FREE THINKERS

Eliot Spitzer's assault on Wall Street greed ended in April last year with a $1.4bn payout by leading banks and embarrassment for a group of once highly respected financial figures.

The New York attorney general exposed corruption among some of the world's biggest investment banks on a grand scale. He uncovered evidence that in-house analysts, keen to please lucrative corporate clients, had sometimes produced biased investment research. Internal e-mails and other documents showed that they were often inspired more by their desire to earn banking fees than their duty to investors.

The repercussions of Spitzer's US investigation were quick to reach Europe. The loss of confidence in broker research has acted as a catalyst for the formation of independent research boutiques, which claim to offer truly objective research to institutional investors.

Conflicts of interest

Like their American peers, European analysts have come under fire in the last two years over the quality of their research. In the UK, brokers are under pressure to "unbundle" (split) commission fees for trading and research, which are traditionally grouped together, in an attempt to break the link between research and investment banking. This, it's hoped, will placate the critics who accuse integrated houses of serious conflicts of interest.

The UK's Financial Services Authority (FSA) has been leading the call for reform. The regulator has stopped short of implementing proposals to ban the practice of bundling charges for execution with fees for research. Instead, it has decided to leave the market to find its own solution – although this will be reviewed in December.

While the FSA wants to encourage greater transparency of research pricing, for the moment, it has resisted the temptation to intervene any further. Yet an FSA report on the issue clearly outlines continuing concerns: "Fund managers who use these [bundled] arrangements face conflicts of interest in their relationship with brokers, and are not directly accountable to their clients for expenditure on bundled and softed items," it says. "The lack of transparency makes it difficult for customers to tell if the manager is acting in their best interests or obtaining sufficient value for money on their behalf."

All this is good news for independent research boutiques. Jamie Stewart, head of institutional marketing and research at Eden Group, a UK financial services group, reckons that changes to the operating environment will fuel their commercial prospects.

Ever since the shake-up of the City that followed the technology bubble, boutiques have been making their presence felt. Some were spun out of Ivy League investment banks when the market was still at its height; others have been formed by casualties who were made redundant when the bubble burst. But they've never quite managed to penetrate the market.

Key points

* The tarnished reputation of brokers' research has boosted the popularity of independent research boutiques.
* Boutiques' backers say they have more experience, more freedom to specialise and more independence than brokers.
* Some IROs are sceptical about boutiques' influence with investors. But many believe that their credibility and thus importance will continue to grow.
* Institutions are increasingly willing to pay for third-party investment research.
* Visit www.investorside.org for a list of independent research boutiques.

CUTTING TO THE CHASE

Iain Johnston and Simon Roberts quit well-paid jobs in the City to set up independent research firm New Street Research (NSR) in February last year.

Johnston, former head of telecommunications research at JP Morgan, and Roberts, ex-head of UK equity capital markets at UBS Warburg, had become disillusioned with the traditional world of investment banking. They felt there was a gap in the market for unbiased, ideas-driven research and that fund managers would be prepared to pay for it.

Roberts and Johnston had been caught up in a world where analysts routinely arrive at work at 6.45am to begin a highly structured day. On top of producing research notes, analysts at investment banks are also expected to generate ideas for proprietary trading desks and in-house corporate finance departments. This, so the argument goes, can compromise the quality of the research and has led to allegations that some research is biased in favour of existing and potential corporate clients. Given their wide-ranging responsibilities, many analysts are left short of time to actually write research and talk to clients.

Roberts and Johnston were determined to offer something different. According to the firm's mantra: "NSR is truly independent. We do not underwrite securities; we are not proprietary traders; we do not offer corporate finance advice and we do not manage assets."

The firm also refuses to publish "maintenance research" based around company results. So, says Roberts, its analysts have 40 per cent more time to write meaningful research: "we write and say what we believe and we publish research when we have something to say. If you can cut out day-to-day maintenance and concentrate on quality research, it hits home and adds value – and you are doing the buy-side a big favour. Also, from the writer's point of view, it's much more satisfying."

Roberts says New Street's research is concise and to the point – its notes are rarely more than ten pages long. The firm has eight analysts specialising in the pan-European telecom services sector. Companies covered include France Telecom and Vodafone, as well as Colt Telecom, Thus and Eircom. The firm also publishes topical theme-based industry research.

Despite the abundance of "free" research pumped out by investment banks such as Merrill Lynch, Goldman Sachs and JP Morgan, Roberts is adamant that New Street's research is worth paying for: "we maintain individual financial models on all the companies we follow," he says. "And we analyse a company's entire capital structure – both debt and equity. Our research is ideas-driven and focused on the fundamentals."

