency becomes clearer, firms are becoming more discerning regarding the type of research they consume, as well as their method of access. The production and consumption of research is ripe for change.

Although bulge brackets remain the dominant providers of research today, the future sustainability of their business model appears to be being called into question. As the buy-side revisit budgets and conduct broker reviews ahead of 2019 to select future providers of research, the sell-side are having to make decisions regarding where to invest scant resources and which clients to service going forward. Bulge bracket brokers are still assessing what they can expect to earn from the continued provision of research; attempts to lower the minimum waterfront entry point appear to have been underestimated in the hope of continued higher revenue analyst access. As transparency over cost and quality of research emerges, our discussions tell us that portfolio managers are not only becoming more selective regarding which analysts they access and what they are willing to pay, they are exploring new methods of accessing investment ideas as firms come under increasing pressure to lower operational costs.

Corporate Access is a case in point where some asset management firms are now being excluded from broker roadshows as a result of declining commission payments. In response, these firms are now electing to engage direct with company investor relations departments instead; even employing internal staff to manage this process globally. By altering how firms gain access, new challenges emerge; consumers require servicing and the companies that they invest in need to develop new methods on how to engage with investors, whether that is self-funded research, or utilising new portals such as Alphametry, Ingage, ResearchPool or RSRCHXchange. The increased use of data via companies such as Network Valuation Metrics Inc, provide quantitative tools to match investors with assets offering a wider selection of bespoke offerings—connecting asset owners with assets direct rather than automatically relying on a broker to act as an intermediary.

All of which is leading to changes in the production, access and distribution of investment ideas—and not just in Europe. While there is a current split between payment from P&L for MiFID firms and clients' money for non-MiFID business, the increasing focus on end clients is seeing a gradual adoption of research unbundling practices globally. Irrespective of their regulatory obligations in the US and APAC, some of the largest asset managers are looking to demonstrate their firm's capability as a protector of client assets and are electing to pay

for research out of their own P&L. This is creating a knock-on effect for other non-EU local managers and their providers of research, irrespective of where they are on the globe and the instruments covered.

Active managers world-wide have to adapt and adjust their business models if they are to succeed in an increasingly competitive landscape. With the growing adoption of index funds and automation to enhance decision-making in a globalised economy, successful asset owners need to become more efficient in marshalling big data along with human insight to develop diverse investment strategies most suited for the millennial investors of today.

Irrespective of the size of individual asset managers, investment models have to take into account increasingly sophisticated risk and return systems and methods, while developing sustainability practices in a more centrally-managed way, as well as focus on multiple investment time horizons. This complex multi layered approach to investment today requires the provision of research ideas to follow suit. A mere replication of what has gone before at a lower price point will no longer move the dial. The adoption of technology is moving from execution to investment and the impact of unbundling on research provision post MiFID II is just one element of the process; like the canary in a coalmine, it may be the precursor to far greater change that lies ahead.

Key Findings

1. Research unbundling is already going global—**53% of buy-side respondents have already implemented a global policy & a further 20% will do so within the next 5 years.** In Europe the change may be regulatory driven, but across the rest of the world it is being led by end investor demand.

2. Overall research spend and number of research brokers engaged is on the decline but the buy-side are still consuming research. **61% of asset managers have reduced number of research providers but 55% still take research from more than 50 providers globally & 76% access small and mid-cap research from more than 10 different brokers.**

3. The bulge brackets continue to dominate the top 10 research broker lists with **69% choosing global investment banks over regional specialists or independents.** However, **61% still see the sell-side as viewing clients' revenue holistically;** as there is increased transparency in all research pricing, THIS situation may change.

4. While bulge brackets dominate for now, change is underway—**77% are using alternative sources of research to traditional written research and 59% of buy-side firms are now investing in quants and data scientists as execution of investment ideas moves from the sell-side to the buy-side.**

5. **38% of asset managers have seen a change in service levels by the bulge brackets,** as the sell-side begin to select the clients and coverage they offer, adjusting the ability of portfolio managers to access ideas in the traditional manner.

6. **78% of asset managers see small and mid-cap research as more impactful in investment decisions. 46% believe there has already been an impact on small and mid-cap coverage**—yet **43% of sell-side have not altered their coverage of small & mid-caps** and **57% plan to increase coverage.**

7. **52% of buy-side respondents now choose to access written research via platforms,** often as a minimum entry access point to keep the communication channels open; but use of portals is also an efficient means of controlling access and tracking usage to ensure firms are getting the maximum benefit from research procured.

8. **46% think unbundling research has led to a change in how they source liquidity** with **94% now having the freedom to select a more diverse range of execution providers** where access to liquidity, particularly blocks, remains key for respondents.

9. **Just 16% have chosen to increase their access to traditional high touch trading post unbundling. 53% are selecting brokers based on greater automation of workflows** including data analytics in addition to algorithms, making low touch trading a more bespoke high touch execution service.

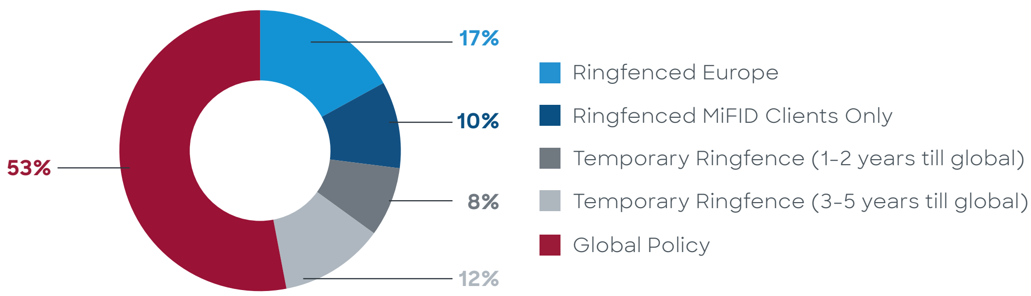
10. Increasing pressure on ensuring successful implementation of the investment strategy is leading to a growing partnership between portfolio managers and their dealing desks. Rather than relying solely on portfolio managers for investment strategy, **55% of asset management firms now recognise the role the dealing desk has to play in optimising alpha opportunities alongside longer term fundamental strategies.**

We spoke to 55 firms between August and November 2018 to understand the implications of MiFID II on the unbundling of research and execution. 40% of the buy-side respondees were headquartered in the UK, 31% in the EU, 19% in the US and 10% in APAC; 65% are regulated as a MiFID II Investment Firm, 41% as UCITs and 21% are regulated under AIFMD. Buy-side interviews were augmented with interviews with sell-side and research providers to establish a full holistic picture of research provision post MiFID II.

MiFID II—not just a Question for European Equities

In the run-up to the implementation of MiFID II, many predicted there would be a reduction in the number of analysts and the consumption of research, particularly in relation to small and mid-cap stocks, putting the European asset management industry and the companies they invest in at a disadvantage. Instead the process of unbundling research from execution services is going global with 53% of buy-side respondents already having implemented a global policy & a further 20% anticipating they will need to do so within the next 5 years (see Exhibit 1). The reality is that a shift in the provision of research has been on the radar for some time for a variety of reasons—and while research unbundling in Europe may have been initiated by regulation, across the rest of the world it is being led by perceived end investor demand, as well as the practicalities of implementing regulatory policy across different jurisdictions.

Exhibit 1: Have you implemented a global policy or ring fenced the EU?



Source: Liquidnet market structure July-November 2018

The requirement to unbundle research is leading to more formal processes being put in place to establish ex-ante research budgets, more transparent pricing models and service agreements, alongside processes to ensure ex-post adjustments to future procurement. As a result, firms are becoming more efficient and diligent in tracking their consumption of research, as well as evaluating the quality and pricing of research they receive.

The improved efficiency in how research is being utilised internally for MiFID II mandates is leading some firms to extend the process to global research procurement arrangements, ahead of any regulatory demand. Others remain wedded to limiting the unbundling process for now, ring-fencing their European operations, waiting to see the regulatory direction of travel from global regulators as well as how their peers adjust internal policies in US and APAC.

As firms make their intentions to move to P&L globally known, the tipping point may well arrive sooner as peer pressure begins to play its part. But it is a delicate balance, every firm wants to be first in demonstrating to clients they are a protector of assets but only if they are the first of many, and not the first of one. As such, the current level of firm implementation regarding unbundling is not only dependent on MiFID II obligations, but on the individual fund structure, where clients are based, whether firms have recognised a business operational requirement to comply, or even a potential marketing opportunity to win mandates going forward.

There are noticeable differences in the adoption of the MiFID II requirement to unbundle even in Europe. For instance, UK firms have, in the main, adopted a global approach (see Exhibit 2). The obligation set by the FCA to bring UCITs and AIFMs in scope for best execution and unbundling standards resulted in the UK capital markets being more unbundled than the rest of Europe. In contrast, jurisdictions such as France, home of the highest proportion of registered UCITs in Europe, have left firms free to decide whether to extend MiFID II requirements to UCITS and AIFMD creating a European Union operating at two different speeds (see Exhibit 3).

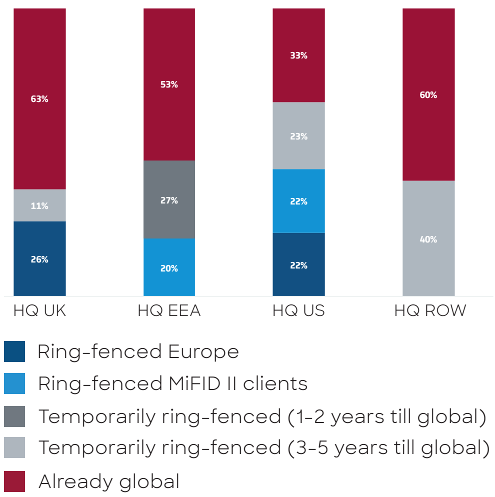
"We have seen a change of behaviour from those analysts under MiFID II, how they value and consume research. There is more conversation amongst them about what they value and what they are willing to pay for, they are getting more efficient on how they use research and that's the reason why we are now looking to roll this out globally".
Global Asset Manager

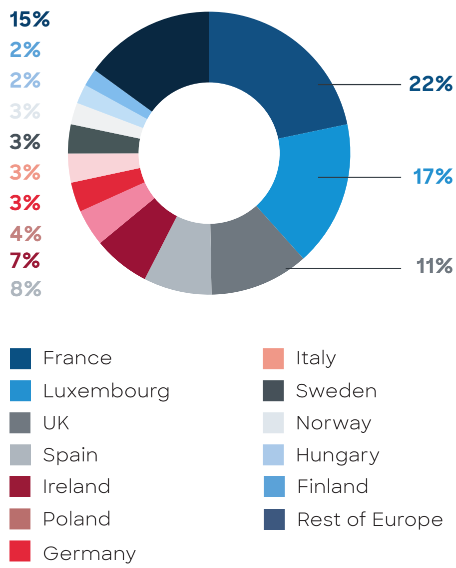
"We have implemented one global policy to cover everything. I think it is a detailed process that will allow us to be more efficient, accurate and more cost saving on what we actually consume and how we use research."
UK Asset Manager

"There are European clients whose countries haven't implemented MiFID II yet such as the Spanish, some of the French, Italians who are theoretically subject to MiFID II but not moving down that path. Most of the UK has gone global and most of the US have ring-fenced Europe but from the conversation we are having they are expecting to be unbundled within the next 5 years. It is regulatory driven in Europe and client driven in the US. I think in Asia it will take longer than people expect for having regulatory or client push on that given that in some markets it is still difficult to unbundle."
Global Bulge Bracket

"In France they are all UCITS. They are reducing their research budget and what is paid for research. They know it is temporary and they will have to change and unbundle in the next year. For those who had to be MiFID II compliant, none of them are paying out of pocket, they are still paying research with client's money via an RPA."
Buy-Side Dealing Desk

Exhibit 2 & 3: Geographical breakdown of Research Unbundling – UK, EU, US and ROW / Population of UCITS Funds across Europe





Source: Liquidnet EMEA Market Structure Research / ESMA Register and Liquidnet market structure July-November 2018

The difference between MiFID II and non-MiFID II European firms may be temporary given the renewed focus by ESMA to ensure regulatory and supervisory convergence among European states. Some respondents have already anticipated the forthcoming change and acknowledge the likelihood for all UCITS to be unbundled in the next two years. Other firms with UCITs and MiFID II accounts have decided to adopt one internal policy and unbundle all activity rather than implementing separate research budgets, contracts and operational processes based at an individual fund level.

