News Analysis: Research Message Is Loud And Clear

Martin Essex and James Rutter, eFinancialNews.com, February 20, 2005

Independent research is struggling to become established among UK fund managers, despite bold predictions for its future following the scandals at investment banks' research departments. A survey of 100 institutional investors by Financial News in association with Instinet found that only one in three fund managers uses independent research. On the face of it, this would suggest that concerns about the conflicts of interest in investment banks' research departments have receded. Rusty Ashman, chairman of the UK's Association of Independent Research Providers and director of Stockcube Research, said: "After the fright of the investigations by Eliot Spitzer in the US, investment banks put up Chinese walls and tried to cut the links between corporate finance and analysis. If it works, there is every reason to have their research and analysis rather than independent research and analysis."

The survey, by Richard Davies Investor Relations, showed that while fund managers have increased sensitivity to conflicts of interest at investment banks, it is not a big driver in prompting them to consider taking independent research.

Those managers that use independents have been prompted to do so by the quality of the research, rather than by concerns over bias in sellside offerings. Professional fund managers were hardly ignorant of how investment banks operated in the late 1990s. Many took trading recommendations with a liberal pinch of salt.

They remain aware that research from investment banks may have a hidden agenda. Martyn King, a director at RCM, an arm of Allianz Global Investors, said: "Clearly there are other relationships in investment banks that can affect research. We all see reports occasionally that seem downright bizarre."

However, the furore that accompanied the Spitzer investigations, and the resulting $ 1.4bn (E1.1bn) global settlement with 10 Wall Street banks over conflicts of interest, was expected to upset the status quo and prompt rapid growth in the independent research industry.

In the US, the banks included in the settlement have been forced to distribute independent research to clients alongside their own analysis - and fund the independent sector to the tune of $ 430m over five years. But there has been no such decisive action from UK or European regulators.

Some feel that the rule-makers should put their weight behind the independent sector. George Moeller, chief executive of Robeco, the Dutch fund manager, said: "The regulatory environment for independent research must be favourable. There must be recognition that independent research is useful and in some cases has the edge over investment banks - as is the case in the US." Moeller is chairman of a group of influential investors that is asking the European Commission to promote independent research.

In the UK, the threat by the Financial Services Authority to force the industry to unbundle trading commissions, and make clear what services are being paid for, has receded. The FSA favours an industry-based solution and is expected to endorse a proposed voluntary disclosure code developed by the UK's Investment Management Association and the London Investment Banking Association.

The IMA has suggested that fund managers should provide analysis of trades conducted for each client. They should report trading costs net of commission and with commission attached. The latter should be split into trades conducted at the usual negotiated rate and those executed at other rates, for example, programme trades or trades backed with a bank's capital. The IMA submitted its code at the end of last year and is expecting a response from the regulator this month. A source at the association said it hoped the code would encourage wider use of independent research.

Some in the industry feel the greater degree of transparency will provide a genuine boost for independent providers. Glenn Bedwin, international head of equity research at Thomson Financial, the financial information provider, said: "The push for transparency, combined with the demand that the industry come up with a price for research, will lead to virtual unbundling. Having to understand how much research costs and how much it is worth will drive growth in independent research. However, the industry won't be as quick to develop as it would have been if there was mandated unbundling."

Julia Streets, European head of independent research at Instinet, said: "Many pension funds don't really know whether or not their fund managers are using independent research. We expect that when the LIBA/IMA disclosure code comes out that may well change. Because of their fiduciary duties, pension funds have a responsibility to understand what their fund managers are doing and question whether it is in the best interests of their fund."

Few pension funds are exerting any pressure on their fund managers to use independent research. The majority of managers surveyed by Financial News and Instinet said that fewer than one in five of their pension fund clients had enquired about independent research.

Of the 32 externally managed pension funds polled, almost 60% said they did not know whether their managers used independent research - and did not want to. One said: "We don't get involved." Another commented: "We have external fund managers who may use independent research but we have no influence on that. It's up to them."

More than 84% of pension funds said they should not have an influence on the sources of research that their fund managers used. One pension fund said: "Fundamentally, we give them the mandate and we monitor them in terms of performance. I think that if their performance is good, it means that the research they are using is good and vice versa."

Another added: "If you appoint an external manager, you have confidence in their systems and investment approach. Also I have to say independent research doesn't come cheap. It's a cost issue and we're not sure if it would add value."

Some independent research providers suggest that investment banks will always be able to offer a lower-cost alternative to their services. Lucy Cottrell, an analyst at Independent Minds, a London-based research boutique, said: "Unbundling will solve some problems, but cross-subsidies will remain at investment banks. There is not a level playing field in terms of the pricing of research."

Ashman added: "The cost of research has come hurtling down. That's why there hasn't been the burgeoning of independent analysis that seemed likely 18 months ago."

However, investment banks are not oblivious to the lower cost attached to research. They may have deeper pockets than boutiques, but they do not want research to become an excessive burden. Many have made deep cuts to their research departments in the past year. Citigroup and Goldman Sachs are the latest preparing to lay off research staff, as Financial News revealed this month.

Bedwin at Thomson Financial said: "I believe sellside institutions will see research as a profit centre going forward. I'm not sure they have the luxury of providing loss-leader services." While the decrease in the research produced by investment banks should create opportunities for independent firms, few report a surge in demand for their services.

Alice Enders, research programme co-ordinator at Enders Analysis, said: "I think there's a demand for a different kind of research, but it doesn't seem to us that there's a vast move away from broker research at all."

FUND MANAGERS CLAMOUR FOR THE STATUS QUO

Institutional fund managers who are not using independent research claim they are more than satisfied with broker research and their own internal analysis. One said: "We are happy with the research we get from brokers so there isn't a need to get independent research from boutiques." Another added: "We are absolutely happy with the research we get from brokers and we have internal analysis as well."

Seven institutional fund managers cited expense as a reason for not using independent studies. One said: "We don't use independent research mainly because of the cost. We are happy with the company research we get from brokers. Also, I don't know who these people are. I don't know how good their research is; how good the quality is."

Another respondent added: "Generally speaking, we prefer our own research, company views et cetera. We prefer using a variety of other sources and I don't think that independent research providers add much value. I can't rely on them as a business either. Usually, they are very small firms which may disappear in six months or two years' time."