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Commodities Now
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Independent Commodity Research

Independent research is garnering further support propelled by structural changes, market developments and legal and regulatory issues. As ever, the US has led the way. But what are the prospects for this specialisation in commodity markets? **JAMIE STEWART** offers his views.

TEN YEARS AGO independent research was little known and little appreciated but has since assumed an increasingly important profile. This has been propelled by structural changes and market developments, together with legal and regulatory factors, as much as by the natural commercial forces involved in identifying an opportunity, filling a niche and satisfying demand.

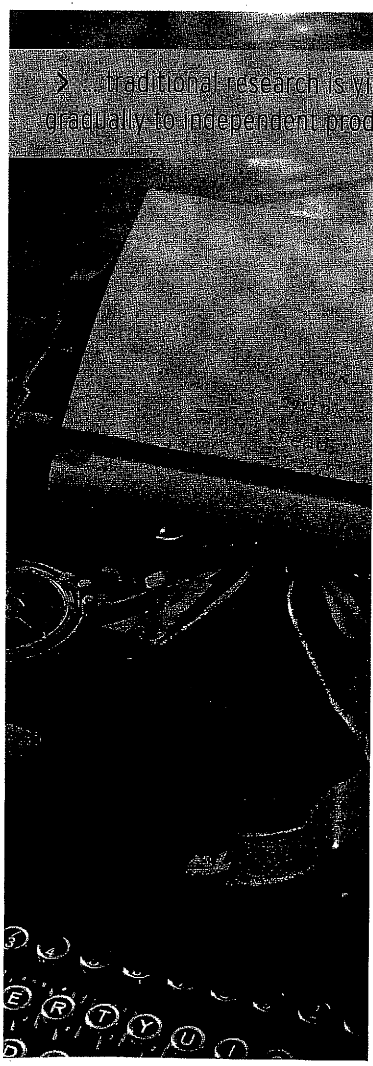
As is true of many aspects of traded markets, the US led the way in this respect, stealing a 10 year march on the UK and leaving continental Europe as a 20-year laggard in the rear. The emergence of independent research in North America - with Canada not far behind the US, though more selectively so - was fuelled by pushing out the boundaries in financial services in various respects, combined with American flair and entrepreneurial push.

In the current climate - one marked by recent pressures of the long, post dot.com bear market, a series of scandals arising from corporate fraud and analyst misrepresentations, and by the tightening in terms of legal and compliance structures - the role and potential of independent research have benefited exponentially. If one thinks of these forces in 'push - pull' terms, structural tightening has driven independent research forward. This force is complemented by an increasingly competitive and demanding environment in the institutional investment area, where requirements for superior returns - both relative and absolute - have led fund managers to seek out superior research and then to pick the best of the bunch.

It would be extreme to talk of the 'demise' of traditional research, which is still being generated in huge quantities. What is evident, however, is a series of deep-rooted changes which are gradually squeezing the lynch-pin position that traditional sell-side research has enjoyed for many years. This bit of 'withering-on-the-vine' is partly the result of the points set out above. It is also partly, however, the outcome of natural commercial pressures arising from the better understanding of financial products, commoditisation, and 'de-cross-subsidisation' in a field which no longer needs - nor wants - to carry lame ducks or nurture loss-leaders.

These factors go hand in hand with the effective ousting of all but the best products from investment banks' research departments as a concerted result of globalisation, communication and automated market transaction systems. This 'ousting' is also at the behest of an increasingly hard-pressed and choosy consumer: the money manager who needs ever more urgently to get the best information first in a world in which immediacy, mass distribution and lightning response through electronic trading systems, stop-loss programmes, computer driven rebalancing and index adjustments mean that the late birds don't get any worms at all.

In its simplest terms, the fund manager who relies on traditional sell-side research to keep informed and take decisions will die wormless. With 1,750 copies of a Glaxo 'buy' recommendation circulating



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electronically and simultaneously worldwide, the manager is unlikely to be able to strike first - however quick his or her reading speed and decision to trade. Apart from exclusiveness (in the right sense of that virtue), money managers seek a personal relationship with an analyst who has talked to the company, knows its products and built the analytical spreadsheets. In the absence of exclusivity, vital snippets of information managers need to make investment decisions are fed to competitors in Tokyo, Calgary or Johannesburg before they can get a look-in.