The view from the US

For US based respondents, those firms who have been able to ring-fence Europe have chosen to do so but with an acknowledgement that with a fiduciary duty to treat all clients fairly, a growing number of asset managers are deciding to align themselves to MiFID II, without the regulatory obligation to comply. The resulting decline in overall costs for EU investors relative to their US peers is leading large asset managers to question how they can continue to justify current business practices.

The obligation of their European domiciled clients to unbundle their research payments is leading to difficult decisions regarding whether to maintain a client relationship or not; but the real challenge for US firms is how to remain compliant within US regulatory obligations, as well as those emanating from Europe.

These conflicting challenges for US asset managers in implementing cross-border adoption of MiFID II led to the U.S. Securities and Exchange Commission (SEC) to issue three no-action letters in October 2017. These provide the industry with a 30-month grace period to enable the US Commission to monitor and assess the impact of MiFID II's research provisions on brokers and research providers before providing more tailored solutions.

Under Section 28 (e) of the Exchange Act, investment advisors are now able to obtain research financed through RPAs[1] if all other applicable conditions of Section 28(e) are met. Under the US Exchange Act Section 28 (e), investment advisers use a single bundled commission arrangement to obtain both brokerage and research from brokers. Under Article 13 of MiFID II Delegated Directive (EU) 2017/593, research supplied to MiFID II investment firms is subject to a separately identifiable charge, requiring US broker-dealers' to be able to accept payments for research as well as US firms to separate research from execution.

"We only have a handful of European clients, most of which fall under UCITS or AIFMD. Just one told us they needed to be MiFID compliant in December last year. Because they were the only client and it was so last minute we said at that point of time we are not ready to start paying for all of our clients' research and we ended up parting ways."
US Buy-Side

"US funds are looking at the data, and it's hard not to reach the assumption that EU funds are now being treated better than US funds"
US Research Provider

"We have comments from US based fund managers that say "I am not going to take that meeting with an analyst because I am not looking at that space and I will get charged for it internally" because that firm has applied a global budgeting process internally, regardless if the assets fall under MiFID II or not."
Global Bulge Bracket

[1] https://www.sec.gov/divisions/marketreg/mr-noaction/2017/sifma-amg-102617-28e.pdf

Regardless of the final regulatory outcome, a growing number of US asset managers have already implemented an internal budgeting process inviting fund managers to become more careful about the meetings they take and the research they consume as they will be charged internally for it. Because of these changing behaviours, 33% of respondents headquartered in the US have implemented a global policy to unbundle research payments and an additional 23% are expecting to be fully unbundled within the next five years (see Exhibit 2). With individual firms keenly monitoring peer behaviour, the question mark is whether we see a rapid move to P&L in a similar manner as in Europe Q4 2017.

The view from Asia

In Asia there has been no firm regulatory response as yet, making the process complicated for organizations with European and Asian mandates. While it is unlikely APAC firms will have to unbundle from a regulatory perspective, the operational nightmare of managing in-scope and out-of-scope clients adds to the challenge of setting up individual team research targets, and where portfolio managers have mixed mandates firms have been incentivised to implement a global policy.

For Australian firms who do not invest in European instruments nor have any offshore clients, there is no requirement to unbundle research, but it is now necessary to unbundle all transaction costs and charges. The recent Australian Royal Commissions review, RG97, requires investment firms to provide full disclosure of explicit and implicit costs of investment. ASIC commissioner, Cathie Armour, recently described the MiFID II reforms as "resetting expectations for asset managers acting in the interests of investors into more concrete behaviours,"[2] and some asset managers have decided to take this additional step in order to define and attribute an explicit cost to research, corporate access as well as trade execution rather than continue paying an aggregated bundled fee. This demand for greater transparency in costs is leading to the emergence of new local portals such as MST Marquee or SmartKarma to provide firms with an improved toolkit to manage and evaluate their research costs, as an outcome of evaluating execution and market impact costs.

Fixed income

Evaluating the price of research remains complicated for fixed income. According to sell side respondents, fixed income teams have benefited from subsidized access to research for many years, leaving a question mark on how much asset managers are willing to pay for the same access going forward. Equity research carries a price tag that is not recognised by fixed income research teams, creating challenges in agreeing budgets and managing PM expectations, as well as ensuring equality in research procurement across different asset classes.

Once the research budget is agreed, understanding and determining who consumes the research internally, how much is being consumed and who should pay adds to these challenges. Equity research is often consumed alongside fixed income research for corporate bond investments, making the process of determining and pricing fixed income research more complex still.

In its Q&A, ESMA highlighted that while written FICC research could be priced and paid through a subscription agreement, "firms would need to document how they arrive at their pricing structures and ensure there is no inducements risks."[3] Yet, the price of broker offerings may vary for similar access given that most research agreements are still bespoke agreements based on bilateral negotiations. This not only adds to the challenges for the buy side to establish what a fair research price is, but also raises questions whether the amount paid could be viewed as an inducement by the regulators.

In fixed income particularly, bulge bracket banks tend to retain a tight grip on the market as the main provider of macro-economic research and by carefully selecting the range of firms they cover. The lack of diversification in fixed income providers ultimately limits firms' ability to uncover new investment opportunities. However, as buy-side firms continue to employ their own analysts, the future consumption of research is likely to remain in a constant state of flux.

"The change is being driven by clients, but it is an operational nightmare to have in and out of scope clients. We struggled with setting research targets per team because we have PMs with mixed mandates which are both in and out of scope."
Global Asset Manager

"Certain accounts that are derived from EU mandates are execution only and there are also a handful of accounts that are still bundled, and we are still discussing how we are going to approach those accounts. Those accounts are some of the Asian mandates, but I would see us going global within 2 years."
APAC Asset Manager

"From a regulatory perspective it is unlikely we will have to be compliant as we don't invest in European instruments and don't have European clients. From a practical perspective, we are definitely looking at segregating execution and research. We are not required to evaluate research but that's something we will do so we can put an explicit cost on research, corporate access and trade execution rather than paying an aggregated bundled fee."
APAC Asset Manager

"A fixed income team accessing similar coverage to an equity team is only willing to pay a tenth of the price the equity team have to pay."
Global Sell-Side

"Macro-economic fixed income research being distributed at lower price point: Isn't that an inducement? You have got analysts, you have costs within the same team and you are going to subsidize one part and not the other?"
Global Sell-Side

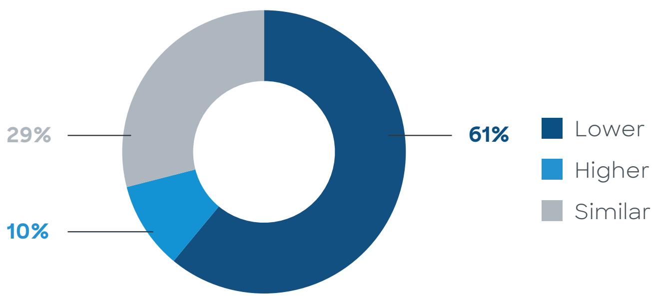
[2] https://www.moneymanagement.com.au/news/policy-regulation/australia-headed-mifid-ii
[3] Question 9, p60 https://www.esma.europa.eu/sites/default/files/library/esma35-43-349_mifid_ii_qas_on_investor_protection_topics.pdf

Increasingly the buy-side are becoming more stringent at looking at what and how much research is consumed as well as evaluating the quality received from individual brokers. However, fixed Income, equity or multi asset, the assessment process remains a work in progress that will require months of accurate data consumption before adjusting budgeting, pricing and selection processes. The outcome of which could lead to surprising changes. As the sell-side begin to appreciate the true value of their analysts, not all pricing models will remain in decline, and by honing in on quality and alternatives, the opportunity for growth in research provision could be an opportunity for providers globally, not just in Europe.

Changing Consumption

As the buy-side reviews what to buy, from whom, and how to pay for it, there is a natural initial shift between sell- and buy- side dynamics as the creation of investment ideas moves from one to another. Sixty-one percent of firms interviewed now consume research from a lower number of firms than pre-MiFID II, dropping anywhere between 20-70% of their brokers, and barely a third have remained constant (see Exhibit 4).

Exhibit 4: Is the number of firms you take research from higher or lower than pre-MiFID II?



Source: Liquidnet market structure July-November 2018

For some firms, the reduction of brokers has mirrored a reduction in consumption as portfolio managers become more judicious in the research they choose to purchase externally, moving the research process in-house. Similar to the rise in execution "juniorization" by certain sell-side firms, there appears to be a split between those bulge bracket brokers who are investing in research, and those who now view research as a secondary service to other business strategies such as wealth management. For other buy-side firms, the extent to which the individual asset manager is dependent on external research will factor into the number and type of providers they are looking to engage, as well as the overall budget available to spend.

The more portfolio managers come under pressure to justify whose research they use and why, the greater the need to collate complete and accurate statistics for quantitative as well as qualitative methodologies to demonstrate decisions made. In absence of reliable data today and as this process evolves, there is still a natural tendency to use the most reputable banks and brokers as a safety net, and as consequence 55% still take research from more than fifty brokers globally (see Exhibit 5), with bulge bracket brokers figuring unsurprisingly in every top-ten list (see Exhibit 6).

Currently global bulge brackets can dominate through a greater number of analysts and touch points, and as a result, in aggregate, their proportion of the budget will be higher. However, as the focus hones in on the quality on the individual research consumed and reasons why, there will be a continued shift to individual analyst's value-add to that of a waterfront research coverage for multiple clients.

While bulge brackets still factor as a safety net in the current environment, it will depend on the extent to which they can hold on to their assets going forward. An ill-timed downgrade or reweighting by a junior analyst based on no change in fundamentals can have a significant and unnecessary impact on the performance of a fund, as well as the opinion of a portfolio manager as to whether they wish to continue accessing the research services of the bulge bracket in question.

