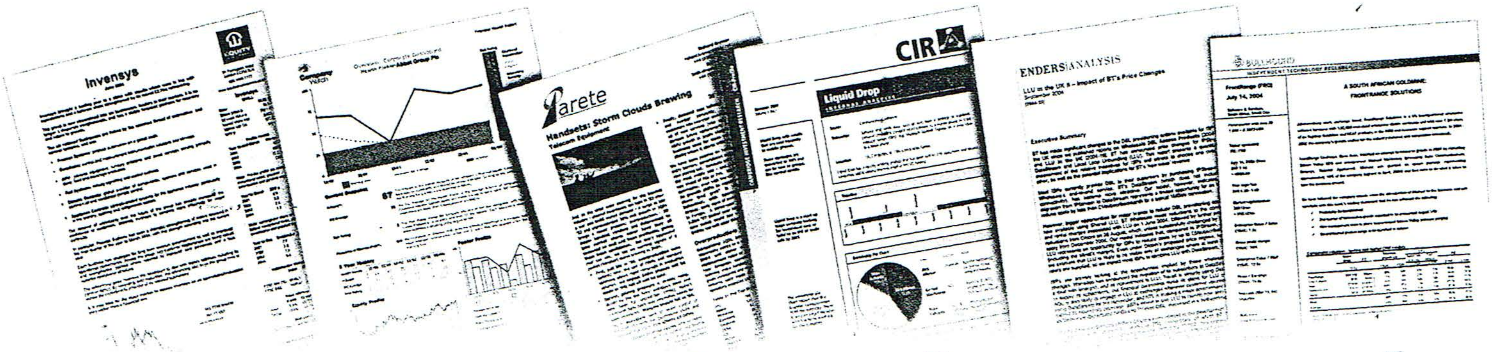

Jury is out on independent research

Equity analysis from firms without conflicts of interest has failed to take off in Europe as it has in the US. Martin Essex reports

Investment banks' equity research has been so discredited that providing genuinely independent analysis should be a sure-fire way to make profits. However, in Europe at least, the fledgling industry is struggling to find a market for its output.

The founder of a well-respected independent research house said: "Frankly, it's vanity publishing. It's very difficult to persuade people to write out a cheque for pure research; very difficult for everyone in this business." Not surprisingly, he asked to remain anonymous.

His pessimism, however, is by no means shared by all in the industry. At the other end of the spectrum, Standard & Poor's is cock-a-hoop after winning a contract to provide Nordea, the largest Nordic banking group, with all the company equity research for its institutional and private clients.

Julien Hardwick, senior director in charge of equity operations at S&P Europe, said: "We consider it a huge success. We've got a good pipeline of deals and we're confident Nordea is far from being a one-off."

Between these two extremes, plenty of head scratching is taking place, with companies adopting dissimilar models. In the US, since July, Wall Street's largest banks have been forced to provide their private clients with company research from independent providers as well as their own analysts.

However, there is no such requirement in Europe, where there has been less rampant abuse and where regulators have leaned towards consultation and guidance. This has annoyed some independents.

Richard Kramer is managing director of Arete Research, which describes itself as the largest independent equity research provider in the UK to be regulated by the Financial Services Authority. He said: "The whole problem in Europe has been swept under the rug. We'd like the regulator to take determined action about conflicts of interest."

Eden
& IR

Jamie Stewart, head of institutional marketing and independent research at Eden Group, said: "The industry needs regulatory support. It's in everyone's interests except the research departments of the integrated investment banks, many of which can't hold their own." Eden Group provides institutional European equities trading services as well as private-client broking and portfolio management.

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>
> Julien Hardwick, S&P Europe

Others disagree, arguing that regulators should leave the issue to the markets. In a paper for the Adam Smith Institute, a free-market think-tank, Miles Saltiel suggested: "The old saw that 'sunlight is the best disinfectant' has been insufficiently applied to research."

Nonetheless, in the absence of action forcing the big banks to circulate independent research, the difficulty remains how to persuade European investors to pay for research that they can receive free from investment banks. S&P has proved that it is possible but others have adopted different strategies, such as being paid via soft commissions or even being remunerated by the company being analysed.

