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Paying It Forward: The New Era of Investment Research

Fundamental change is coming to how research is paid for under new European rules, and the impact cannot be underestimated.

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NEED TO KNOW

Mifid II's unbundling of payments for investment research and execution means asset managers are now likely to significantly reduce the quantity of research they are consuming as well as the number of research providers they utilize, placing a far greater emphasis on research quality going forward.

As a result, a new wave of independent research providers has come to market seeking to undermine banks and brokerages, shunning traditional research models in favor of a more bespoke approach or using platforms to connect portfolio managers with independent analysts best-placed to fulfil buy-side requirements.

New technologies are also facilitating the move toward independent researchers, as AI and alternative data continue to improve both the quality and granularity of investment.

Under the revised Markets in Financial Instruments Directive, payments for investment research can no longer be bundled together with execution fees, and the implications for both the buy side and the sell side are not to be underestimated. John Brazier examines what this change means for the industry as a new breed of research providers comes to the fore, and the role technology will play in the emergence of this new market model.

The driving force behind the revised Markets in Financial Instruments Directive (Mifid II), which comes into force in a little under three months' time, has always focused on increasing market transparency and investor protection. However, the reality of implementing and maintaining compliance with such a broad directive has left many market participants on both sides of the Street scrambling to get their houses in order.

Arguably the most complex element of the new trading rules are those separating payments for investment research from execution fees, which were historically bundled together and acted as an inducement for asset managers to trade with specific sell-side providers. Mifid II means that the buy side must now be far more selective of the research it consumes, while the sell side must rethink its traditional waterfront research coverage model.

"This is a fundamental paradigm shift for both the buy side and the sell side," says John Dwyer, senior analyst at consultancy firm Celent. "There has never been this need to charge for this enormous sea of research that has been produced, and frankly, nobody on the buy side has ever had to record how much research they received in a given time series, how much they read and genuinely look at, and how much they use. I don't think it can be understated how much of an impact this will be."

Choices

One of the most pressing issues for the buy side when it comes to laying down a strategy for the upcoming changes is how to pay for investment research. Asset managers that plan to continue using client money to pay for research must implement a specific research payment account (RPA) to do so, funded exclusively by fees charged when obtaining external investment research on behalf of their clients. "This is going to require a level of data and systems and governance internally that hasn't been required before," says Dwyer. "We've found that in the small-to-midsize end of the buy-side universe, they are a little slow in terms of integrating a solution to be ready for Mifid II implementation in January, and are still in the process of working through how they want to do this. I wouldn't understate that as an issue."

It is little wonder then that the majority of buy-side firms have now chosen to absorb the cost of paying for investment research themselves. With the largest buy-side firms in the market, including BlackRock, JPMorgan Asset Management and Vanguard, all opting for this route, it will become harder for other firms to justify passing the expense on to clients without the necessary systems in place to evidence clear returns.

Whatever option an asset management firm plumps for, there is a clear need to reassess both the quantity and quality of research being consumed, and how that research is then valued. Like so many other areas of the investment process, the answer lies in the potential of technology to both increase the value of research and ensure Mifid II compliance.

"What technology brings to the table is clarity—how much are people going to use different products and when are they going to use those products versus others?" asks Charlie Henderson, managing director at research analytics vendor FeedStock. "This sort of transparency, and, in turn, accountability, of value will certainly improve the sell side, which has been under immense cost pressures over the last 10 years, partly because there has been a lack of understanding on the sell side as to what exactly they are getting paid for."

Under Threat

The emergence of independent research providers as a go-to source of more focused, bespoke research is expected to have significant impact on the research departments of numerous brokerage houses and investment banks that have, until now, been able to turn on the research taps and push it out to the buy side indiscriminately. While the true level of impact won't be measurable until several months after the implementation of Mifid II, the warning signs for entrenched sell-side research providers are there to see. A report titled *A Brave Call*, published in June this year by consultancy firm Quinlan & Associates, estimates that some investment bank research departments could face potential losses of up to $240 million by 2020 as a direct result of the new regulation. "I spent a long time in investment banking and worked with a lot of analysts with enormous overlap of the research that was produced among the different banks," says Dwyer. "It was done because there were various motives for publishing research. A lot had to do with positioning for corporate mandates or IPOs, or giving credibility to sales teams. There will only be a small number of large banks that have the brand, credibility and financial wherewithal to maintain 'waterfront' research coverage, and I use that in quotation marks because I think that is going to change or be diluted in terms of what it means."

It's unlikely that bulge-bracket investment banks will be significantly impacted by the new regulations, and will therefore maintain their supply of research to the buy side. However, the importance of dedicated research will surely increase. Smaller banks and brokers that have relied on the waterfront research model may find themselves in a more precarious position once Mifid II comes into effect. "There is definitely room in the marketplace for smaller, niche players rather than just the big ones, and if buy-side firms do decide just to go for a few of the bigger guys, they are limiting their exposure to different opinions and that's what the sell side has always been there for," says Feedstock's Henderson.