"In Fixed income, the service is decreasing and the market is logging day to day conversations. We have put in place some buckets/units of research. PMs have difficulties to understand where we are in terms of consumption—over consumptions vs under consumption."
European Asset Manager

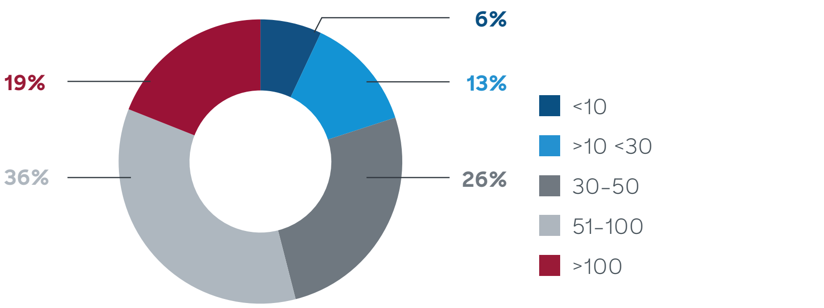
"It's an opportunity for players to stand out I don't think much of the bank's credit research but brokers like Autonomous, Sanford Bernstein, I am willing to pay for. The bulge brackets are artificially holding the industry back through ridicously cheap agreements. We are getting close to shake-out time, once we have got rid of the dross, those who improve can charge more."
UK Asset Manger

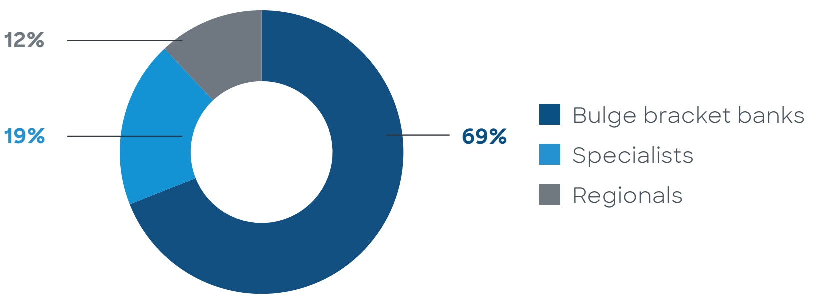
"We are 5% lower. There is not much change as we have broad requirements and are multi asset. We trimmed 2-3 years ago but have no resources internally so it's harder to reduce further."
Global Asset Manger

"The number is more or less the same, but PMs now have to justify who they use and argue to company management as to why the media spotlight and any negative publicity is a real worry here."
European Asset Manger

"When you compare a specialist to a bulge bracket. One is a 10K and one is 80K, you need to make a decision of what you willing to pay for that level of service and that conversation is definitely evolving."
Global Asset Manger

Exhibits 5 & 6: How many firms do you take research from globally?/ Who are your top 10 research providers globally by commission paid?





Source: Liquidnet market structure July-November 2018

For the portfolio manager, loyalty is to the analyst rather than the global bank, and an unbundled environment offers the potential for smaller brokers and independents to compete head-on. However, this depends on the portfolio managers ability to impact the overall firm's budget, but also on whether the smaller regional specialist or the independent can hire the relevant talent and to what extent their niche expertise will matter in the global budget. Many country and sector specialists may not make it to the top 10 research providers due to a lack of global vote but are still highly valued by individual portfolio managers.

The individual firm, the assets they invest in and the underlying methodology are going to dictate the proportion to which bulge bracket brokers remain dominant in research lists. As price discovery evolves, then the question arises as to whether the external research provided is worth paying for, or if alternative opportunities to validate internal investment ideas emerge. Technological innovation is forcing a change in the traditional bottom up fundamental research approach. The rise in the use of alternative datasets—social media, web data, satellite imagery—and the mining of these data streams mean that the current providers of research may no longer provide what is now required from the research process.

As the creation of investment ideas moves from the sell-side to the buy-side, no single source of research—whether that is written research, 1-on-1 analyst meetings, corporate access or access to alternative datasets—can be viewed in isolation. The value is now in the aggregation and collation of multiple pieces of information from different sources. As the quality of external research wanes and the number of external brokers shrinks, the more asset managers will turn inward to their own resources as well as be more selective about what to consume externally, in whatever form it is now required.

"With the bulge bracket banks, I guess it is always the fear of loss. It is the view that maybe one piece of research isn't enough to an investment decision but the more you get it helps shift your view, the way you manage a strategy. A lot of our guys like to go on Factset and access as many pieces of research as they can. A lot of the bulge bracket broker research is like an enhanced wikipedia. You can get a lot of information and a lot of our guys use it to fill the blanks."
Global Asset Manger

"We use 15 brokers globally. We have a core broker list of 15 brokers we use globally but PMs also have the ability to pay regionally on top of this, so in addition to the 15 globals, we have 5 regionals in Japan, Hong Kong and for Australia"
Global Asset Manger

"It's still unlikely if we were to discuss in 12 months that independent research providers would have made it to the top 10 as the global bulge brackets we use for everything—fixed income and equity. But where is the true value, that's the question"
Global Asset Manger

"Internally we have a multi-layered approach—alt data, data science, external sources of data—it's what we can integrate with the model that we already have—our data scientist team is now fully imbedded with our investment team—we don't need the sell-side to do this for us."
US Asset Manger

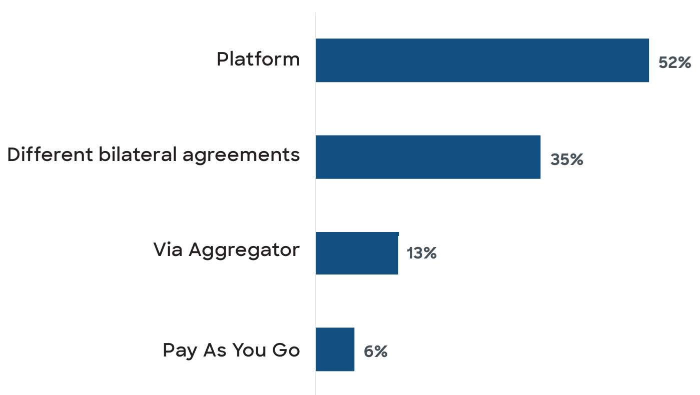
Current Methods of Access

The challenge for firms today is in the differentiation in expectation both in terms of absolute price and understanding where the real value in the research relationship lies. A reality check is still on the cards as consumption on the buy-side continues to evolve both as a consequence of the regulation, but also as a direct outcome of how sell-side counterparts respond to the changing research environment.

In the unbundled world, the separation of individual products and services together with the scrutiny over the price of each item, means that every element of research is potentially up for negotiation. Itemization, transparency, and flexibility of individual methods of accessing research can lead to improved competition through differentiation in the provision of research by the sell side, as well as consumption by the buy side.

However, this level of competition has yet to emerge; the majority continue to pay a base level platform entry fee estimated on historic access, rather than actual consumption. Fifty-two percent of respondents now access written research through a platform, with 35% setting up different bilateral agreements, including all-you-can-eat access to written research, far outpacing pay-as-you-go methods (see Exhibit 7). Access to written research via a platform or portal acts as a base entry point, which then allows additional bespoke payments to be made to access analysts or specific datasets and attend conferences, either across the board or limited to a number of users dependent on the individual agreement.

Exhibit 7: What is the method of access for written research?



Source: Liquidnet market structure July-November 2018

As firms rushed to ensure compliance with MiFID II, base level entry agreements with key counterparties appeared the logical first step to maintain minimum access. However, it is the additional analyst time, access to conferences or corporate access as well as data where the value for the buy-side lies—platform access is seen by many as merely a method of keeping the channels of communication open. Price and level of access to sell-side analysts then depends on the coverage provided by the buy side's own analysts, the importance of an individual sell-side analyst, as well as the flexibility of the broker and the perceived importance of the client.

In contrast to written research, where "pay-as-you-go" accounted for just 6%, 44% of respondents' chose to access analysts on this basis, tracking consumption and assessing the value of each analyst within each firm and paying accordingly (see Exhibit 8). This method of access is the most popular for corporate access also, with 63% preferring this route compared with 25% including corporate access in an all-you-can-eat model (see Exhibit 9). Buy-side firms who have their own analysts may be more oriented towards corporate access themselves but still prefer to take a corporate call together with an analyst they particularly like.

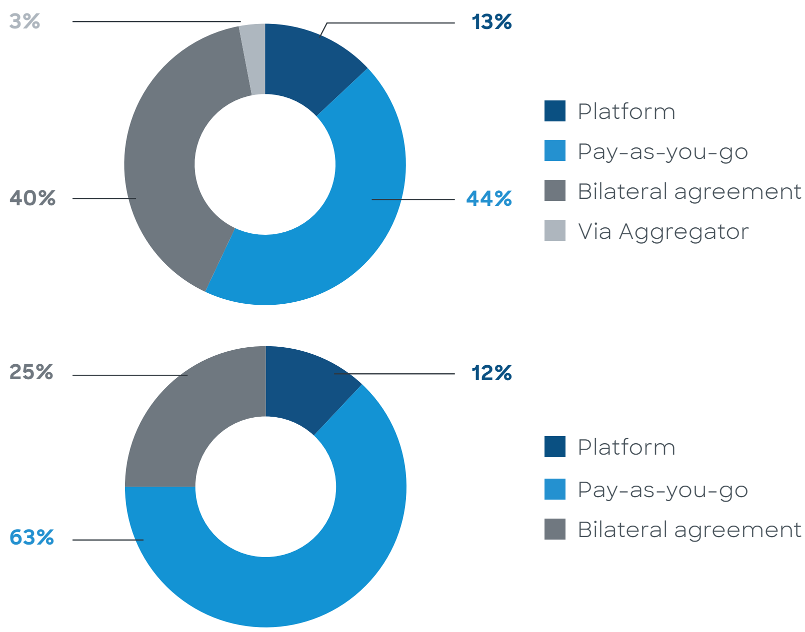
"Platform access keeps the relationship going—basic data and models for a nominally fixed fee of $10k but it varies massively and is operating on a supply and demand basis. Each is bilateral arrangement based on a budget rate card based on historic usage. The platform gives us transparency of cost."
US Asset Manager

"We are definitely ascribing more value to the more bespoke area whereas actually, old school bulge but the more waterfront coverage houses are a bit of a safety net. There are individual good analysts at big and small houses, it has always been the case and it does not change. In terms of where your dollars are going it is more about quality than quantity."
Global Asset Manger

"We pushed for global agreements to be in place where you access written research via a website for a minimum access fee based on a number of users. Analyst access and corporate access are bespoke and come at an additional cost that comes out of a PMs own budget."
Global Asset Manager

"We agreed a general price with every counterparty and it includes everything except for corporate access. Corporate access is on a transaction basis, it is completely separate."
Global Asset Manager

Exhibits 8 and 9: What is the method of access to analysts/Corporate access?



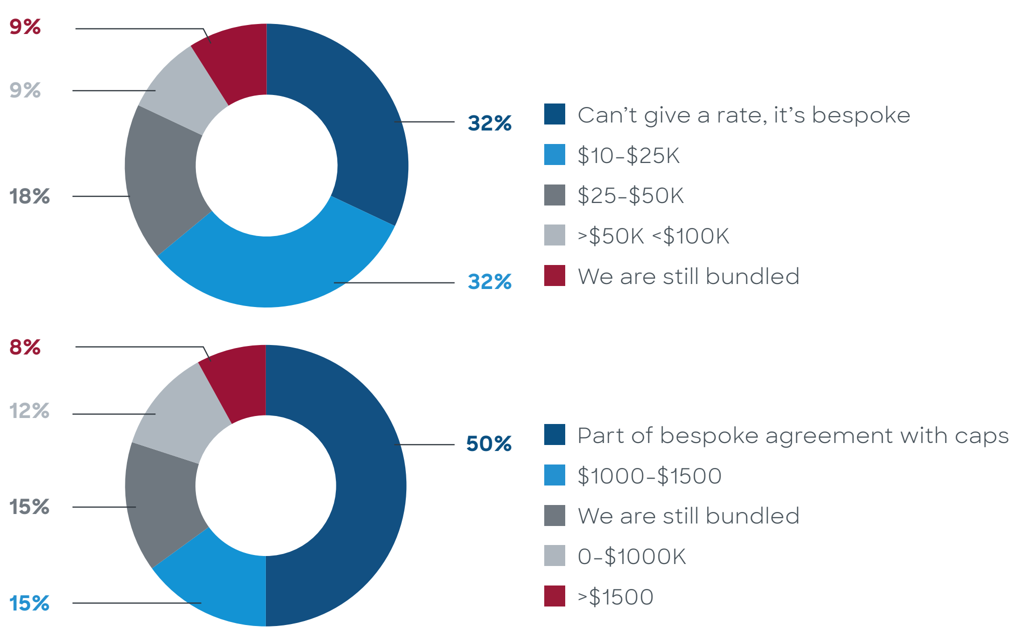
Source: Liquidnet market structure July-November 2018

The benefit of receiving research via a platform however is not only the ability to control access in line with regulatory obligations but also means with which to track usage—whether that is who has read a particular report, which analyst has been contacted, or which conference has been attended. Firms can then begin to build a picture of exactly what research is being consumed internally; as prices are agreed, cost of access to the type of research can be accurately mapped versus its perceived value. As firms move into research arrangements for 2019 however, it is becoming clear that estimated versus actual usage is a vastly different figure for many firms.

