RETHINKING THE RESEARCH FUNCTION
A BAD BUSINESS MODEL

When it comes to the research function, investment banks turn the traditional business model on its head. They give away their product—in this case, research—for free in the hope of attracting trading commissions in the future.

In the past, research was also a pillar for investment banking fees supporting the IPO process. At the peak, between 2000 and 2003, Sanford C. Bernstein estimates that roughly 40 percent of this revenue stream was allocated to supporting research.¹

That all changed with the National Association of Securities Dealers (NASD) Rule 2711² and the 2003 Global Analyst Research Settlement among the US Securities and Exchange Commission, the NASD, the New York Stock Exchange (NYSE) and 10 of the largest investment banks—both of which aimed to curb conflicts of interest between research analysts and IPOs.³

Regulations were created to separate research from investment banking activities. In addition to physically separating the two functions, these regulations changed how research analysts and investment bankers (and the companies they follow) interact. “Analysts have had to earn their keep without subsidies from investment banking fees.” Today, according to Institutional Investor Magazine, “they live by commission revenue alone.”⁴

Additionally, Regulation Fair Disclosure prevents companies from disclosing any information deemed material to their business unless it has already been disseminated publicly.

All of these measures have helped to vastly reduce the ability of sell-side analysts to provide alpha-generating ideas—and the resulting impacts on research quality and quantity are evident.

ELECTRONIFICATION IS CHANGING THE GAME

Electronic trading and alternative trading services have driven equity trading margins to nearly zero. Some argue that the buy side pays for research with “tack-ons” to base best execution rates, but the incremental revenue is minimal and shrinking in reality.

SELL-SIDE RESEARCH REMAINS ONE OF THE MOST CHALLENGING ISSUES FACING THE INDUSTRY. ON ONE HAND, RESEARCH HAS BECOME A COMMODITIZED PRODUCT WITH LITTLE DIFFERENTIATION.

Aside from unique insights provided by a limited number of specialized boutiques, non-differentiated research is generally not something the buy side needs or wants. On the other hand, research provides a way for investment banks to demonstrate to potential clients their expertise and thought leadership on initial public offerings (IPOs) and mergers and acquisitions (M&A). The situation is now worsening, and changes mandated by MiFID II will bring the issue into even sharper focus over the coming year.

QUICK FACTS

Research budgets will likely shrink further by:

25 TO 30% OR $15 BILLION

Source: Quinlan & Associates, Research in an Unbundled World: The Outlook for Sell-Side Research Providers Post-MIFID II

AN ESTIMATED 40% of trading commissions were allocated to supporting research between 2000 and 2003

Source: https://warrington.ufl.edu/graduate/academics/msf/docs/speakers/prereading_McMahon_Ward0405FortuneMag.pdf
The internet has exponentially increased the amount of freely available information, and made it easier than ever to target and analyze relevant data streams. Gaining an information “edge” and rising above the “noise” is immensely more difficult.

Small players are taking advantage of low barriers to entry to join the research space. These “independent” research providers may not need a broker-dealer license, they usually have a much lower cost structure compared to traditional sell-side companies, and they can monetize their products through subscription services and pay-per-report models available through venues such as Capital IQ and hard-dollar agreements.

**MiFID II, THE NEXT WAVE OF DISRUPTION**

The Markets in Financial Instruments Directive II (MiFID II) rules designed to separate broking, or trading, from research fees are expected to take effect in January 2018. Long delayed, these rules could have a profoundly negative impact on research revenues. A recent report published by Benjamin Quinlan, former head of strategy for Deutsche Bank’s equities business in Asia Pacific and its investment bank in Greater China, predicts that research budgets will further shrink by 25 to 30 percent, or $15 billion by 2020, having already fallen between 20 and 25 percent since 2012.¹

The intended consequence of MiFID II is to encourage the creation of a hard-dollar research market in Europe, which might influence other regulatory agencies to adopt similar rules. However, it will also alter the economics of asset managers’ business models, forcing them to pay for research services from their own profit and loss statement, rather than passing costs on to investors through the price of securities. The alternative under MiFID II is that money managers can carve out from investors a fee to create a separate research budget to have them pay for research, but one can doubt that this will be much of a factor given cost and complexity.

These regulations could have significant impacts. Faced with the true price of research, money managers will likely scrutinize the research services they purchase, leading to more selective consumption, a flight to quality and declining revenue streams for “me too” research providers. Less research coverage is also likely—especially for smaller, less liquid issues—as banks will realize how little money they can make from research and are forced to make tough choices regarding their depth of coverage.

