

# WALL STREET BANKS BACK IN THE GAME

**T**his year's survey sees the big investment banks re-establishing their dominance for both independence of research, and usefulness. UBS Warburg, Deutsche Bank, CSFB and Morgan Stanley have all polled well, supporting the theory that as asset managers reduce their broker relationships they will inevitably end up favouring the big boys. But the really tricky issue to emerge in this year's survey is the fact that whilst asset managers say they want to use more genuinely independent research, they are reluctant to pay for it outright. This suggests investment banks may end up footing the bill for their rivals' products. Meanwhile, regulators on both side of the Atlantic are proposing a shake-up in how research is provided and paid for, pointing the way to more disclosure, unbundling of research and execution, and a cut-throat climate in which only the fittest will survive.

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# PUTTING A PRICE ON INDEPENDENCE

This year's annual broker research survey was conducted in the wake of the UK regulator's proposals to end softing and introduce unbundling, whilst in the US, the Spitzer settlement firms are doing a slow dance with the independent houses they must soon climb into bed with. Accordingly, the value that asset managers attach to independence has assumed greater importance – the big question now is: are they prepared to pay for it? By *Claire Milhench*.

**T**HE CONFLICTS of interest that fuelled the dotcom boom and later returned to haunt Wall Street's investment banks can be encapsulated in one senior research manager's telling observation: "In the five years I spent on Wall Street, I can remember only one sell recommendation the whole time I was there." Since then, the endemic sickness of a system that led to such extremes has been treated with a combination of fines, prosecutions and the global settlement, instituted by New York state attorney Elliot Spitzer.

But it is in the UK that the cat has really been set among the pigeons with the FSA's feared CP176, a consultation paper which proposes to end softing – the system by which research is paid for – and introduce unbundling. Asset managers and investment banks alike, squeezed by continued poor performance and rising costs, have been forced to face the unpleasant prospect of developing new pricing models and rethinking the entire way they do business. In this environment, who will be best placed to benefit? Will asset managers, who insist they value broker research, be willing to pay for it? Or will more specialist independent houses grab the bulk of the research budget?

Interestingly, our survey shows a revival of fortunes for the big investment banks, with better showings across the board for the Wall Street firms, whilst UBS Warburg has regained its place as top dog, trouncing the opposition in Europe in both the independence and usefulness categories. Nick Pink, managing director in the European research management team, said that UBS had done so well because it had maintained its sector, macro, small cap and countries coverage, whilst competitors were retrenching in some of these areas. "That coverage has resulted in UBS being the top-ranked house for recommendation accuracy in 2002. Good ideas from broad coverage is a key competitive advantage," he said. In terms of paper-based product, one of the key focuses for UBS has been its

company notes, where Pink said it had written a 'landmark' piece on 70% of the Eurotop 300 over the last 18 months. "These are the bedrock of the franchise." He conceded that overall UBS was issuing less paper-based research but that was principally because many clients were accessing maintenance research via the web or e-mail.

Tom Hill, global head of research, added that UBS had tried to make its analysts respond much more quickly to movements



**Citigroup's Bill Kennedy: US is taking CP176 very seriously.**

On a Scale of 0-5 (0 being irrelevant and 5 being vital)

Average

How important is the independence of broker research? 4.1  
How independent, do you feel, is the broker research that you take? 2.8

## WHAT INFLUENCE DOES BROKER RESEARCH HAVE ON YOUR INVESTMENT DECISION-MAKING?

	%
0-20	21
20-40	40
40-60	29
60-80	10
80-100	0

## IF YOU CONSIDERED BROKER RESEARCH TO BE MORE INDEPENDENT, WOULD YOU GIVE IT GREATER WEIGHTING IN YOUR INVESTMENT DECISION-MAKING?