Roberts adds that New Street's own business model depends on the quality and value of its research. It prefers to get paid on a commission-sharing basis, pioneered by Gartmore, where fund managers can execute trades through one broker and pay separately for third-party independent research.

Roberts hopes commission-sharing arrangements will become more transparent: "commission-sharing has been tainted with the soft-dollar brush. If it were to become an acceptable and fully transparent method of paying for research, that would be a good thing for firms such as ours, as it formalises a payment mechanism and allows the institutional client to split out the cost of execution and research."

So could the recent change of climate finally give boutiques their first big break? Stewart thinks they're here to stay this time. "Fund managers will feel actively encouraged to make use of independent research as an antidote to the flawed output from analysts in integrated houses," he says.

Nick Hill, managing director of Independent Research, which has a database of published independent analysis, agrees. He reckons that Europe is entering a golden age for independent firms. "A lot of analysts [at investment banks] have been sacked over the past five years – all of whom have areas of expertise. If [boutiques] demonstrate a specialisation and a high quality of analysis, there's a market for it," he says.

But in a world where investors are still bombarded with "free" research from in-house brokers, why should institutions bother to pay hard cash for additional material?

Experienced, specialist and free from bias

Stewart believes the independent firms have several attributes that set them apart from the investment banks. "They tend to be run by people who are not in the first stage of their career so they have a lot more experience and ability," he says. "The average age of in-house brokers is 27 to 28, whereas it is 42 to 43 at independent houses."

There's certainly a healthy sprinkling of grey hairs and lengthy CVs at some of Europe's leading independent research boutiques. Harriet Tory, chief operating officer at Arete Research, believes that his firm boasts the telecoms industry's crack team. "Most of our analysts have industry experience and they each worked for up to seven years as analysts prior to joining Arete," she says. "They have far more experience in the sector than their peer group – so they have a better understanding of the industry and better contacts."

Arete was set up in 2000 by Richard Kramer, a former Goldman Sachs analyst. For four years running, he was the UK's number one ranked telecoms analyst. He decided to quit Goldman Sachs after becoming disillusioned with the world of investment banking.

He recalls the malpractices by many banks at the height of the internet boom – the overly optimistic "buy" notes on companies with fundamentally flawed business models, designed to support internal financial services functions.

In contrast, independent research boutiques can pick and choose which companies and sectors they cover. In fact, most independents refuse to write "maintenance" research around company results. They prefer the specialist topic-based research route, which should help their clients make more informed investment decisions.

"They specialise in areas of their own choosing, in line with their own abilities and interests," says Stewart. "And they set their own parameters, styles and objectives – rather than having them imposed by a head of research."

But perhaps the most important selling point is that independent research houses are free of conflicts of interest. They aren't duty-bound to feed the internal corporate machine as they don't have corporate finance departments, they don't offer money management services and they don't trade shares.

"Traditional in-house researchers have to support the secondary trading desks with recommendations," says Stewart. "And they have to be sycophantic to increase corporate finance business. That is a catalyst for telling lies."

Not everyone believes bundled research is biased. David Boyd, head of IR at mmO2, says: "I am not sure that there is that much bias in the big bank research. They can be pretty critical. Pieces do appear that don't fit the me-too maintenance role that can be quite thought provoking."

Everything to prove

The future of independent research boutiques still hangs in the balance. Many people predict that they will either thrive or die based on the quality and accuracy of their valuations and recommendations. That should keep them on their toes.

As Stewart points out: "an analyst at a big brokerage can miss-call over and over again, and not be any worse off for it. But if an independent gets it wrong, say three times in a row, they're in trouble. The incentives to get it right are far higher."

Arete has built up a reputation for independence and integrity. "The analysts choose the companies they think are interesting and that our clients can make money from," says Tory. "If we hear about a company we think may be interesting, we contact the investor relations department and hopefully they will give us access." This open approach means it covers a wide range of companies from large-caps such as Vodafone, mmO2 and Telecom Italia to smaller businesses such as Bookham Technology and Spirent.

Jamie Stewart

"Independent researchers have far more credibility, which makes it very important for corporates to be covered by them"

Worth wooing?

Given the quantity and diversity of broker research that is already available, why should IROs make the effort to open their doors to independent firms? "Independent researchers have far more credibility, which makes it very important for corporates to be covered by them," says Stewart. "They are far more focused on [specific] sectors and show greater expertise when it comes to assessing a company's prospects."