This example rounds off the balanced 'push-pull' reasoning to show that traditional research is yielding gradually to independent products for many reasons other than pure cost cutting by investment banks. It combines with reasoning triggered by the 'high level' factors explored above to convince the market that brokers' broadly-based, integrated research which has for years - in theory, at least - been

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'given away' to clients cannot survive. There is always the exception and pockets will thrive, of course - the top level specialist, the best-of-breed and the protected remnant of the species. Where investment banks' research is pegged internally to particular services and products which represent rarefied and well established skills (such as sought after structured securitisation or hotel sector merger and acquisition business) it will doubtless flourish. Investment banks will cherish such units, but at the expense of the teenage scribblers and clerks with calculators whom they will have to let go.

The corollary of this rather discouraging and unenviable picture of the traditional broker's analyst as an endangered species is, of course, the profile of the new found independent analyst, whose business structure and model are completely different and eminently manageable - even when the market going gets tough. Typically, independents will offer a narrow specialisation in terms of topic and methodology, work with a small, lean team and restrict services to what is considered the optimum number of clients - between 20 and 40 is often the case in a 2 or 3 person team. This modest critical mass may appear to contradict the 'economies of scale' theory, but the logic lies in the structure of the remuneration. In itself a complex side of such services, the key is that exclusiveness to a very small group of investing clients makes high quality research sufficiently important and attractive to a fund manager to lead to flexible remuneration which pays well above the indicated service price to reflect value added, success and therefore - put bluntly - the amount of money made by portfolios following that analyst's advice.

It is interesting to note the fundamental elements which differentiate the species from the ranks from which they have broken. To dwell on a couple of those distinguishing features, consider that the average age of independent analysts is probably between 10 and 20 years greater than that of the broker's analyst generating research to support secondary trading activity. In an industry which has proved relentlessly ageist, it is interesting to see the relative lack of experience of the investment bank's 'teenage scribblers' (however expert their knowledge of Black Scholes or random and chaos theories). This is giving way to the maturity and 'market-wise' outlook of the independent analyst. They have typically lived through a number of economic and market cycles, and are possibly less likely to lose their heads when the next inflexion comes. Again, the 'get rich quick' ethos of the leading brokers' analysts of recent years has translated into a more virtuous and pragmatic outlook amongst the leading independents, many of whom tend to work on the belief that independence, transparency, accountability and being the master of one's own destiny are preferable to 'filling their boots' in financial parlance.

Independent research is at too early a stage to be able to catalogue and categorise. Part of its essence is originality and the ability to adapt to match market mood and demand. It is a field which will bow to the theories of evolution where flexibility and opportunism will lessen as the segment becomes more fully populated and ranked in terms of track records.

At the moment, the richest seams are being exploited by analysts - many of them amongst the best from investment banking ranks who have walked or been helped out through revolving doors. If one were to try and define the direction which these trends are following by setting up a matrix, then the number of axes one would need would challenge the perspectives of even the most sophisticated Cadcam software. We can legitimately cut corners by saying that there is a visible initial division of independent product into pigeonholes by regions, countries, industries/sectors, approach ('top-down' - the strategists, economic and political analysts and asset-allocators - or 'bottom-up' - corporate/stock analysis), methodology (quantitatively based, technical analysis, fundamental, conceptual, arbitrage, trading systems) and mission (smaller and mid-cap.; issuer-sponsored research; sophisticated data archiving, selection and retrieval, for example).

This provides a sprawling series of coordinates and reference points, even without starting to flesh out the sub-strata of specialised approaches and niche analysts who reckon to the be the only, as well as the best, proponents of their chosen type of analysis. A rough and ready approach to understanding the 'streaming' patterns might well emulate the characteristics of a dichotomous botanical key: e.g. start by dividing a product into 'top-down' or 'bottom-up', and then label it more precisely according to the further characteristics and focus of the product.

There is little doubt that the most heavily populated stream would be that of industry sector-specific services, a tendency made logical simply by the increasing globalisation of major industries and by the relationship between sector fortunes and economic cycles - a self-evident feature which cross-carves the investable world into neat swathes allowing the competent analysts to say something new and interesting about the stocks he covers whatever the weather.

This may appear too obvious an advantage to mention. But bear in mind the increasing amount of funds under management in the hedge fund segment - around US$ 1 trillion worldwide - and it becomes plain that money is made by

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selling rotten companies short when their prospects are poor just as much as by catching the rising star when the cycle favours growth and investment.

Independent Commodity Research

The context of a publication dedicated to commodities calls for a close view of the ways in which independent research has approached this cross section of the industrial world. It advisedly reflects the fact that no single 'commodities sector' truly exists, either regionally or globally. The term is readily bandied about by financial journalists who want to refer to the effect of China's demand for raw materials with convenient labels, or by a lecturer explaining to budding economists how cycles affect different stages in production.