"Our estimates were based on historical levels of analyst time. However, there was a massive drop off in the amount of analyst meetings consumed on our side, which meant the estimated vs. the actual was way off the mark."
UK Asset Manager

"We found that there was a massive drop off in terms of meeting consumption on our side. The banks overestimated consumption of analyst time and underestimated the fee charged to access analysts. I think at the end of the year they will re-assess, and the entry point may probably creep higher. At the moment, our average entry point is at $35k with the lowest being at $10k."
UK Asset Manager

Exhibits 10 and 11: What is the average cost of waterfront written research? / What is the average cost of Tier 1 analyst?



Source: Liquidnet market structure July-November 2018

While for both asset managers and brokers, the buy side is the price setter, this remains a work in progress. Summer 2017 saw a number of providers announcing research prices of six figures, yet by end of 2017 prices were down to an average of five figures. Thirty four percent of respondents still could not give an overall rate for waterfront written research given the bespoke nature of individual agreements (see Exhibit 10). Many on the sell side instead established a tiering system for research access to give the buy side enough flexibility and ensure to keep a seat at the table. Almost a third of firms evaluate the flat entry rate for access to a portal for all written research anywhere between $10,000 and $25,000.

"In April in 2017, one broker quoted us based on our 2016 usage $435k for a similar relationship including written research, analyst access and conference access. We eventually concluded a commitment of $70,000 at the end of 2017."
UK Asset Manager

Similarly, the average cost of access to tier 1 analysts is difficult to estimate for 50% of respondents given that access has been bilaterally negotiated based on historic consumption and will come at an additional cost to the basic flat entry rate. For those firms having selected the "pay as you go" option, depending on the broker and the analyst reputation, the hourly price to access an analyst can range from $200 to $3,000 (see Exhibit 11). This could well be a legitimate variation dependent on the analyst and the coverage they provide, but transparency over what is being charged and by whom will allow portfolio managers to establish whether the benefit equates to the cost being charged.

From conversations with buy-side respondees, it appears that while most agreed a fixed base entry level with their providers with an incremental fee for meetings and calls and a separate fee for corporate access, the entry fee based on historic levels of analyst time was made on the assumption that previous levels of analyst interaction would subsidise the base level payment. The issue with this is that certain banks appear to have over-estimated the level of analyst consumption post MiFID II and under-priced the basic fee for accessing the product.

"You are seeing a transition in idea generation, execution has moved from the sell-side to the buy-side now its idea generation. Internal research is our primary function—12 years ago we had 3 or 4 analysts, now its 25/26 on one desk, 10 on another. It's a reversal of what is happening on the sell-side. It's a very competitive environment and the sell-side need to pitch their added value to us to stay relevant."
Global Asset Manager

Sustainability–The view from the Sell Side

As the economics of certain business models is called into question, some on the sell-side are already adjusting their post MiFID II strategy. Research previously shared freely by bigger houses is now locked behind an access code, as the sell side becomes more stringent and precise about where research goes, and the economics of research supply and demand is scrutinized on both sides. Others on the sell-side are choosing to whittle down existing research operations, replacing senior with junior analysts, choosing to focus on alternative sources of research, or even getting out of research provision and investing in different revenue streams.

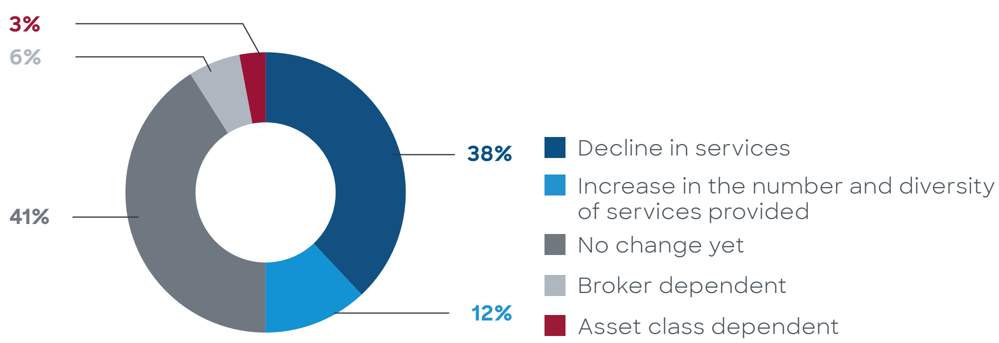
"In the first quarter to the first half, some of the clients did not know what the policies were, they were unsure of what they could do, they were scared they were going to run out of budget, so they turned everything down."
European sell-side broker

As brokers target resources more effectively, turning off accounts or business streams that are unlikely to be profitable, the argument is that buy-side firms with smaller research wallets dependent on external research have less negotiation power and asset managers with internal resources and larger budgets will be able to gravitate to new suppliers of research.

Forty-one percent of respondents say it is too early to draw conclusions on the longer-term trend regarding the sell-side provision of research (see Exhibit 12). However, almost as many respondents are already witnessing a decline in service provision and it is clear the status quo in research provision and consumption is unsustainable; just 12% see their sell-side research partners increasing their coverage, cementing research as part of their business strategy going forward.

"We expect even more consolidation at the end of this year because if the buy side is paying relatively low price for 20 providers, they are going to move to 10 providers to pay them more to get better service because some are now realising that paying a bulge bracket 10k a year does not bring much value. It is all in transition."
Research Aggregator

Exhibit 12: What has been the impact on coverage & research by the sell side?



Source: Liquidnet market structure July-November 2018

For many on the buy-side, these changes in research provision were in train before and are not solely MiFID related. Just as execution moved from the sell-side to the buy-side, so now too is idea generation given the important differentiator internal research has become in fund performance. But this transition will take time; and in the interim the sell side needs more clarity and direction on what their clients need and how this content should be delivered. This not only requires assessing the value of constituent research pieces, from how much written research is required, to how many analysts are valued, but also what alternatives can be substituted at a lower price point such as multi-client rather than 1-on-1 analyst meetings, datasets and valuation models rather than individual analyst interaction.

Rethinking the provision of sell-side research will enable the buy-side to consume more individual products tailored specifically to their needs using their wallet more effectively—large or small asset manager—and this will be a continual iterative process between the buy side and sell side for the foreseeable future.

There are those brokers who have already recognised this trend and are adapting their business models accordingly, whereas others have yet to recognise the changes required to survive. For some brokers, research unbundling has meant the number of clients is on the rise, as brokers sign up smaller asset managers who were "free-riding" on research previously and who are now being forced to pay a nominal fixed fee for read-only access or a middle market sales desk that provides low level sales coverage. The question is whether this is just an interim stop gap, as these brokers still must determine which of their clients are willing and able to pay for research going forward as the question of sustainability at current price points kicks in.

Other non-bulge-bracket sell-side brokers are hiring new analysts, having watched their competitors shut down secondary market trading and sales trading in equities, keeping investment banking, and reining back to aspects of research such as corporate brokerage or small and mid-cap specialism. Those without an existing legacy cost base should be in a better position to grow and be market disruptors in the new environment. Others are looking to partner with their peers across different European regional markets to develop a deeper broader product offering for institutional investors.

The elephant in the room remains whether the drop off in research consumption this year is permanent or merely a temporary response to asset managers having to adjust to the post-MiFID landscape. The sell-side view is that clients acknowledge the lack of consumption in the first half of 2018 but attribute this to portfolio manager nervousness utilising budgets too soon. The assumption being that once portfolio asset managers realise the true cost of research production they will be willing to pay more to retain access to the top analysts given their importance in formulating investment ideas. This assumption though relies on top analysts remaining the only source for quality investment ideas and this may yet be a precarious opinion to base future business models and profitability levels given the rise in the internalisation of the research process and hunt for alternatives.

However, for future providers of research, the market currently remains difficult to enter. Larger asset managers are hamstrung in their ability to add new independent providers as compliance grapple with first round implementation of research unbundling. Pricing is still a work in progress as firms assess which provider is really going to be needed, what level of service and for what price. While the price for written research is becoming transparent and is relatively low, is it now too low to avoid regulatory concerns regarding inducement. For other interactions such as analyst meetings, the pricing remains volatile.

An unnecessary race to the bottom is not in anyone's interests to retain a competitive and diversified research market. With some of the bulge bracket banks bring their minimum entry levels for research down to an annual average price of ~€10,000, such prices could still be profitable for a handful of global banks, but independent and niche research providers are unable to compete at the same economies of scale, and are left with no other choice but to discount heavily to remain competitive or to change their model in terms of how research is provided.

"In January and February there was a clear buyers strike, PMs did not know what they were getting charged and for what and they stopped consuming. Our meetings went down very heavily and rebounded from March onwards. A lot of clients have said explicitly said to us don't annualise our Q1 payments to assess our value to you on an annual basis because our overall annual consumption is going to be different."
Sell-side Research Provider

"If you look at Australia over the past 5-7 years, that trend has been in place for quite some time; research houses have hollowed out the middle ground between the well-established franchise analysts and the junior, less experienced analysts. There will be more aggregation which means we have to do more internally ourselves."
Australian Asset Manager

"Either the sell-side will need to raise the entry point to compensate for the drop off in consumption, or the relationship will be terminated."
Global Asset Manager

"You are definitely seeing the rotation in some banks with the rock star analysts being replaced by juniors/grads. Others have upped their game particularly in fixed income credit, where they are pumping good high-quality research on a regular basis—interesting events and ideas that we are happy to pay for."
UK Asset Manager

"It's when my PM has to pay out of their own budget that they think again whether they want that service, that access or whether they don't."
Global Asset Manager

However, it is the introduction of new forms of research at alternative price points which have the potential to be the most disruptive across the research industry in its entirety. Given the growing focus on the quality versus the quantity received, competing on price may no longer be enough. Brokers are being asked to demonstrate the value added they provide instead of re-packaging their previous offerings at lower price points. Changes in how research is perceived and consumed by the buy side will ultimately create new opportunities for the sell side leading to greater innovation and diversification in offerings. No one will be able to retain a seat at the table simply by maintaining the status quo, but opportunities for highly valued access to external research will still exist, just in a different format and at a different price point.