	%
Yes	65
No	14
Maybe	21

## MOST INDEPENDENT RESEARCH - EUROPE RANKING 1

	Bank	Score	%
03 (02)	UBS Warburg	69.0	16.6
2. (1)	Sanford Bernstein	35.0	8.4
3. (2)	Deutsche Bank	33.0	7.9
4. (-)	Merrill Lynch	27.0	6.5
5. (-)	Morgan Stanley	25.0	6.0
6. (-)	Enskilda Securities	24.0	5.8
7. (-)	Smith Barney Citigroup	19.0	4.6
8. (5)	Collins Stewart	18.0	4.3
9. (4)	CSFB	17.0	4.1
10. (9=)	Fox-Pitt Kelton	15.0	3.6

## RANKING 2

	Bank	Score	%
	Carnegie	280.0	5.5
	Arete	275.0	5.4
	Collins Stewart	257.1	5.1
	Cazenove	250.0	4.9
	Exane	250.0	4.9
	Fox-Pitt Kelton	250.0	4.9
	Morgan Stanley	250.0	4.9
	Enskilda Securities	240.0	4.7
	CDC Ixis	233.3	4.6
	UBS Warburg	230.0	4.5

## USA

### RANKING 1

	Bank	Score	%
	Sanford Bernstein	41.0	20.1
	Morgan Stanley	27.0	13.2
	Merrill Lynch	21.0	10.3
	JP Morgan	20.0	9.8
	Lehman	20.0	9.8
	UBS Warburg	20.0	9.8
	Smith Barney Citigroup	15.0	7.4
	Deutsche Bank	12.0	5.9
	Prudential	12.0	5.9
	Bear Stearns	6.0	2.9



in share prices, so that it produced timely, practical research. He also pointed to the Q series of reports as being particularly rated by managers – these address a number of questions around a theme or a company. As for UBS's victory in the independence rankings, Hill attributed this to the bank's treatment of research as a profit centre: "We've always taken the view that we'll increase our market share if asset managers find our research useful, whereas some of our competitors have seen research as a necessary cost to support the investment banking activities. But we have always had a culture whereby the analyst is free to say whatever they want and their career will flourish depending on the accuracy of their recommendations."

This is heart-warming stuff. But will the big investment banks stay on top if the FSA has its way? With asset managers forced to dig into their pockets for research, it is questionable as to how much they will be willing to pay. For the banks, meanwhile, the difficulty is knowing what to charge. This debate is not limited to the UK – the US players are watching the progress of CP176 anxiously. "I think people in London underestimate how seriously this is taken in the US," says Bill Kennedy, head of research at Citigroup. "Many asset managers here are looking at how they allocate commissions, and I have to say, if softing is banned in the US, it would have a very large impact on this business because it is much more widely used here." Citigroup is already having discussions with its clients about the impact of CP176, and how they intend to react. "We are also having discussions internally about disclosure and unbundling," Kennedy adds. "We don't have the answer for what to do about pricing but it has forced the organisation to look at this business in an entirely new light."

Steve Klein, senior vice president and director of global equity trading at American Century Investment Management, points out that in the US, the banks are faced with a de facto unbundling of their services. "Research has to be separated out whereas in the past it was supported by investment banking, so they haven't had to break down the cost before. Now, their clients are becoming more careful about how they use their commission dollars and they have started to ask their brokers what they think they should pay. Obviously, brokers are very reluctant to price that because they don't know how to. Also, they're worried that they'll drive customers away or get into a

heavy price war with each other. They're still trying to figure out what they can do."

Some asset managers have already taken steps to separate research and execution. In April Gartmore concluded two such arrangements, with Merrill Lynch and Goldman Sachs. Both deals allow Gartmore to pay for research from an independent house using commissions paid to the banks for execution. Barry Marshall, chief operating officer of the investment division at Gartmore, says the arrangements were negotiated following Gartmore's broker reviews, and acknowledge the fact that asset managers should look for best execution.

"There's no reason why you should have to buy research from the same place you execute a trade," he says. "Our clients have been asking us if we are getting added value, so it's hardly a leap of the imagination to do this." Having said that, it took 18 months of plugging away before the two investment banks agreed to unbundle. "We took the view that if this is likely to come in, we wanted to be one of the first to do it," Marshall adds.