Soft commissions, which are paid when a fund manager agrees to place trades with a broker in return for credits that can be used to buy independent research or other services, remain controversial. The UK's Financial Services Authority decided not to outlaw the practice this year but it remains disliked by regulators and journalists, and could become illegal in some European countries.

Payment by the company being analysed is equally questionable for obvious reasons of conflicting interests. There are doubts, too, about the advisability of offering research and execution, even when the broker offering the deal is not involved in corporate finance. In fact, every model has its critics.

Standard & Poor's, which claims to be the world's largest independent provider of equity research, is owned by a publishing company but even its operations court controversy. S&P's credit ratings are paid for by the companies issuing the debt and, if the same companies are having their equity analysed by S&P, there could be a conflict of interest.

Hardwick said his department was separated from the credit rating business by Chinese walls that are "tall, wide and deep". Such Chinese walls were also said to separate investment banks' corporate finance and research departments. Clearly, clients have to judge the independence of the research on offer, rather than taking it for granted.

There are other problems, including the quality of research. Roger Bootle, managing director of Capital Economics, which produces independent economic research, has considered moving into the equity market. He said: "I would like to think we will but we have to wean the investment banks off doing it. If you set up independently in equity research, unlike in economics, it's very difficult to attract the good people. They've been earning fantastic sums of money and that can't be sustained in the independent sector, but then it can't be sustained at the investment banks either."

Then there is the question of whether the fund managers need independent research. Like the anonymous founder of the research house quoted earlier, John Tacchi, chief executive of Equity Development, said: "It still doesn't look as though people are prepared to get their cheque books out to pay for research." His company distributes free to fund managers "issuer-sponsored" research that is paid for by the companies being analysed.

Others note that while investment bank research has been severely criticised, the quality of some is high and fund managers are able to distinguish between the good and the bad. Justin Hayward, director of Cambridge Investment Research, said: "Everyone takes research with a pinch of salt. The investors still have to do their own research and make the decisions themselves.

"Moreover, the more coverage there has been about conflicts of interest in equity research, the more the fund managers and investment banks have modified their behaviour."

In other words, some investment bank research is high quality. Moreover, most fund managers do not rely on a single research source and have teams of analysts to separate the wheat from the chaff.

"Investors apply an enormous discount to research from investment banks and they do their own. Some of the best analysts I know are on the buyside," said Kramer.

Private investors, by contrast, may be less able to distinguish between biased research and independent analysis. Rusty Ashman of Stockcube Research, who also chairs the Association of Independent Research Providers, said: "Some retail investors probably can't judge. Fund managers may well be in a better position to judge but even some of them don't have time to sift the good from the bad."

It is an industry that will have its day in the sun, if only because investors have become increasingly angry about biased self-serving reports. But it remains unclear when that day will come.

Independent researchers in Europe have also found the business to be highly competitive as researchers made redundant during the recent period of cost-cutting have found themselves unable to find new jobs and have set up on their own.

This competition is likely to decrease as the investment banks are hiring again but, at least for now, making profits remains tough and will become tougher for some if soft commissions are outlawed.

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'Why do you need access to companies?'

Adding to the problems faced by the providers of independent equity research is the question of access to the companies being analysed.

A public company should not give inside information to a group of people that is unavailable to others. However, an investment bank offering to raise money for it may be welcomed more warmly than an independent researcher.

Some independents shrug this off. "Why do you need access? If you have it, you can't act on it because that would be insider trading and you would be breaking the law," said Arete's Richard Kramer.

Cambridge Investment Research, by contrast, relies on access to small, private high-tech companies hoping to attract venture capital or, eventually, seek a public listing. However, the business has not taken off as quickly as hoped.

"I don't expect changes to take place very quickly. It's a very conservative industry to get into. It's a trust business that grows slowly over time," said CIR's Justin Hayward.

This disappointment with the growth of the industry in Europe is shared by Rusty Ashman of the Association of Independent Research Providers, which was set up principally to fight the regulatory threat to soft commissions.

"We anticipated that there would be growth in independent research because of the opprobrium connected with the settlement in the US. But there hasn't been the same impact here," he said.