"We still take external research but the idea process has become much more internalised, so we take the research from the sell side, run it through our own model augmented with different data sources—it's still research—just a different process."
UK Asset Manager

Impact on Mid & Small Caps

A recent survey conducted by the U.K.'s Quoted Companies Alliance which represents small- and mid-caps, indicated that 70% of investors believed that MiFID II will result in less research on such firms. Initially after the introduction of MiFID II, the average number of analysts covering UK-listed companies with a market value below £150m shrunk from 0.8 to 0.6, versus the average number of analysts covering larger companies at 8.9.[4] However, the industry already appears to be responding; when looking at the increase in coverage of small and mid-caps on a country by country basis, France, Germany and the UK have seen an increase in both analysts and coverage for small caps, whereas just France has seen an increase in Mid-caps (see Exhibit 13).

"The media is saying a lot that the sell-side will stop covering small and mid-cap stocks. But if 50 analysts cover Apple, the 25th to the 50th don't get any exposure they will need to differentiate themselves & go niche. I am not convinced by stories saying lesser covered companies will drop off the radar."
UK Asset Manger

Exhibit 13: Coverage of small and mid cap stocks by country

	Stocks Jan 20		Analyst Jan 2018		Stock Nov 2018		Analyst Nov 2018		% Change stocks		% Change analysts	
	Small-Cap	Mid-Cap	Small-Cap	Mid-Cap	Small-Cap	Mid-Cap	Small-Cap	Mid-Cap	Small-Cap	Mid-Cap	Small-Cap	Mid-Cap
Nordics	429	132	147.9	116.5	419	126	145.3	105.3	-2%	-5%	-2%	-10%
Germany	232	76	88.8	91.4	262	66	106.3	76	13%	-13%	20%	-17%
France	266	56	63.8	46.7	288	64	72.8	56.5	8%	14%	14%	21%
UK	709	206	234.5	216.2	727	197	266.5	181.6	3%	-4%	14%	-16%

Source: Eikon from Refinitiv, January-November 2018

The particular concern regarding small and mid-cap companies is that investors are more reluctant to invest when there are fewer analysts covering a stock; this theoretically makes it harder for the companies in question to raise capital, transfer stakes or meet institutional investors' liquidity requirements. There are claims that a reduction in analyst coverage translates to increased volatility in secondary market trading; with less market information, such stocks may have more exaggerated earnings reactions.

The recent focus on passive investing and index tracking funds has already led to growth in the number of analysts covering the large cap stocks in indices. Bloomberg claim that the number of recommendations on Europe's small-cap index has dropped 7 percent so far this year, on track for the sharpest decrease in at least a decade, compared with 4 percent for the large-cap benchmark.[5]

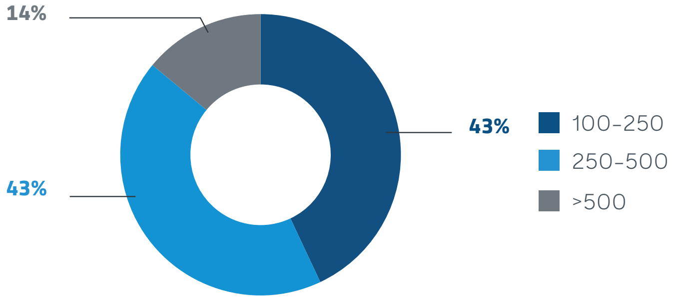
With the increased competition, it appears that certain firms are already recognising the potential opportunity in differentiation and are deliberately targeting the small and mid-cap space (see Exhibit 14). Although bulge bracket banks are increasing their small and mid-cap coverage, both buy and sell side firms acknowledge there is still room for improved coverage, and the breadth required is evident in the number of stocks covered by buy-side firms and their continued appetite for small and mid-cap research (see Exhibit 15).

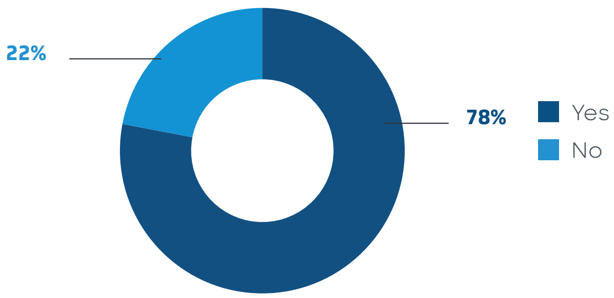
"We have started talking to companies direct as mid-large cap brokers are not covering small cap—the analyst will have been poached or is moving to the buy-side."
APAC Asset Manager

"If you are not relevant you won't get paid, which is why we are focusing on small and mid-caps. I would say the amount of people that are physically paying up for research and access of our portal has significantly increased and I am opening up new accounts on a daily basis."
UK Sell-Side Research Provider

4 https://www.theqca.com/
5 https://www.bloomberg.com/news/articles/2018-09-10/where-are-the-analysts-europe-s-small-caps-battle-to-be-seen

Exhibits 14 & 15: How many small and mid-caps do you cover (Sell-Side)? / Is SME research more impactful to your investment decision?





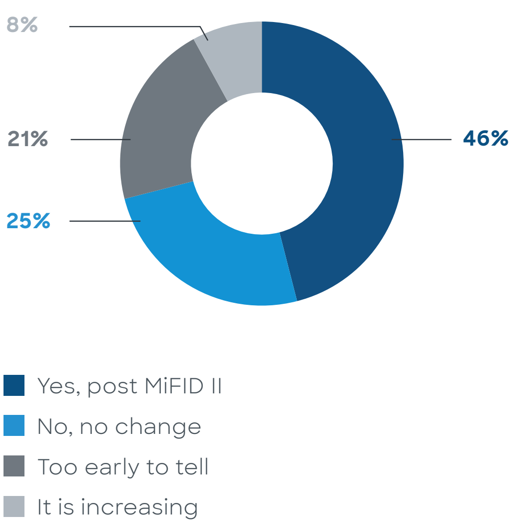
Source: Liquidnet market structure July-November 2018

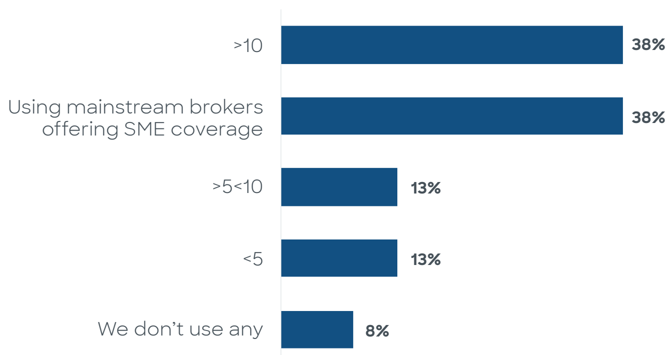
For sell side firms, this perceived gap represents an opportunity to hire new analysts and expand their research and coverage in a less competitive environment. The opportunities may be multiple, such as marketing small and mid-cap companies to asset managers who believe they are currently underserviced in this area; or stronger coverage of lesser-known companies. What remains to be seen is if any increase in sponsored research by the buy side will fit together with or even undermine the value of research offered across the sell side.

While 46% of buy-side respondents have witnessed a decline in coverage in small and mid-caps by bulge brackets (see Exhibit 16), an increasing number of asset managers are diversifying their providers to include more specialised providers. Seventy six percent of the respondents interviewed now engage with more than ten firms that cover—but for the most part not exclusively—small and mid-cap companies (see Exhibit 17) given the value they still attribute in being able to uncover small & mid-cap alpha opportunities.

"Our broker list is made up of bulge brackets and the rest is all mid-tier, smaller brokerage houses. We have to go to the smaller guys to get the coverage on small and mid-caps now—its where we get more value in the investment process."
APAC Asset Manager

Exhibits 16 & 17: Have you witnessed a decline in coverage of small and mid-caps? / How many small and mid-cap providers do you now engage with?



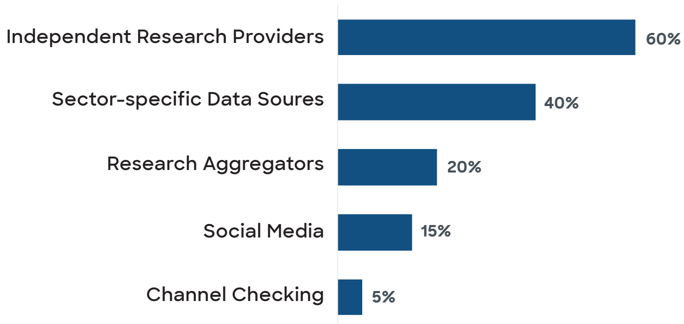


Source: Liquidnet market structure July-November 2018

The Rise of Alternatives

Sixty percent of respondents currently use research that comes from independent research providers, and there is a concerted willingness to grow this area, facilitated by unbundling and the rise of particular interest for products such as macro-economic or political research (see Exhibit 18).

Exhibit 18: What alternative sources of research do you now consume outsid of bulge bracket research?



Source: Liquidnet market structure July-November 2018

The rise in internalisation of research ideas is merely changing what the buy-side chooses to take from the sell-side and in what format. The pick-up in the use of expert networks allows the buy-side to hone in on the relevant specialist. Individual PMs have different agreements with research providers to access aggregate datasets, social media, non-broker boutique research that will suit their mandate.

As clients look for alternative sources of research, some hedge funds are setting up their own data labs; while others are establishing in-house think tanks to explore ways to have more of an edge in the data, and are prepared to pay more for alt data, artificial intelligence, surveys, and threshold research. Research aggregators, used by just 20% currently, and management systems will increasingly offer ways for the buy side to consume research from multiple sources and a variety of different outlets—even company commissioned pieces of research, while still maintaining a direct research relationship with traditional bulge bracket brokers.

Instead of focusing on off the shelf sell-side products, the buy-side is now voting with its feet and moving towards more bespoke interactions that validate internal investment ideas, rather than waiting to be fed research ideas by the sell-side. While the headlines state that overall research consumption is down, it is important to note what type of research consumption is down and why.

In tandem with the close tracking of research consumed, buy-side firms must ward off unwanted solicitations of research. Fifty two percent of respondents deal with this issue through central systems (see Exhibit 19). Permissioning and access tables control research coming in via portals; any research coming in through aggregators is tagged and blocked. In addition, emails are filtered and quarantined; and cease and desist letters issued, sometimes with a bill for the inconvenience to encourage swift compliance. Internally, the use of chat rooms is restricted, distribution lists of authorized brokers are handed out, research providers are blocked and front office staff are trained how to decline research. Cookies allow firms to see the research consumption data and provide granular results to clients on demand.

Seventy five percent of respondents now conduct gap assessments and monitor consumption versus budget to ensure they are paying where they are using (see Exhibit 20). The buy side is now looking at processes to better informed portfolio managers of their quarterly consumption relative to cost. As the buy side becomes more familiar with estimating and tracking consumption, as well as setting up and adjusting budget targets based on ex-post data, the research procurement process will not only continue to become more transparent, it will allow alternatives to emerge through new cognitive networks.

