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SOAP BOX

Free your mind

The days of the sell-side dominating research are over. The number of independent boutiques offering pithy analysis is set to explode. By **Jamie Stewart**.

BATTERED, bruised and increasingly fearful of being *Spitzered*, London's sell-side analysts are quitting the City while they're ahead to escape accusations of bias and irresponsible optimism. The party may be over for many, but their equally stricken fund manager clients still need informed research – whether they want to pay for it, or not.

It was only a matter of time before London's buy-side would follow the US in buying independent research. But what has so far been a trickle of safe, paid-for reading is set to be a flood within 12 months. The days of proprietary sell-side product are well and truly numbered.

When Elena Scott-Forbes set up the first European research boutique after leaving Flemings 15 years ago, her unfamiliar product was greeted with a mixture of curiosity and downright suspicion. Now institutions allocate specific budgets – or votes in their broker selection - for such product, and the proportions are doubling and trebling.

Funds are increasingly familiar with the new homes of Roger Bootle and Jonathan Loynes at Capital Economics, Tim Congdon at Lombard Street Research and telecoms expert Richard Kramer at Arete Research. Their broking connections are almost forgotten.

Hermes recently stated openly that it supported independent product, in line with its love of all things ethical and transparent. The FSA refers approvingly to independent research; Paul Myners reached for it as a building-block of his recommendations.

Sure, tough markets are hammering budgets and some brokers remain happy with free brokers' notes. But about 15% of research budgets are now committed to independent work; 60% of institutions are buying research in some form or another. And those numbers are rising.

Right now, nothing focuses a fund manager's mind like performance. There is a greater premium than ever on ideas that make money, and the independent analyst who knows his or her stuff has a good chance of winning repeat business.

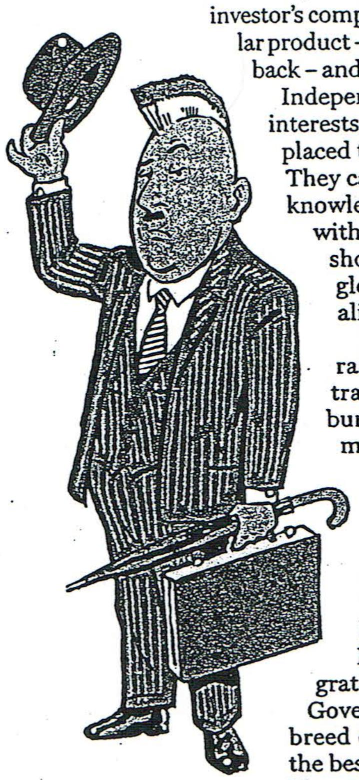
Top of funds' shopping list will be heavyweight sectors where me-too expertise won't suffice, such as pharmaceuticals and healthcare – Datamonitor or New York's Mehta Partners excel here – oils and energy (think CERA) and financials (Ned Cazalet's eponymous insurance consultancy springs to mind).

Clever quantitative work is also needed, reflecting a swing towards momentum-based trading and long-short strategies. Providers are numerous, but those flexible enough to meet the rapid market change are rare.

In practice, managing and funding relationships between a global investment manager and an independent research house are very testing. A mid-sized fund manager might subscribe for between six and 12 services, so relationships with these suppliers may be fragmented.

Independent analysts follow no rules in building their businesses to a certain size, or with a set management style. There are fly-by-nights, as well as a few useless or dull ones. Regulatory authorisation gives reassurance, of course, but the fund manager must feel the comfort of due diligence somewhere along the line.

Trusted, competent agents are needed to dovetail the investor's complex requirements with the analyst's particular product – identifying, matching, monitoring, feeding back – and, if necessary, sacking those who disappoint.



Independent brokers, with no conflicting corporate interests, but with deep market experience, are well placed to screen research on behalf of institutions. They can check out corporate links and specialist knowledge. Ideally, they can marry it efficiently with their own trading and execution. The aim should be, rather, to complete a virtuous triangle of professionals whose interests are all aligned and never conflict.

It isn't easy. Research firms' revenue needs rarely match the rhythm of an institution's trading and its willingness to pay. There are bureaucratic and relationship issues: temperamental analysts and impatient fund managers; vague interest misinterpreted as a firm instruction; trial periods lengthening and stretching goodwill.

There are one or two excellent aggregators of independent research out there, too; but their roles are not designed to be comprehensive. They are like the shop windows on Bond Street, rather than an automated, integrated production line.

Government and regulator will watch the new breed of independent brokers carefully, claiming the best interests of end-investors and pensioners. They will examine the supply chain for links of hidden and duplicated costs, while seeking to weld on a new one marked unbundling.

The link labelled *commission* – an alloy of service, execution, research, freebies, fat margins, golf days out – will be hacksawed off. The strongest link in the chain between institution and broker will most certainly be etched *independent research*.

As for soft commissions, put your money on following the US. Regulators and brokers will sweat it out together, tidy it up, redefine it. Tighter rules will impose proportions, maximums, eligibility and disclosure. At the end of the day, they will keep it. E

Jamie Stewart is head of institutional sales and market at the Eden Group. www.edengroup.com

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