Stewart believes that some listed companies shy away from independent research firms because they are afraid of what they will write. "The risk for corporates is that the independent researchers have a far higher incentive to tell the absolute truth. That may involve being brutal about them. Traditional brokers have a vested interest in recommending stocks because 'buy' recommendations give more support to the business. If an institution buys a stock through a particular brokerage, it will generally sell it through them as well. A 'sell' recommendation brings in nothing."

SELLING THE LONG VIEW

Nick Paulson-Ellis launched Clear Capital in early 2003 as a response to growing demand for independent investment research. He felt that in the aftermath of Eliot Spitzer's successful attack on Wall Street, UK fund managers would be prepared to pay for top-notch, unbiased analysis.

"I recognised a frustration from fund managers about the quality of a lot of research and that it's too short-termist," says Paulson-Ellis, a former Evolution Beeson Gregory and UBS Warburg analyst. "And because of the economics of the [equity research] business, many analysts were still involved in a lot of corporate work and were therefore still seriously conflicted."

Clear Capital aims to provide its clients with "totally objective" research to help them make better investment decisions. Its team of seven analysts focuses on the UK small and mid-cap market, across a broad range of industry sectors. Stocks covered include Capital Radio, Filtronic, Aberdeen Asset Management, Alizyme and Halfords.

The firm pledges that it's 100 per cent research-focused. Paulson-Ellis believes Clear Capital's main advantage over the traditional research houses is that the firm is completely conflict-free. Its offices are devoid of corporate finance activities, it never indulges in corporate broking, there's no money management service and no proprietary trading.

Clear Capital's analysts pick and choose what they write about, based on their individual specialist skills. "The big difference between investment banks and independents is that we are ideas-driven and we give a long-term view, not short-term updates," says Paulson-Ellis.

"We are very much value-driven. We tend to look for a valuation anomaly or a change in the economics of a business. And we don't write 'hold' recommendations. We just give a positive or a negative view."

Although mmO2 is covered by independent firms Arete and New Street Research (see panel, opposite page), the firm's head of investor relations, David Boyd, is rather ambivalent about the value of independent research. "We rate [Arete and New Street] very highly, but whether their research is superior is hard to say. It is different, and in many ways more thought provoking. But I don't know how important it is to the investment funds," he says.

Like many firms, mmO2 doesn't make a special effort to gain coverage by independent firms. This is understandable as most companies list on the public markets for one main reason: to gain access to international capital. If independent firms are unable to make introductions between the big investment banks and cash-hungry companies, then their role may be limited.

But Stewart thinks that public firms need to take a longer view: "investor relations officers should realise that it's important to solicit the support of good quality independent research houses. Their evaluations will help them attract the support of institutions when it comes to raising new capital."

Don't mention the bill

Independent research comes at a price. Who pays, and how, remains a thorny issue. Some boutiques expect hard cash payments for their analysis. Unsurprisingly, this isn't popular with potential customers. "Buy-siders don't like doing this," says Stewart. "Their business is contracting in terms of margins, as competition is fiercer, and their budgets are under pressure."

Many have preferred soft dollar arrangements, although this form of payment is under close scrutiny by the FSA, as part of its crackdown on unethical research practices. Under soft dollar arrangements, broker-dealers provide mutual funds with services, including research and share dealing, in a single commission charge.

Given the inherent flaws of so-called "softing", Stewart says that commission sharing, in one form or another, is probably the fairest and most practical form of remuneration for independent houses. This system lets fund managers execute trades through one broker and pay separately for third-party independent research. The question is whether fund managers and investors are prepared to pay for it.

Robert Talbot, chief investment officer at fund manager Isis, is not sure that independent firms offer a superior service that is worth paying for. "It is wrong to presume that independent research is better," he says. "It's true that independent analysts don't have to write what you want to hear, but you could argue that investment bank analysts have better access to management and so can provide better insight. And that is something worth paying for."

Talbot adds that bundled research is often of a very high quality. "I don't start with the presumption that all investment bank research is rubbish," he says. "I like a diversity of sources and differences of views, which we can input into the investment process. We are looking for the best quality product, from wherever we can get it."

But Talbot agrees that fund managers are increasingly willing to consider paying hard dollars for research. "That is why a lot of investors are investigating ways to deal with one organisation, but obtain research separately from other sources."

Analysts at independent research firms the world over have their fingers crossed that this trend is more than just a flash in the pan.

LAUREN MILLS is small business editor at the UK's *Sunday Express* and a veteran financial journalist.