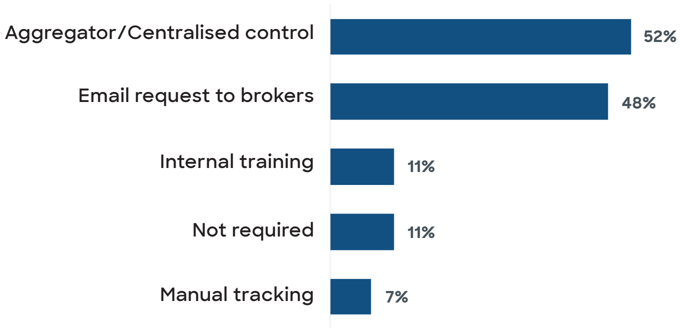
"We are now paying more for AI and for firms doing survey and threshold research. It is people that do research on our behalf. We have decided to do that because we feel we don't have the edge and we feel there is more of an edge in the data we are getting."
US Asset Manager

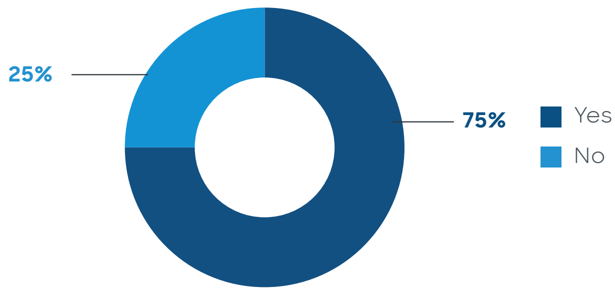
"We have definitely seen a pick up in the use of expert networks and there has been a little shift away from traditional stock brokers. In terms of alternative datasets, it is now more about consumption data in relation to social media."
UK Asset Manager

"We look at the public and private side so we utilize data so there is no change to that, but we recently hired a guy to facilitate aggregation of news streams to better mine the data we have."
US Asset Manager

"We are working with a new provider to use their research recording function to track and reconcile usage with the particular provider and budget. You have your waterfront coverage, and then the investment teams will have individual models to access negotiated additional specialist research. There is a vote every 6 months to create the budget but its WIP, I am not sure what we will take going forward. It has been a year-long education process since 2017."
Global Asset Manager

Exhibits 19 & 20: What measures has your firm taken to block unwanted solicitation of research? / Do you conduct a gap assessment of your research provider list?





Source: Liquidnet market structure July-November 2018

Greater innovation and the emergence of market disruptors such as research aggregators and new alt data providers will not only offer more diversified research but also act as a tool for the buy side to better understand and manage their consumption requirements, as well as expand their research in different dimensions to enrich their investment process.

The Technological Push

Whereas an analyst would pour over financial statements to establish the validity of a single investment decision, now the creation of alpha comes from multiple datasets, interrogated in aggregate to establish outlying risk factors which could impact the underlying investment decision.

Technology offers asset managers a quantitative way of assessing and evaluating their research which has not yet been widely adopted by either research providers or consumers. It will facilitate data-driven purchase decisions so that buy-side managers can gain access to the research they need by providing insights into the value of consumption, making the procurement process is more efficient and targeted.

Research evaluation methodologies, combining qualitative and quantitative measures, will facilitate the optimal buy-side proprietary view as to the relative benefit of each external research provider. Individually each provider can only provide a single narrative, whereas the value today is in the internal view of aggregated sources, as well as the ability to understand the impact on an individual as well as group holdings. By establishing benchmarks to track recommendations based on existing holdings or interest provides tools to interrogate and simulate investment ideas, creating collaboration across the entire investment process.

"We have data driven alpha capture products that we are now selling to a small number of more quantitative type funds. It is definitely growing, but it is our primary research that's still been our focus. The evidence lab is more of a supporting tool."
Global Bulge Bracket

"We need access to the data that is not so easy to get hold of, that is valuable but currently labour-intensive, but you don't need 12 waterfront relationships to produce this. It really needs to become a data service a fintech data company that can provide this at a much more effective price point, so we can use this more efficiently."
US Asset Manger

Technology also provides efficiency. If an analyst covers 50 names, they may only actively cover a smaller proportion of that number. Using internal quantitative models needs to include consistent monitoring for changes at the individual and aggregate level to accurately validate a hypothesis. Data mining regarding who are the owners of an instrument, are there net buyers or net sellers and the reasons why help formulate a full picture; information that would previously have been held by the sell-side broker is now available for portfolio managers to access direct without having to disclose their investment intentions. However merely employing quants who speak python is not enough. It will be the quantamental combination—access to datasets with the ability to create meaning and extract value—which will determine the success of asset management firms going forward.

For many firms this extensive use of data and analytics within the investment process is stage 2 of a two-stage process. In the interim we are likely to see greater interaction between the asset owner and the underlying investment, either by a move to self-funded research by corporates; direct interaction with company investor relations by PMs; companies submitting articles and interviews to websites and hosting investor days. Some independent providers are also looking to alternative ways to differentiate their research offering; for instance, AlphaValue recently launched a crowdfunding model where they offer a single stock coverage and those interested will participate a pre-defined amount. If the stock coverage is priced at €16,000, those interested will make a contribution of €2,000 per company. As soon as they have gathered eight companies, the system closes and the research starts for that particular stock.

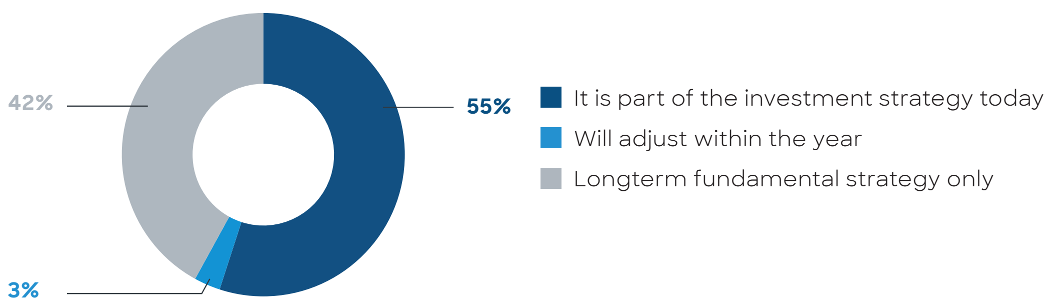
While new alternative ideas may not achieve widespread immediate adoption, they nevertheless provide a strong indication of the longer-term direction of travel—technology within the research process is here to stay.

"The Head of Sales told me I no longer could have access to the conference, but the companies complained to the analyst, so I had to explain that his sales guy wouldn't let me attend. It's no problem for me, I just rang up the companies and arranged to meet them independently. Those who have good investor relations people—that will be the way forward."
UK Portfolio Manager

The Role of Execution

As liquidity challenges arise, more asset managers are extending the role of the dealing desk in the investment process; 55% of buy-side respondents see the provision of short term alpha as important within their organisation. While long term fundamental strategies remain firmly in the PMs domain, it is the opportunities from use of greater technology which facilitates better identification of potential risks and opportunities. This can improve the timing of investment decisions to enter or exit, add or reduce the holdings, speed up or slow down execution of an investment decision.

Exhibit 21: What Importance Does Your Firm Place on the Trading Desk Providing Short Term Alpha vs Long Term Fundamentals?



Source: Liquidnet market structure July-November 2018

Not all firms, nor PMs, share the same view. Some still see the role of the dealer as limited to execution of their ideas only, particularly in relation to executing fixed income assets. Other firms link this to liquidity, believing that this approach is only compatible with liquid instruments, where ironically the increased use of data and analytics can have a greater impact on performance. Technology on the trading desk that provides higher value analysis than a blunt algo wheel, the higher the benefit that can be achieved in understanding the parameters around individual trades and communicating this information to the PM in a timely manner.

"The core of what we do is long-term, but there is an increased focus with the trading desk to try and add alpha through execution. We are not looking for opportunities to trade that are different to the underlying fundamental strategy, but more how can we improve execution, should we be looking at alternative strategies/venues/brokers, how can we improve the process of investment"
EU Asset Manager

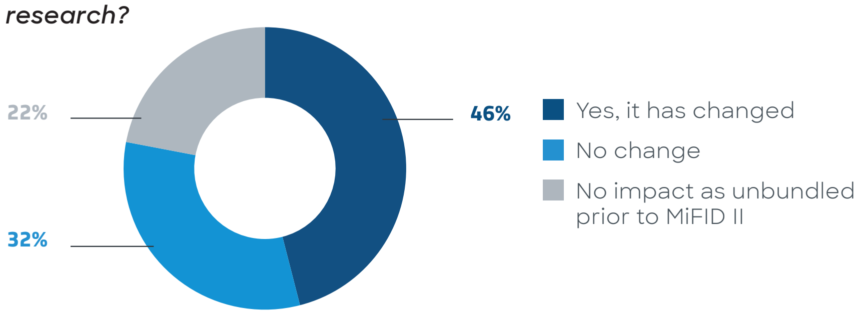
"The job of the trading desk is to provide execution only. We indicate levels on specific bonds to buy or sell—the dealing desks job is just to get it done, to deliver best ex. Even our analysts don't have buy or sell ability—its just us, as the PMs"
UK Portfolio Manager

Almost half of the firms interviewed said the process of sourcing liquidity has changed due to research unbundling (see Exhibit 22). For those that were already unbundled, this change has already occurred, and MiFID II has had little or no impact on how investment strategies are executed.

The buy side acknowledges the greater freedom it now has in selecting execution counterparties as unbundling has changed the historical sell side/buy-side relationship. The responsibility to find liquidity is now with the buy side trader, who must navigate a more fragmented and complex market structure.

"There are two ways of looking at this. For liquid assets, there are short-term opportunities there. For illiquid assets we trade, transaction costs are so high that we have to think differently. It depends on the product we trade."
Global Asset Manager

Exhibit 22: Has the process of how you source liquidity changed post unbundling research?



Source: Liquidnet market structure July-November 2018

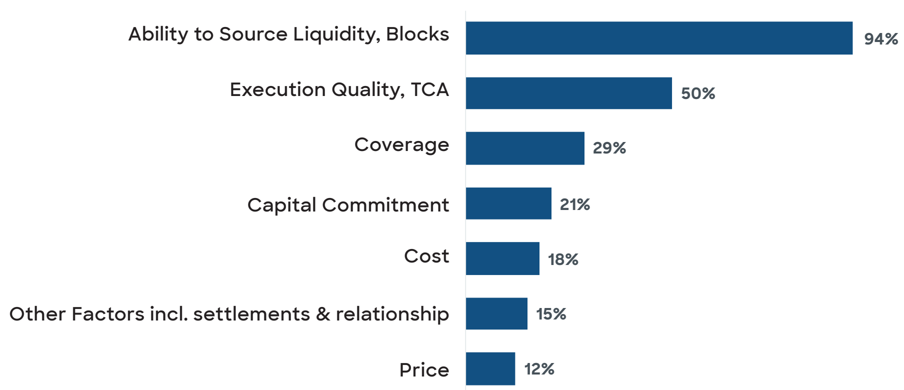
Good trading relationships, market knowledge, pre-trade and historic information, and access to risk capital if necessary are all important but sourcing liquidity, especially blocks, still trumps other criteria in the selection of execution brokers and venues (see Exhibit 23). Standalone execution and the requirement to evidence best execution puts a greater focus on the process, quality of execution and cost of accessing liquidity and is resulting in nuanced shifts on a firm by firm basis. Greater emphasis on liquidity and execution quality has seen an increasing reliance on Large-in-Scale (LIS) trading from the buy side. The proportion of dark trading traded LIS has increased substantially post the introduction of the Double Volume Caps (DVCs). Although the first expiry of the DVCs on 12 September has seen a return to sub-LIS dark trading, LIS volumes still represent 40% of total dark markets as MiFID II has led to an adjustment in investment strategies and trading patterns (see Exhibit 24).

