

Under a Spotlight

By Lynn Strongin Dodds

European research analysts have faced a growing number of challenges in recent years: cutbacks by major securities firms, closer scrutiny by regulators after the abuses of the dot-com boom, lawsuits by angry companies. Now the industry is bracing for a squeeze on soft commission arrangements by British regulators. The job of sell-side analysts will only get tougher.

The U.K.'s Financial Services Authority introduced new rules last month requiring fund managers to tell clients what they are buying with their commission pounds, euros and dollars. The regulator is stopping short of mandating the unbundling of execution and research fees, as some fund managers have advocated, but the rules promise fundamental change nonetheless.

For an industry struggling to cope with increased cost pressures, including the growth of cheap, execution-only services, the transparency required by the new regulations is likely to squeeze the amount of resources devoted to research.

Fund managers "will need to stop and think carefully about what they need and

what they want and how much they are prepared to pay," says Jamie Stewart, head of institutional research at Eden Financial, a London-based brokerage firm that runs a network of independent research outfits in Asia, Europe, the U.K. and the U.S.

The new regulations will put a greater premium than ever on quality, as fund managers are forced to justify their research expenditures. Large global securities firms that can offer sophisticated analyses of a wide range of stocks stand to benefit, industry executives believe. The new rules also should favor independent researchers and niche players that provide specialized information or bespoke services, particularly

with the growing popularity of commission-sharing arrangements that allow fund managers to earmark a portion of their commission payments for independents. Midsize and mediocre players, by contrast, are likely to be squeezed from both sides.

"We'll see a migration to quality," predicts John Tattersall, chairman of the financial services regulatory practice at PricewaterhouseCoopers in London. "Anecdotally, most fund managers will take research from an average of two brokers. All the rest of the research they get is confirmation. If you're not in the top notch or two, research isn't a great investment."

Client: Precise Media (PR)
Source: Institutional Investor (International Edition) (Main)
Date: 01 February 2006
Page: 56,57,58,59,60
Circulation: 0
Area(cm²): 1362

A survey of 31 European fund managers that manage nearly €500 billion (\$615 billion) in equities found that most planned to use less research from full-service brokerages and more from independents as a result of the new rules, according to U.S. financial services consulting firm Greenwich Associates. "It's clear that research will become more democratic" as clients spread their commissions around to a wider range of providers, says Greenwich consultant John Webster.

"There is excess capacity in sell-side research," says Steven Hash, global head of research at Lehman Brothers. "The worst place to be is in the middle. The bigger investment banks will continue to invest in their research departments, while the smaller research houses can offer unique products."

Some players are already feeling the squeeze. ABN Amro is cutting back its equities business as part of a broader retrenchment in investment banking; its joint heads of equity sales and research, Alastair Barr and Hamish Dickson, quit in May 2005 after only 14 months on the job. Commerzbank has scaled back its European equities business to focus on the German, Swiss and Austrian markets.

The European cutbacks are occurring within a research business that has taken a huge hit globally since the collapse of the technology stock bubble and the U.S. crackdown on conflicts of interest among sell-side analysts. Research budgets at the seven biggest U.S. securities firms have dropped by more than 40 percent since 2000, and the average salary of a senior analyst has fallen by 50 percent, to roughly \$750,000, according to analysts at Sanford C. Bernstein & Co. in New York.

The new U.K. regulations should give an added push to such trends as the combining of equity and fixed-income research as firms look to analyze the entire capital structure of companies in their

hunt for distinctive investment advice. "At the end of the day, the key determinant of who will be successful is whether you can consistently deliver alpha-generating ideas," says Simon Greenwell, head of European equity research for Merrill Lynch & Co. in London.

Sandy Black, head of equities at Insight Investment, the asset management arm of British banking group HBOS, which manages £84 billion (\$150 billion) in assets, agrees that the new rules will push fund managers to become more selective and to focus their research spending on ideas and analysis that produce tangible returns. Disclosure requirements "could lead to changes in the business as comparative periods build up," he says. "It depends on the relationship you have with your clients. If it is good and the fund manager is performing well, I am not sure the costs will receive that much attention."

It's not only the fund managers that are becoming more selective. Sell-side analysts need to focus on producing tradable ideas rather than me-too company coverage. "Analysts have to become more commercial," says Michael Oertli, European research director at UBS. "They have to think twice before they engage in an activity to determine whether it is value-added to the client."

As profound as the potential ramifications of the new disclosure regime may be, most analysts and fund managers expect evolution rather than revolution in the near term. The new regulations took force in January, but fund managers have a six-month grace period to comply with them. What's more, pension fund trustees and other clients will need time to assess performance and determine whether they are getting value from their fund managers' research spending.