In effect, 'commodities' has naturally and continuously sub-divided itself in almost amoeba-like style since the days when Iron Age Britons dug up chunks of ore to make axes. This isn't an isolated phenomenon. We have all got used to 'communications' and 'technology' spawning sub-sector terms; even the time-honoured 'TMT' (technology, media and telecoms) is starting to break down in to sub-terms such as 'wireless telephony', 'mobile handsets', 'software' and so on. This gives those who design commodity indices such as the MSCI a headache most mornings as they have to split down their industry sectors into smaller splinter groups.

The nature of commodities overall is subject to qualification because of the nature of the activities involved: upstream, downstream, exploration, exploitation, trading, processing, distribution, utilities ... and so it goes on.

Having trampled where angels fear to tread - namely on the ground of categorisation, terminology and industrial processes as these apply to commodities - one encounters the biggest paradox of all, which is that, despite the vast scope and role of commodities on the world's stage, markedly few independent analysts have dedicated themselves to the concept. This is not because there is no money to be made. Neither is it because commodities are horribly complex. It isn't because the financial analysis is obscure and challenging. The truth is that not many independents tend to get involved in commodities analysis for four very simple reasons.

First, the 'industry group' is so broad, yet so fragmented, that it is a daunting prospect to establish coverage and recognition in terms of even a relevant or representative cross section of commodities topics. Given that independents typically fund their operations on a shoestring - albeit a geared one - the initial and ongoing investments needed to do so are beyond the means of most.

Second, the very cyclicality of commodities to which that lecturer in economics was referring is an antidote to commitment to the cause. An independent researcher will aim to get involved in an industry field which, although inevitably affected by economic cycles, will not fluctuate wildly and, at worst, go dormant for months if not years when conditions are adverse. Electronics, retail, brewing, logistics ... they are all sectors which keep on going when interest rates, growth and inflation are at extremes, and there is money to be made whatever is happening at the Federal Reserve or the Bank of England. There are times - sometimes protracted - when little or nothing stirs in commodities. That may now have changed.

Third, commodities represent an area of industrial activity in which there is already a huge amount of industry-to-industry research: 'I2I' (like 'B2B' or 'B2C') that has already begun to supply fund managers with a sideline to their consultancy businesses, which relies more on skill and knowledge relating to hard hats, seismic evaluation, exploratory drilling and the building of dams than to the niceties of brand loyalty, depreciation, asset-disposal, off-balance-sheet debt and other nuances of accountancy which are natural ambrosia to analysts.

Fourth, when we think commodities, we think of certain regions: North America, Australia, South Africa, various marine tracts, Russia, India and China - the biggest suppliers and consumers. For an independent analyst to know their onions, they need to grow them, sit on them or eat them. The share of commodities spoken for by the east coast of the US, by the UK and Europe is tiny ... and so is the fraternity of independent analysts who research them.

There are some notable examples, or exceptions which have created the critical mass and the profile to generate excellent independent research on commodities. They show a permutation of three characteristics: they are based in a commodity-rich territory, they are dedicated to their cause, or they happen to cover commodities-facing corporates in the pursuit of a conceptual research area such as arbitrage, forensic auditing or momentum-driven trading system development.

It is invidious to mention some and not others but consider a few standard bearers. The Center for Financial Research & Analysis (CFRA), a US based forensic auditing analysts, is as likely as not to come up with pre-emptive recognition of an accounting irregularity in a commodities group. Cambridge Energy Research Associates (CERA), the US-based group acquired by IHS Energy last year, is outstanding as an independent in its coverage of energy based commodities globally. PFC Energy are another offering a broad, integrated range of consulting services covering all aspects of the oil, gas and power business. The last vestiges of Wood Mackenzie has established an excellent reputation as an energy expert, taking on the mantle of the original Wood Mackenzie, where brokerage expertise in oils sprung from early recognition of the attractions of an opportunistic marriage between portfolio management and the North Sea oil boom of the 1960s and 1970s.

In metals companies such as CRU, GFMS, CPM Group and TheBullionDesk.com spring to mind. Delving deeper than this into the ways in which independent research faces commodities is an intricate and involved matter. Yes, there are other indirect and oblique instances of interplay, and if one entered the relevant keywords into Google, it would come up with multiple examples.

The kernel of truth is twofold. First, independent researchers are there, and they are generating excellent product. Second, there are few of them as yet - so there is huge potential for more. The marriage is, by nature, a tricky one - but they do say that as many strong marriages smell of fire and brimstone as of roses and violets ■

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