"When it comes to trading small-cap it is all about our ability to locate a block. Now we are completely unbundled, we are looking to trade even more LIS than pre-MiFID 2."
EU Asset Manager

"It is all about finding liquidity, more block liquidity but no risk. We are happy to cross at mid for block to avoid market impact cost."
EU Asset Manager

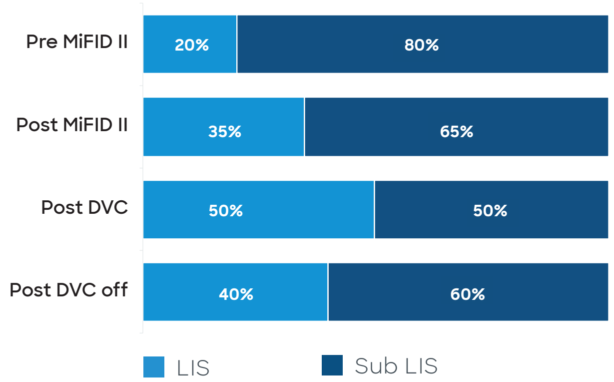
"When executing small and mid caps we will typically look for blocks for those. We will typically look for natural but if there is risk position, we haven't found that pricing is what you want it to be."
EU Asset Manager

Exhibit 23: What are your selection criteria?



Source: Liquidnet market structure July-November 2018

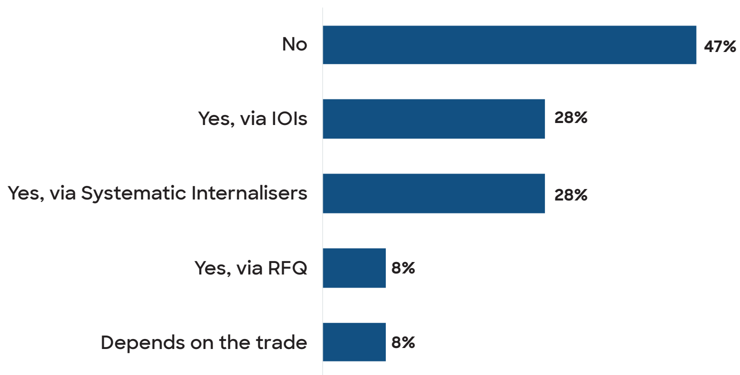
Exhibit 24: Proportion of LIS trading – EMEA



Source: Bloomberg & CBOE Market Data Share

Almost half of respondents are not actively seeking to do more principal trades. Based on the market, product and liquidity, those who are actively trading more using risk capital are responding to IOIs or trading via SIs, but only 8% are sending out more RFQs (see Exhibit 25). The bulge bracket banks are the primary draw as they offer the most avenues in the form of a syndicate, a block trading desk and a cash desk, and their balance sheet enables them to compete aggressively on a long-term basis.

Exhibit 25: Are you actively seeking more principal trades?



Source: Liquidnet market structure July-November 2018

Interestingly, while systematic internalisers have seen a steady rise under MiFID II, only 28% of our respondees are using this construct to access principal trades. SIs existed pre-MiFID II but their rapid growth seems correlated with the decline of off exchange trading and the prohibition of broker-crossing-networks (BCNs). Yet, the current confusion around the true number behind SI market share continues to frustrate many in the industry. Eleven months post the implementation of MiFiD II and the industry is left with the same questions regarding what is addressable vs non-addressable SI volumes with a growing number of participants pushing for regulatory guidance on the adoption of the FIX MMT regime to resolve the issue.

MiFID II has led the trading desk to re-consider its individual relationships with execution brokers. Any change in broker lists over the next six months will depend on the emergence and direction of the firm's business. Fifty one percent of respondents expect no change to their lists (see Exhibit 26)—with the caveat of adding providers with execution capabilities the firm does not currently have or removing a broker that no longer fulfils the approval criteria or whose execution is subpar. Just 27% expect to consolidate the list as they migrate to lower-touch trading but acknowledge the slack may be taken up by finding a new specialist in another area, for a specific type of flow, who can now compete better in an unbundled world.

"We don't necessarily use risk capital, but IOIs are very key to our process"
UK Asset Manager

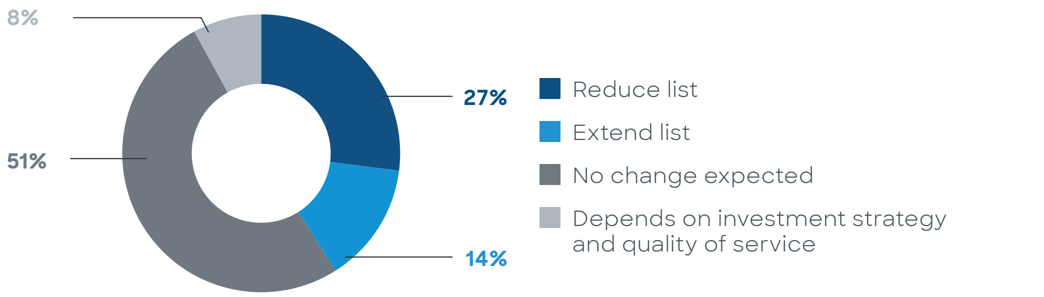
"We use high-touch risk for more subjective liquidity opportunities particularly in the small and mid-cap space, but this is BAU rather than increasing our principal activity."
EU Asset Manager

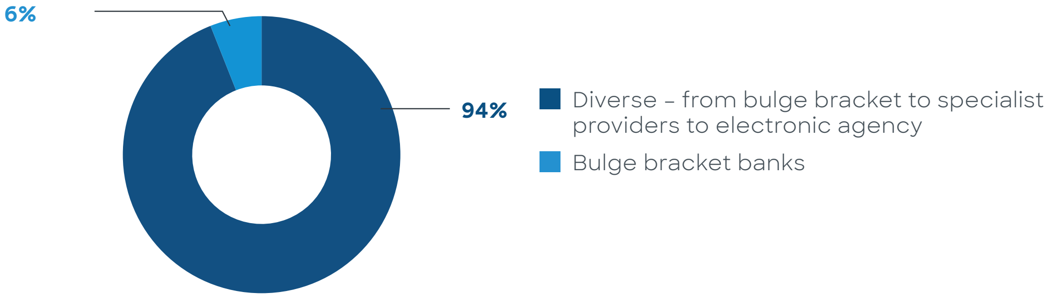
"I don't really care if it is risk or natural, I just want my whole ticket dealt within the spread. I don't want a huge risk on 10% of my order. If you find them with the IOIs and if it suits you trade with them, if it not then you pick something else. We use SIs, but we do not do any RFQs."
EU Asset Manager

"We are doing more and more blocks as we don't see right appetite from the sell side in offering risk solutions. They prefer to advertise their IOI solutions than offer risk. We also don't see appetite from PMs to move back into risk where they are succeeding finding blocks."
EU Asset Manager

"I don't go to ELPs if I don't have to. I am going to a central risk book because I am going more often to a syndicate or block trading desk or a cash desk. The bulge brackets are better at risk. It is not just they are better but it is more they are willing to because they are trying to win market share. Those that have been selling their risk desk for the last tow years ahead of MiFID II are crushing it, its now paying off and people are starting to like the liquidity they are see."
US Asset Manager

Exhibits 26 & 27: Do you plan to extend or reduce your number of execution providers in the next 6 months?/ What type of broker makes up your execution provider list? Which execution channels are you accessing more?





Source: Liquidnet market structure July-November 2018

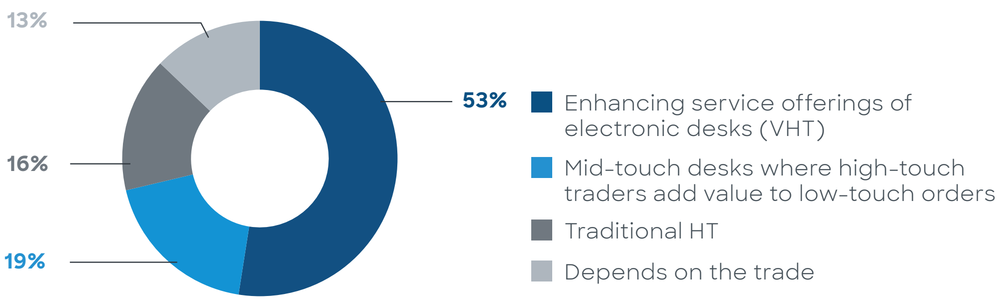
The large majority of firms have a broker list made up of a broad range of brokers from bulge bracket to regional brokers, technology and algo providers, and niche specialists such as small and mid-caps (see Exhibit 27). The provider list varies across geographies and market caps to ensure the ability to transact for accounts across the range of the firm's investing strategy for both active and index accounts. Pure execution brokers, who may historically not have made the cut because of their lack of research, offer new liquidity avenues to buy-side traders willing and able to send flow more freely.

Fifty three percent are now selecting brokers based on greater automation of workflows encompassing a variety of electronic services in addition to algorithms, making low touch trading more bespoke (see Exhibit 28). In comparison, just 16% of respondents have chosen to increase their access to traditional high touch trading post unbundling, while 7% have not made any change yet.

"We will only add a provider to our list if they provide execution capabilities that we don't currently have. It's a continual monitoring process to see whether our execution brokers are still delivering."
UK Asset Manager

"Historically the broker who did not have research would never have made it onto the list. It's a different freedom, we can send our flow where we should. We don't need to worry about trading volumes affecting the research relationship."
US Asset Manager

Exhibit 28: Which execution channels are you accessing more?



Source: Liquidnet market structure July-November 2018

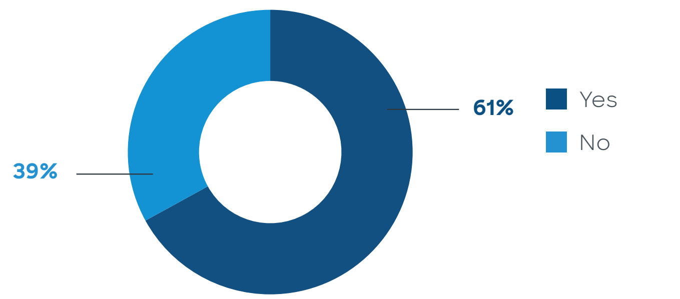
Firms are now looking to automate the low touch flow as much as possible, especially for liquid instruments where the order size is deemed to have negligible market impact, while traders focus on more complex orders where they can have greater impact in deciding where and how to trade. Greater automation across all different trade lifecycle stages will continue given the constant pressure faced by investment firms to improve efficiency. Ultimately, greater reliance on technology will empower and transform the role of the dealing desk as it focuses on orders where they can generate alpha.

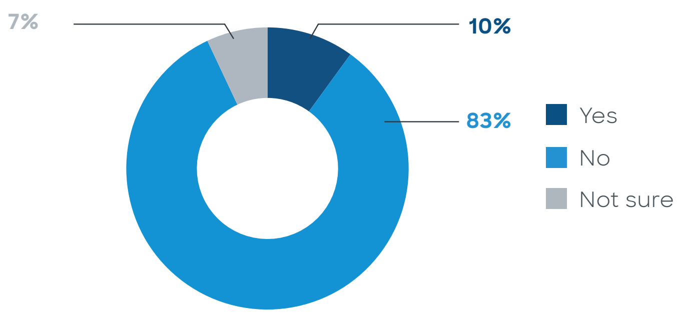
As asset managers take full advantage of the freedom they now have in selecting execution brokers, firms' initial concerns were to be cut off essential liquidity if they decided to not consume brokers' research products in parallel. However, although 61% respondents are finding that bulge bracket brokers still look at revenue holistically, a majority have not felt that services such as risk capital and allocations would be jeopardized if no research agreement were signed (see Exhibits 29 & 30).

