Independent Research – Text by Jamie Stewart for Talking Head, FTfm, and Global Investor, February, 2003.

Recent events, many, varied and exposed with increasing and alarming frequency in a challenging market environment in which the finger of blame, the comfort of reason and the taste of revenge combine to bring analytic focus increasingly to bear on cause, effect and remedy, are typified by a Highest Common Factor - or is it more appropriately an LCM ? - the havoc wrought by biased research.

Given the US' lead by 10 years or so over the UK (and more relative to continental Europe) in terms of market practice, it has been evident for some time that London's buy-side is following the US fund management tendency to rely at least in part on the strengths of high quality Independent Research in increasing proportion to traditional sell-side proprietary product. The evident ability of premium independent research entities to thrive, the tendency amongst analysts uprooted from the erstwhile comfort of integrated houses to consider, for preference, setting up with – or as – independents, increasing reference in the specialist press to independent researchers in preference to the erstwhile tied-house gurus (one need scarcely reinforce this by pointing out how often Roger Bootle and Jonathan Loynes at Capital Economics, Tim Congdon at Lombard Street Research, Richard Kramer at Arete Research or Ned Cazalet of Cazalet Consulting, for example, are cited where it used to be the economists, strategists or telecoms. and insurance analysts beholden to A, B or C Securities Ltd.) and portfolio managers' increasing familiarity with the independents' names as opposed to those of the old favourites from the brokerages all combine to testify to the tendency on the part of investment management houses to open their corporate arms to this relatively new resource.

When Elena Scott-Forbes led the market here in setting up the first such 'boutique' for European company analysis after leaving Flemings 15 years ago, her unfamiliar new product was received with a sentiment positioned between courteous curiosity and downright suspicion. Now increasing numbers of institutions allocate specific amounts of budgets – or points and votes in their broker selection and allocation procedures - specifically for such product: and the proportions are growing.

Houses tend to make such decisions known as a point of strength and profile: Hermes recently stated openly that it espoused such product, and that house has long enjoyed the profile of supporting what is ethical, transparent and best, even if controversial and confrontational. The FSA refers approvingly to Independent Research; Paul Myners reached for it as a building-block within his recommendations; portfolio managers, their analyst colleagues and heads of research together with CIOs and CEOs acknowledge not only that the substance of good independent product enhances their performance but also that its flexibility, variety and reliability make for greater efficiency, better deployment and more effective resourcing in their respective hard-pressed houses.

Few institutional consumers will readily reveal their budgets and expenditure patterns, notably in these quicksands of changing obligations and responsibilities to pension funds' boards of trustees, corporate clients and retail investors. In the current climate fees, returns, performance and the composition of 'bundling' – or not - are as much under the searchlight of the press, regulators and government as under the pressures exerted by inclement markets. At the extremes lie a hedge fund which uses only independent research and emphatically 'buys' none from proprietary analysts; at the other, the cry is still, "What's that ? Why should I buy research when I get it free from all the brokers anyway ?". Somewhere in the middle lies the happy average telling us that about 15% of votes cast, points awarded, commissions generated or budget allocated reflects commitment to Independent Research. Some 60% of institutional investors now appear to subscribe Independent Research product in some form or another.....and both those percentages are rising numbers.

In today's environment, nothing focuses the mind of a fund manager like performance. The mantraps and disappointments of awkward markets have set a greater premium than ever on 'ideas that make money', and the independent analyst who knows his or her (I can't bring myself to say the politically correct 'their'....) stuff is on strong ground. The commercial reality looking independent entities in the face is the fact that association in the mind of the manager between research and a rising stock price in the portfolio leads to subscriptions – sometimes hefty – and, more significant, renewals and extra customized or consultancy work.

Given the way markets are currently moving, this translates in to expanding demand for quality output based on the volatile, evolving and heavyweight– and therefore key – industry sectors such as telecoms., biotech. and technology (keep Arete Research, Enders Analysis and Bullhound in mind); on those where middle-of the-road or generalist analysts' expertise won't suffice, such as pharmaceuticals and healthcare (Datamonitor's healthcare practice and the pharma. research from Mehta Partners in New York excel), oils and energy (think CERA) and – a yearning largely unrequited - good independent product on financials (Ned Cazalet of his eponymous insurance sector consultancy being a notable exception). Apart from outstanding sector-based product, clever but reliable (not as easy a twosome as that glibly sounds) quantitative and 'black-box' work, reflecting an increasing orientation towards technical and short-term trading together with momentum-based trading and long-short strategies, are in demand: they are numerous, but the ones with a proven track record and the built-in flexibility constantly to meet the demands of rapid market change are few and far between.

It looks convincing on the surface – and, indeed, the product remains wholly convincing even when you lift the lid – but the associated practicalities of initiating, monitoring, managing, applying and funding relationships between a global investment management house and a specialized independent research entity are very testing, rather like the challenge facing the proverbial elephant and ant courting each other with intent. Big generally goes with big; small with small. Not only that: a mid-sized fund management house which has woken up to Independent Research will tend to settle at subscribing between 6 and 12 services, implying that the relationships with the research entities are naturally fragmented yet unnatural in terms of respective sizes. Independent analysts follow no rules in terms of size, structure, organization and management style in building their businesses: each to its idiosyncratic identity. There are fly-by-nights and try-it-on concerns as well as a few useless or dull ones. Regulatory authorization gives reassurance, of course, but the fund manager must feel the comfort of due diligence somewhere along the line, get to know the scope and limitations of the product, know that delivery is monitored, dues properly paid, meetings and opportunities harnessed…..all in a world where he's meant to be making money as well.