He has already had a lot of calls from other asset managers interested in the mechanics of the agreement. "Some of them dismissed it when they found out it wouldn't be allowed if CP176 was applied in full, but the FSA has said it is looking for market solutions and we would consider this a prototype. No one has disagreed with the logic of it. In order for things to change there has to be a real sense of constructive engagement and dialogue throughout the industry. Expelling hot air, while protecting the status quo, is no longer a viable option."

#### Valuing research

Marshall recognises the value of independent research over that of the investment banks: "If you're a fund manager and you're getting the same research as everyone else, how can you differentiate yourself?" he asks. But other managers are keen to stress the usefulness of the broker relationship. "We use multiple sources of information and compare them to each other, then we challenge the broker analysts about their views. We find that very valuable," says Bob Yerbury, CIO at Invesco. He stresses the importance of the dialogue that occurs between fund managers and broker analysts, adding that Invesco also uses independent research. But Yerbury is unsure whether firms will be prepared to stump up if softing goes. "I



UBS's Tom Hill: Culture of independence.

#### RANKING 2

Bank	Score	%
Sanford Bernstein	273.3	10.9
Lehman	250.0	9.9
Morgan Stanley	245.5	9.8
Prudential	240.0	9.5
JP Morgan	222.2	8.8
Merrill Lynch	210.0	8.3
Bear Stearns	200.0	8.0
Deutsche Bank	200.0	8.0
Smith Barney Citigroup	187.5	7.5
AG Edwards	166.7	6.6

#### ASIA

##### RANKING 1

Bank	Score	%
UBS Warburg	28.0	22.8
Credit Lyonnais	18.0	14.6
Morgan Stanley	15.0	12.2
Smith Barney Citigroup	12.0	9.8
CSFB	12.0	9.8

##### RANKING 2

Bank	Score	%
Merrill Lynch	300.0	16.6
Credit Lyonnais	242.9	13.5
Smith Barney Citigroup	220.0	12.2
UBS Warburg	200.0	11.1
Cazenove	166.7	9.2

#### MOST USEFUL RESEARCH

##### EUROPE

##### RANKING 1

03 (02) Bank	Score	%
1 (2) UBS Warburg	46.0	21.9
2 (1) Deutsche Bank	36.0	17.1
3. (3=) CSFB	23.0	11.0
4. (7) Morgan Stanley	18.0	8.6
5. (3=) Smith Barney Citigroup	17.0	8.1
6. (8) Merrill Lynch	17.0	8.1
7. (-) ABN Amro	13.0	6.2
8. (9) Lehman	12.0	5.7
9. (10=) JP Morgan	8.0	3.8
10. (-) CAI Chevreux	6.0	2.9

##### RANKING 2

Bank	Score	%
UBS Warburg	242.1	9.5
Lehman	240.0	9.5
CSFB	230.0	9.1
Smith Barney Citigroup	212.5	8.4
Merrill Lynch	212.5	8.4
CAI Chevreux	200.0	7.9
JP Morgan	200.0	7.9
Deutsche Bank	189.5	7.5
Morgan Stanley	180.0	7.1
Goldman Sachs	166.7	6.6

think firms will try to identify what they are paying and whether they are getting value, but a lot of firms are already doing this because the revenue base has declined. I would hope that there will always be good economic, strategic and industry-specific research available from independents so that you can challenge the broker analysts. Information exchange is part of the process and you interfere with that at your peril."



# GLOBAL BROKERS SURVEY

## USA RANKING 1

Bank	Score	%
Merrill Lynch	12.0	19.0
UBS	11.0	17.5
Morgan Stanley	8.0	12.7
Deutsche Bank	5.0	7.9
Lehman	5.0	7.9
Sanford Bernstein	5.0	7.9
Smith Barney Citigroup	4.0	6.3
Goldman Sachs	4.0	6.3
JP Morgan	3.0	4.8
Prudential	3.0	4.8

## RANKING 2

Bank	Score	%
Lehman	280.0	11.8
Smith Barney Citigroup	250.0	10.6
Morgan Stanley	237.5	10.0
Prudential	233.3	9.9
Merrill Lynch	225.0	9.5
Sanford Bernstein	220.0	9.3
UBS	218.2	9.2
SG Cowen	200.0	8.5
Goldman Sachs	175.0	7.4
JP Morgan	166.7	7.0