The consequences of the MiFID II regulations regarding payment for research are further exacerbated by the fact that money managers face their own margin pressures. The long-term underperformance of many actively managed funds has in general given rise to unprecedented growth in exchange-traded funds (ETFs), and other passive or index products. It is also driving managers to interact with fewer brokers in an attempt to get more leverage from commission dollars paid to The Street.

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**Figure 1: Commission rates for US equity trades (cents-per-share)**

![Figure 1: Commission rates for US equity trades (cents-per-share)](image)

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1. Normal “high-touch” agency-bundled trades
2. Average “all-in” blended commission rate
3. Algorithmic/smart-order routing trades

Note: Based on responses from 271 traders in Q1 2007, 272 in 2008, 290 in 2009, 286 in 2010, 304 in 2011, 316 in 2012, 294 in 2013 and 316 in Q1 2014.¹ Not of rebates and excludes portfolio and electronic trade.² All-in blended rate across single-stock, program, and electronic trades, including any commission management program “tack-on” rate.³ Excludes any “tack-on” rate to pay for research.

Source: Greenwich Associates 2014 U.S. Equity Investors Study
What has not changed is that money managers continue to value access to unique insights and information, access to capital and access to deals (IPOs and primary issues).

**THE ROAD AHEAD**

Despite all of the negative fundamental trends around the sell-side research process, the function remains part of the business model. As said before, money managers are still willing to pay for research, albeit with much smaller budgets. The question is how to optimize research to stop its decline and prevent its ultimate demise.

Investment banks should be availing themselves of digital opportunities to right-size and make research profitable again—but that will require thinking outside the box.

**Fintech is probably the largest threat and opportunity**

There are plenty of examples of niche service providers offering unique insights to the buy side in an attempt to generate alpha. A recent *Wall Street Journal* article titled “Wall Street’s Insatiable Lust: Data, Data, Data” drove that point home: “The opportunity we are chasing is that in all this huge data there are little nuggets of alpha gold.”

Investment banks should be looking at innovations such as e.g. Planet Labs Inc. This company launched a small constellation of “cubesats” that can deliver imagery of economically sensitive spots much more frequently than traditional satellites and will be supplying information to Orbital Insight Inc., which mines satellite imagery for hedge fund trading tips. Leveraged alongside existing capabilities or on their own, these types of data providers have the potential to become alpha-generating services.
Blogs, social networks, micro-blogging services and message boards are becoming more important

Eighty-six percent of investors recognize the importance of these platforms and see them as having a growing impact on their investment decisions—a function, in part, of generation digital's growing share of the workforce.⁸

Not only is the consumption of digital information increasing, but contributions in the form of conversations and posts are also on the rise and having a big impact. Technology makes it possible to layer analytics and learn which digital contributions are deemed important and credible through artificial intelligence capabilities. Furthermore, it incorporates new data sources to create customized research offerings based on client-directed interests, management styles and demand.

Not nearly enough is being done to create holistic, full-service, interactive digital delivery platforms

While many claim to have “the solution”, most are simply repackaging versions of the old built-for-purpose silos or binary asset-class products rather than creating an opportunity to interact for collaborative engagement. What the buy side wants is the right information at the right time for global ideas with a local presence.

One of the main challenges for digital delivery will be rising above the competitive noise. A truly mobile, regulatory-compliant interactive interface for the buy side could be a competitive differentiator. It could also be used for post-delivery analytics to better understand consumption patterns and client usage, and as a lever for making the case to clients for increased revenue opportunities.

All of this points to the fact that sell-side companies have vast quantities of historical and real-time market data and other data streams that should be leveraged to create meaningful, real-time research products and services.

Data applications with access to news, blogs and other editorial and media content from around the world can be quickly integrated into research reports. New data sources, such as social media, can provide additional insights into derived sentiments. Sentiment analysis applied to customer messages on Twitter, localized data and subject-matter expert inputs can yield interesting results (e.g., determining crop yield based on localized weather and tweets from farmers). By employing advanced analytics to connect streams and events, companies have the potential to create alpha-generating trading strategies that can be monetized.

THE QUESTION IS HOW TO OPTIMIZE RESEARCH TO STOP ITS DECLINE AND PREVENT ITS ULTIMATE DEMISE.
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