New Values

London-based independent research provider StockViews is one such example of the new breed of firms coming to market to challenge the sell-side incumbents. Tom Beevers, CEO of the company, says one of the main drivers behind the company's formation was his personal experiences during his tenure as a portfolio manager at BNY Mellon subsidiary, Newton Investment Management. "The key driver was a frustration with the existing quality of sell-side research and the fact that much of it at the moment is maintenance-style research," he explains. "A lot of it came from my own personal frustration with the industry. Particularly with Mifid II coming up, much of the sell side is quite ill-prepared for the imminent changes regarding the way research is valued and procured."

In September, StockViews launched an equity research platform focusing on around 70 London-based buy-side firms ahead of the Mifid II go-live date. The platform connects independent research analysts with asset managers, with an emphasis on quality and bespoke research designed to drive alpha generation. "What we are trying to do is move away from a coverage-type model where the sector analyst perhaps covers between 10 and 15 ideas within their sector," says

Beevers. “We’re moving toward an opportunity-led model, so we are only going to initiate on an idea where there is a particularly strong opportunity.”

Analyst compensation is directly linked to levels of alpha generated from their ideas through the StockViews platform, creating a transparent view of all analyst performance data that is designed to provide portfolio managers with a far deeper level of insight into how researchers can improve alpha generation.

“This is going to be one of the areas that will evolve, because when you are talking about research ideas and something that is going to drive the alpha generation of a fund, it’s not like other areas of ecommerce,” says Celent’s Dwyer. “The value of input is quite subjective, but there is also information decay with time, so the longer an investment research idea is in the public domain and the broader its dispersion, the lower the value of that particular idea.”

Feedback Loop

The ability to provide consistent, transparent feedback to research providers was a key consideration for Principal Global Investors (PGI), an Iowa-based group of asset management firms that has implemented a dual solution to the investment research problem, comprising ITG’s RPA system and the One Access platform for research valuation from Visible Alpha.

Jennifer Sadiq, director of equities at PGI, says the firm made a strategic decision to evaluate how technologies related to investment research evolved over the previous three years before opting for a solution that would provide Mifid II compliance coverage and improve the firm’s research evaluation capabilities. “We realized that not only did we want to have a better handle on the broker evaluation process, but we also wanted to account for the research we consumed at a much more granular level and be able to recognize the value of that consumption point, as well as entering it into the administration piece of actually directing credits and accounting for them,” she explains.

The combination of the ITG and Visible Alpha solutions will replace PGI’s existing broker evaluation system, which has been in place for the best part of a decade and was developed in-house. Sadiq explains that research consumption was previously reviewed on a biannual basis, which in turn would help guide how PGI was allocating commission credits for research across those firms that provided research as a bundled service offering. “Where we needed improvement was being able to provide that level of transparency to our research partners,” she says. “To some of them it can be like a fire hose they just turn on and hope that pieces stick. Sifting through it all can be very challenging.”

The core of the issue for PGI was the desire to maintain its investment process, alongside compliance within the new regulatory landscape. It’s a common challenge among buy-side firms that have teams set up across the globe where one approach might not be suitable across the board. Sadiq says the ability to measure it at a “more granular level didn’t come to market until very recently,” probably in direct response to Mifid II. “I think we are already at the point where we are very efficient in our research relationships and it’s not a result of Mifid II, but rather it is something we have worked on intensely over the past five or six years,” she says. “People have asked if this will change the number of research relationships or the number of execution relationships. It probably will on the fringes, but we already feel pretty efficient about what we do.”

Future Potential

Aside from existing solutions and new vendor partnerships coming to market in time for Mifid II’s introduction, there are also emerging technologies that hold the potential to enhance the processes around investment research production and consumption. StockViews is actively working toward integrating artificial intelligence (AI) elements into its equity research platform, although Beevers says this is a long-term objective for the firm, as it seeks to effectively replace traditional junior analyst roles with AI-based technology for routine tasks such as fact-checking, data collection or basic analysis. “We think it is important to use AI to supplement or support the work the analysts do,” he says. “Our ethos has always been to combine human intellect with AI, because there are some things that humans are very good at in terms of making subjective judgements across a range of disciplines, and then there are jobs that AI is much better at, which tend to be quite narrow-frame tasks.”

Celent’s Dwyer also highlights the increasing importance of alternative data within the investment research process, which can include environmental, social, and governance (ESG) and also mobile location datasets, and that it has already “seduced some” on the buy side. “We’re going through a period right now where the next 12 to 18 months will be about validation of the alpha that can come from these new data sources,” he says. “There are some very smart, well-funded hedge funds and quant funds out there that say they have been doing this for a long time, which is probably true. I think we're going to see much more data go into the overall capital allocation process and much more focus on that from a validation perspective in the next 12 to 18 months. However, just because you've got data doesn't mean that it is useful or that it leads to an improved investment decision."