Trustees "will need a year or two to make comparisons between fund managers and their payment systems in order to pass any judgment," says Graham

Field, head of AQ Research, a London-based firm that rates analysts' earnings forecasts and recommendations. "Performance is what really matters. If fund managers are beating the benchmark by 10 percent, I am not sure how much they will care about execution and research costs. However, if the markets are bad and fund managers do not outperform, then I think they will have a harder look at those costs."

The FSA is working closely with the U.K.'s National Association of Pension Funds to help trustees understand the new disclosure regime. The agency is conducting an industry survey now, and will again in two years' time, to assess the impact of the new regulations. "It will take time for the rules to pan out," says Richard Sutcliffe, manager of the FSA's wholesale policy division. "We will have to wait and see whether real unbundling will take place."

The long-running debate over the bundling of execution and research fees in trading commissions has intensified since 2001 when Paul Myners, then chairman of Gartmore Investment Management, issued a report criticizing the lack of transparency in brokerage commissions. European fund managers paid some \$5.4 billion in commissions in 2004, the latest year for which estimates are available, according to consulting firm Mercer Oliver Wyman. Under so-called softing arrangements, a big portion of that money is used to pay for everything from stock research to trading screens and data feeds for fund managers.

The FSA's initial consultation paper, issued in 2003, concluded that costs were opaque and that bundled commissions did not create an incentive for firms to seek best execution. That's because the commissions are paid out of fund assets — that is, client money — rather than out of the fund managers' own pockets. The regulator toyed with banning soft com-

Client: Precise Media (PR)
Source: Institutional Investor (International Edition) (Main)
Date: 01 February 2006
Page: 56,57,58,59,60
Circulation: 0
Area(cm²): 1362

missions, an idea that most fund managers and securities firms strongly opposed, before deciding simply to require full disclosure of commission arrangements.

Under the new rules commissions must be restricted to the purchase of execution services and related research, and clients have to be informed of how the money is being spent. The FSA hasn't specified how firms must comply with the rules but expects them to adopt a disclosure code drafted by the Investment Management Association, a U.K. lobby group for institutional and retail fund managers.

The IMA code, drawn up in 2002 for pension funds and revised for adoption by all institutional investors last year, requires fund managers to inform clients of their general disclosure policies once a year and to provide a detailed breakdown of trading volumes and commissions every six months. That breakdown must show how much is spent on execution and research, respectively; how much commission money is pocketed by the executing brokerage and how much paid to third parties; and how each individual client's trading and commissions compare with the fund manager's overall average. More than half of the major fund managers surveyed by Greenwich Associates are already disclosing their general policies to clients; only about a third provide any detailed breakdown of commissions.

Complying with these disclosure requirements won't be easy for fund managers, industry executives say. "I suspect it will prove quite a challenge for the buy side to produce," says Mel Stimpson, global head of trading at Edinburgh-based Standard Life Investments, which manages £106 billion in assets.

Few executives on either the buy or sell side expect European fund managers to follow anytime soon in the footsteps of Fidelity Investments. The fund manager recently struck deals with Deutsche Bank and Lehman Brothers in the U.S.

under which it will pay commissions only for trade execution and use its own money to buy research. A spokeswoman at Fidelity International in London says the firm is waiting to see how those U.S. arrangements work before deciding whether to replicate them in Europe.

"We are looking at a five-year transitional period until the new landscape gels," says Eden Financial's Stewart.

The new disclosure rules are giving a boost to commission-sharing arrangements, which stand to aid small independent research firms.

"We expect to see a growing number of CSAs over this year," says Standard Life's Stimpson. He gives an illustrative example of the kind of commission-sharing arrangements his firm is striking with brokerages. Its dealing commissions average 19 basis points in the euro area, he estimates. "About 7 basis points will be directed toward execution and 12 basis points — or perhaps €500,000 — will go to research. The bulk of that — say, €350,000 — will remain with the broker, but the rest will go to other firms. I think the strong will get stronger and the independents will be the clear winners in this."

Insight Investment also is reaching more commission-sharing arrangements with its brokerages, says equity head Black. He notes that Insight continues to look for maintenance research, the type of periodic assessments of corporate performance that some fund managers scorn. "We do not do maintenance research internally, but it is important to look at the gradual evolution of a company's profitability and growth," he explains.

Investit, a London-based fund management consulting firm that is conducting a study on the impact of the new rules, sees independent research firms benefiting from the new rules. "At the moment, about 1 percent of commissions are directed toward independents, but I expect that to increase," says Clare Vincent-Silk, a consultant at the firm.

With competition for research funds heating up, most major securities firms are looking for ways to distinguish their output from the rest of the pack's.

Merrill Lynch has increased its U.K. and European small- to midcap research team to nine analysts from two over the past year in response to client demand, and it will continue to expand the team this year, says European equity research chief Greenwell. The firm also expects to produce cross-asset-class allocation and company visit notes, which provide detailed information without a recommendation. "We are giving clients additional reference points, which will enable them to conduct due diligence in an industry to confirm if the trends they are told are affecting company A are also impacting companies B and C," says Greenwell.