Practice has made it plain that a trusted and competent agent is needed to act as the legendary honest broker who can dovetail the investor's complex requirements with the analyst's particular product, and that in every respect: assess, identify, match, introduce, monitor, feed back, communicate, fund, remit....and, if necessary, cut the umbilical and sack the one who disappoints.

Enter the child Invention, born of mother Necessity: the independent broker (precious few of them around.....) whose corporate context does not contaminate the ethos of the independent product and producer that he represents. The role precludes any in-house research capacity or activity on account of inevitably conflicting interests; broad and deep market experience to ensure that the universe is correctly screened and evaluated; a natural and rich network to find the candidates from far afield and those who are shy and retiring; well honed research and analysis skills as well as editorial and presentational interests, to ensure that all those qualities are in place; the resources to check backgrounds, track records, references, corporate links and specialized knowledge........and that's not all. Knowledge of the compliance and regulatory area, and of legal principles, at least; and, of course, close familiarity with trading and execution, which lend the logic to the bond and can provide the basis for funding the subscriptions. That may sound easy: it isn't. Research entities' revenue and cash flow requirements rarely match the rhythm which dictates an institution's inclination to trade and its willing to pay. There are the bureaucratic and relationship sides: temperamental analyst meets impatient portfolio manager; vague interest is misinterpreted as a firm instruction; trial periods become elasticated but goodwill is overstretched; someone leaves or changes responsibilities and the hiatus needs to be negotiated. There are financial risks to be measured and mitigated, and efficient communication to be ensured and implemented. That honest broker isn't doing it all out of the goodness of his heart, of course: he can now ply quality product at measured risk to his overlords, and the additional trading activity brought about as a result of the operation comes in useful when markets are running close to dry and empty.

This role of the 'expert and independent intermediary', apart from being almost impossible, by definition, to fulfil, is emphatically not played by the 'soft houses' nor by the research redistributors of old: those roles in this context equate with oil vs. water, active vs. passive, proactive vs. reactive. In its perfect incarnation, it completes a virtuous triangle of professionals whose interests are all aligned and never conflict

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

Important not to overlook the further significance of this quiet but determined move towards Independent Research. It is also telling us of what lies ahead, as much – for once – in the US as here. There is a strong, heavy and chain of causation in evidence. In an increasingly capitalist world with governments keen on higher revenues, less responsibility and lower profile as protectors of last resort, chancellors and exchequers have more than an ulterior motive to promote the best interests of supposedly polyphiloprogenitive end-investors and pensioners. Such governments are holding and twitching the chain increasingly sharply. At the far end of it, the links of hidden and duplicated costs clatter and shudder. To achieve their aims, incidentally to promote transparency and ethical standards, and supposedly to make financial markets more efficient, they are welding new links labeled 'unbundling' to the end of the chain. The link labeled 'commission' – the one cast from an alloy of service, execution, research, freebies, backhanders, fat margins, golf days out – is hacksawed off and decommissioned. From the iron filings, new links are cast and welded on: one is called 'Execution Only', the next one in line, perhaps, is named 'Consultancy' or 'Advisory', the third one is etched with 'IPO Subscriptions' and another, sparkling brightly in this Bunyan-like allegory, carries the words 'Independent Research'……it is the link which is lighting up the Coming: the Coming of Independence, of Unbundling, of De-integration, of Unbundling ………QED.

No allegory nor prognostication is complete without someone pretending knowledge as to what will happen to Soft Commissions. One could take the view of the recent past that interfering busybodies learnt about such things, tut-tutted at them and decided to ban them for being naughty and lending themselves to the greasing of other palms. Then the sages on the sidelines pointed out that, actually, everything in the form of fee, commission, honorarium, call it what you will is actually a form of soft commission. Even bare, execution-only mini-bps, they explained, were actually soft commission in their way, because they divide up in to components which pay taxes, stock-exchange fees, electricity, salaries, a light lunch for the fund manager…..so if you bin Soft Commisssions, you've got to bin everything. Stalemate; check-mate; limbo; re-think.

Take the next and last cue from the US, which has already been through its heart- and soul-search on softing (- not for nothing is it also called 'soft dollars'). Put your money on the likelihood that we will go their way. Once the parliamentarians, the regulators and the market practitioners talk it through and sweat it out together, they will tidy it up, redefine it and form tighter rules imposing proportions, maximums, eligibility, channels, and, above all, standards of declaration, and the whole matter will settle in to its new place. At the end of the day, they will keep it. Meanwhile, Hedge Funds will go on using it as is whilst any house nursing a pension fund or unit trust will steer clear of the bogeyman until the writing is transferred off the wall and in to the rule-book. Ergo, and The End.