"We are increasingly moving to high-touch electronic desks offering a variety of electronic services in addition to algorithms."
EU Asset Manager

"Orders that go to High Touch tend to be more difficult ones but recently I think our skew has moved towards algo trading so we are probably trading 70%+ via algos at the moment. Instead we are slowly becoming the high touch desk."
APAC Asset Manager

Exhibits 29 & 30: Are bulge bracket brokers still looking at revenue holistically? / Have you felt that other services may be at risk without an agreement to take research product?





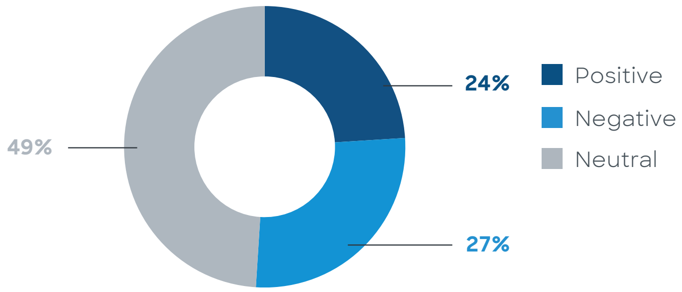
Source: Liquidnet market structure July-November 2018

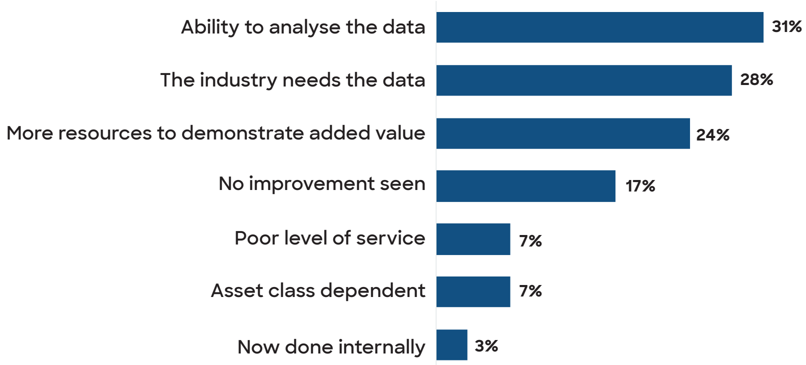
Unbundling is unlikely to prevent the sell side from looking at clients on the basis of the firm's overall relationship or considering and comparing multi-channel revenue streams; rather what matters is the focus on ensuring that any holistic measurements do not impact the delivery of services and products, nor provide conflict at dual capacity firms. It may still be too early to measure the impact of unbundling on execution services as research payments to the sell side have yet to be fully digested. The question is whether this will change if sell side firms face important future losses in their research revenue.

Yet, as discussions progress and market participants adjust behaviours ahead of 2019, some firms are instead suggesting that access to specific services from the sell side is now dependent on the execution commission paid by the asset manager rather than research consumption. High execution volumes, for example, may open the door wider and offer a better sell-side risk assessment for the trade when capital is required. This could change the game and overturn the current race to the bottom regarding execution commissions; Asset managers may even need to increase execution commissions to brokers in order to access natural liquidity and capital commitment.

"Take our top 5—they are all bulges. Is our trading subsidising the research relationship? We want to pay a fair execution rate for premium execution services, but if that means paying a higher rate—10bps not 5bps—is that subsidising the research relationship? How do we make sure we are not overpaying—if 5bps is HT Execution only and we are paying 10-15bps—is that justifiable? Are we just now factoring a bundled rate into execution?
UK Asset Manager

Exhibits 31 & 32: What has been your experience with TCA? Why?





Source: Liquidnet market structure July-November 2018

The need to evidence best execution and review execution broker lists based on quantifiable facts allow for a greater reliance on different metrics from the buy side. Yet, insufficient or inaccurate data, as well as lack of investment by incumbent providers is proving a hurdle for many in order to fully embrace the value of TCA, and a 24% positive experience is a poor vote of confidence in a function that has been around for a number of years (see Exhibit 31). Thirty one percent of respondents lack the functionality to analyse the data properly, and 17% say there has been little improvement (see Exhibit 32).

However, the need for proof across the consumption chain from resourcing research advisories to trading raises the importance of TCA as monitoring tool and a number of new providers are beginning to challenge the status quo. The fluid definition of best execution makes the use of TCA subjective, as does the difference it makes comparable to the effort involved—for a firm trading billions of dollars daily, shaving a fraction of a basis point can make a significant difference to overall performance.

Greater pre-trade analysis in estimating the cost of trading a block, for example, or monitoring outlier trades with a view to changing the process can provide more value in terms of delivering best execution. The ability to quantify the trading process is useful for demonstrating the added value of the dealing desk to both portfolio managers and other stakeholders; and most importantly, for showing current and future clients that executions and the execution process are checked constantly with a view to improving results; sometimes even as straight-forward as the timing of when a particular PM places an order.

The balance of resource constraints versus the benefits from an enhanced dealing structure is an ongoing battle, and 44% of respondents are not currently investing in trading technology or staff to improve liquidity sources (see Exhibit 33). Yet 56% are investing in analytical trade systems and 33% are installing, switching or upgrading their EMS to access liquidity directly and set up different liquidity venues.

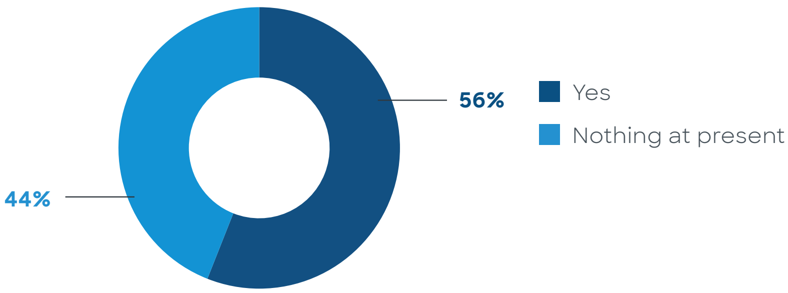
"There is TCA and then there is TCA. The incumbents haven't invested and the product is woefully inadequate for illiquid equities—let alone bonds. Our FX provider is excellent but we are switching providers for bonds"
UK Asset Manager

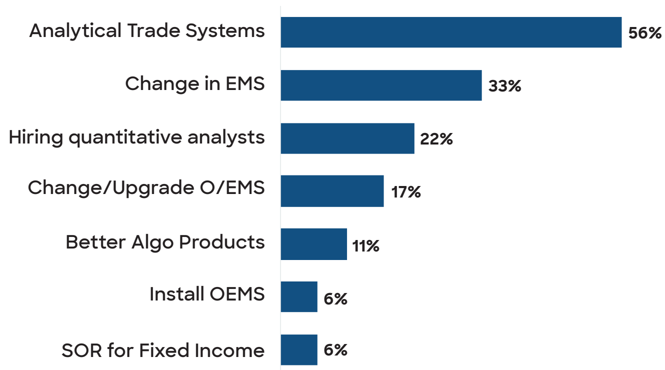
"The value of TCA varies, we need all the tags, there are tech issues & the data needs to be clean. So although the ability to access more data seems positive, it depends on what data and how clean or accurate the data is."
US Asset Manager

"We also look very closely at the timing profile on each PM in our TCA. So we can see that a specific PM may think they can be aggressive so we can show them with data that their timing pretty much sucks."
US Asset Manager

The need to streamline the order and execution process, leverage pre-trade analytics overlaid on trading systems to highlight liquidity and then access that liquidity directly provide both efficiency and a competitive edge. The ongoing issue with EMSs is the cost vs coverage, since most houses need global solutions in multiple products. In addition, 17% are changing or upgrading their OMS, and 22% are hiring quantitative analysts to ensure the optimum use of algorithms and venue access.

Exhibits 33 & 34: Are you investing in technology/staffing resources? What technology/staffing resources are you investing in to source liquidity in the future?





Source: Liquidnet market structure July-November 2018

"Every trade is different—how can you generalise moving parts on any individual trade? There is always something that affects one trade that wouldn't have an impact on another. We need to get better at benchmarking to establish how we can use TCA data and pre-trade analytics in a more meaningful manner otherwise banks will keep coming up with constructs like periodic auctions just to keep market share, rather than really deliver best execution—and then that's a cost for the buy-side to invest—OMS or EMS."
UK Asset Manager

The Future Role of Research

In the current competitive environment, asset managers need to adapt investment strategies to match increasing globalisation, growing political risk as well as changing investor profiles. The ability to access value-add research will continue to be critical; however, it is how that research is accessed, from whom and at what price point that is at stake. Both the production and consumption of investment ideas is set for wholesale change.

Although bulge brackets remain the dominant today and may remain so in the future, the sustainability of traditional business models must adapt and evolve as the creation of investment ideas moves to buy-side ownership. As unbundling takes hold and the quality of traditional research diverges, portfolio managers are not only becoming more selective regarding the analysts to access and the price to pay, they are also exploring new means to uncover investment ideas to lower operational costs and provide additional leveraged insight into traditional fundamental analysis.

As asset managers increasingly look for alternative datasets—from social media, to satellite imagery, covenants, default and recovery rates as well as cyber risk scores, news coverage and twitter feeds—structured and unstructured, the greater the need for sufficient buy-side technology to aggregate and assimilate of vast swathes of data across different asset classes and geographies.

Efficient and easy-to-use tools that drive automation of workflows and improve productivity will be the first next step, freeing up valuable analyst time to effectively research new opportunities and stay ahead of market trends. The ability to combine traditional fundamental ideas with quantitative data analysis will help asset managers address potential investment opportunities and the creation of incremental alpha over a wider universe of instruments and outcomes. Incorporating AI into the research analysis process, portfolio managers and their dealers can more accurately predict trends and identify opportunities over a wider range of possibilities. As access to data becomes exponential, it is which data to access and how to derive value from the particular data set that will provide the greatest value-add.

However effective analysis will also need to determine not only the fundamental risk to cash flow models and investment projections, but also the shorter-term alpha opportunities that exist in the execution. The success of an investment decision no longer sits solely sit with the PM but also with their dealing desk in ensuring the successful execution of any investment decision, wherever the team sits on the globe. MiFID II may have triggered wholesale introduction of research unbundling, but the requirement for technological change in the implementation of investment strategies was already in play, European regulation merely sped up the necessity for change.

While accurate fundamental data, laid out in systematic and standardised format will be the foundation on which to build more effective analysis; in an increasingly global and digitalised economy, the adoption of automation to enhance decision-making by combining big data analytics with human insight will be how asset management firms adjust investment strategies and products for the complex multi layered approach to investment today. The impact of unbundling on research provision post MiFID II is just one element of the process, but it is merely the precursor to the far greater change required in the provision of investment ideas. Challenging the status quo has already begun—not just in Europe, but across the globe.

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Rebecca is considered to be one of Europe's leading industry voices on market structure, regulatory reform, and financial services technology. She has authored a plethora of qualitative research reports and commentary covering the impact of market regulation on all asset classes, changing market structure and developments in dark pools, HFT, and surveillance. She joined Liquidnet in July 2016 to use her 20 years' experience to collaborate and deliver research and insights for both the European equities and fixed income markets. Rebecca is also Co-Chair of the FIX Trading Community's EMEA Regulatory Subcommittee, dedicated to addressing real business and regulatory issues impacting multi-asset trading in global markets. She has held prior roles at TABB Group, Incisus Partners, the British Embassy in Bahrain, Credit Suisse, Goldman Sachs International, and Bankers Trust International.

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