Deutsche Bank, which merged its equity and fixed-income research two years ago, also is stressing cross-asset-class research. "There is a pressure on margins, which is making us all try to be more efficient and smarten up our acts. We will be investing in the research where we believe we can differentiate," says Guy Ashton, head of European company research at Deutsche. "For now that is quantitative research and cross-asset-class research that looks across the whole capital structure to provide a more integrated view of a company."

Lehman Brothers has shifted its research teams toward producing unique material. "We've shrunk the formats of previous maintenance product and seen a significant increase in bespoke work and works of a proprietary nature," says Charles Donald, the firm's head of European equity research. An example: Pharma Pipelines, a drug-by-drug analysis of every pharmaceutical company the firm covers. "That's difficult for anyone to replicate, and it comes to a unique valuation conclusion around a company," says Donald. "You have to be meaning-

Client: Precise Media (PR)
Source: Institutional Investor (International Edition) (Main)
Date: 01 February 2006
Page: 56,57,58,59,60
Circulation: 0
Area(cm²): 1362

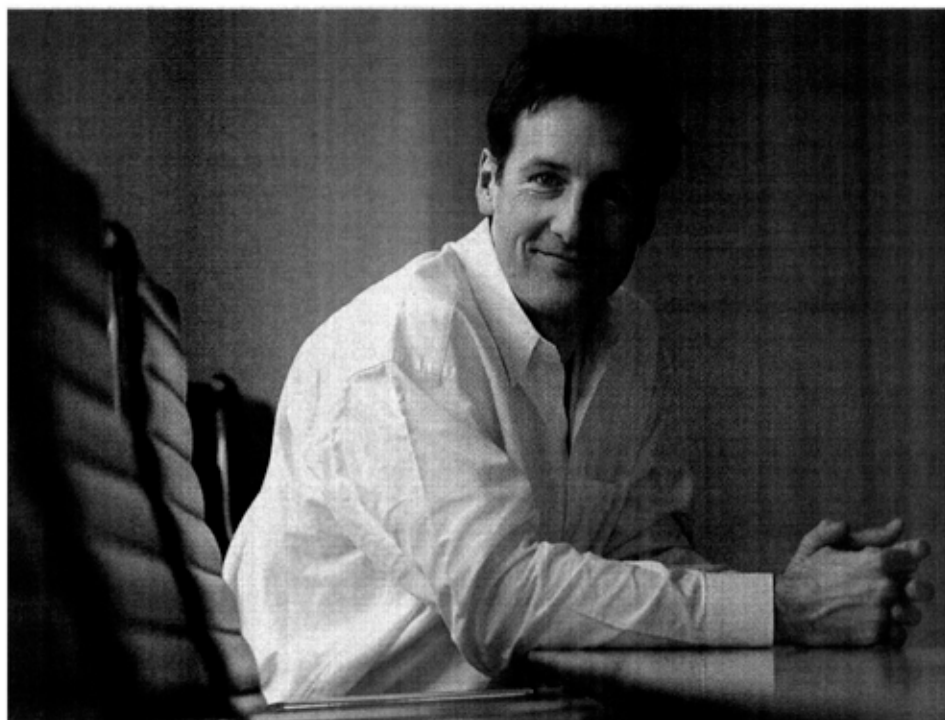
ful to your client base. There's no merit in being the 13th player in a sector. You might as well pack your bags and go home."

Joan Schaper, head of equity research in Europe for Standard & Poor's in London, contends that nonpublished research is growing in importance. "Clients are interested in management access, which is why we organize seminars that bring together fund managers and chief executives or chief financial officers," she says. "We are helping one of our clients, Nordea, to arrange a trip to Japan for their clients so they can better understand how businesses operate in a deflationary environment."

Citigroup is strengthening its global quantitative research and its coverage of U.K. and European small- to midcap companies. Late last year the bank hired Jonathan (Joe) Brent, former head of small- and midcap research at Cazenove Group, to lead its U.K. coverage. "We will see a contraction, on both the research and execution side, in the number of firms that clients do investing business with," predicts Andrew Pitt, the bank's head of European equity research. "If you have a strong product, then transparency is a good thing." **it**

Pam Abramowitz contributed additional reporting for this feature.

New U.K. regulations require fund managers to tell clients how they are spending research commissions. Analysts will face even more pressure to perform.



Insight Investment's Black questions new rules' impact: "If the fund manager is performing well, I am not sure costs will receive that much attention"

Client: Precise Media (PR)
Source: Institutional Investor (International Edition) (Main)
Date: 01 February 2006
Page: 56,57,58,59,60
Circulation: 0
Area(cm²): 1362



Eden Financial's Stewart: Fund managers "will need to stop and think carefully about what they need and how much they are prepared to pay"