## ASIA RANKING 1

Bank	Score	%
UBS	24.0	27.9
CSFB	16.0	18.6
Deutsche Bank	13.0	15.1
Credit Lyonnais	9.0	10.5
Nomura	9.0	10.5

## RANKING 2

Bank	Score	%
CSFB	228.6	15.9
Credit Lyonnais	225.0	15.7
Nomura	225.0	15.7
UBS	218.2	15.2
Smith Barney Citigroup	200.0	13.9

## MOST IMPROVED INTERNATIONAL RESEARCH HOUSE RANKING 1

Bank	Score	%
UBS Warburg	138.0	24.9
Deutsche Bank	74.0	13.3
Morgan Stanley	71.0	12.8
CSFB	55.0	9.9
Smith Barney Citigroup	42.0	7.6

## RANKING 2

Bank	Score	%
BNP Paribas	266.7	7.9
Sanford Bernstein	260.0	7.7
Smith Barney Citigroup	247.1	7.3
UBS Warburg	242.1	7.2
Morgan Stanley	236.7	7.0

Stuart Paul, CIO of First State International, also finds value in the broker service: "One of the most significant developments in the last year or so is that brokers now let you have access to their models so you can tweak the underlying assumptions and form a view as to whether

or not their analysts are being reasonable in their headline projections." He also values the access to companies that the brokers provide.

Other firms prefer to tout the strength of their proprietary research. It's firms like these that are thought likely to benefit the most if CP176 is applied. Jim Goff, director of research at Janus, says that his team uses very little broker research. "By carrying out our own research we seek to gain an information advantage over our competitors. We encourage our portfolio managers and analysts to be open-minded and flexible." In the last four years Janus has doubled the size of its analyst team to over 40, with the intention of growing by 10% each year going forwards.

Newton also places great value on its proprietary research, but Jeff Munroe, CIO of Newton Investment Management, says he still finds broker research important, because it helps Newton understand where the market is and what it is thinking. Newton also uses a wide variety of independent houses, both on a licence basis, and by commissioning bespoke research. "Some of the best stuff comes out of those houses - particularly the strategic and economic stuff," says Munroe. "The research we commission can be very issue specific, for example, in the utilities sector we might want to understand more about public policy issues."

Whilst Newton is not in favour of CP176, Munroe believes the firm may stand to benefit from it because of its internal research capabilities: "If there was less information out there generally, that would be to our advantage," he reflects. There is already evidence that banks are beginning to cut back the amount of research they provide, unable to justify a blanket coverage without the cross-subsidisation from their corporate finance practices. Morgan Stanley has just completed a major restructuring of its coverage, organising its stock analysts into 12 groups, down from 21, with 13 sector heads. The regional coverage has also been restructured - Japan has been folded into Asia Pacific, and Latin America has been folded into the Americas.

Melissa de Vries, a market analyst at Greenwich Associates, said these kinds of regional changes reflected the fact that firms were having to reduce coverage in the areas that weren't profitable for them. "In the last six months we have seen some big cutbacks in Asia-Pacific and Latin America, because the commissions in those areas - which were never that strong in the first place - have fallen dramatically," says de Vries. But the cutbacks are not limited to emerging markets. One leading US bro-

## IS THE NUMBER OF BROKERS YOU USE: RISING, FALLING OR STAYING THE SAME?

	%
Rising	21
Falling	54
Staying the same	25

## ON A SCALE OF 0-5, (5 = VITAL AND 0 = IRRELEVANT) HOW IMPORTANT ARE EACH OF THE FOLLOWING IN DETERMINING THE QUALITY OF RESEARCH FROM THE BROKERS YOU DEAL WITH?

	Average
Creative ideas	4.0
Detailed company reports	4.0
Sector / Industry studies	3.8
Access to analysts	3.7
Timeliness	3.5
Economic analysis	2.7
Portfolio strategy advice	2.5
Stock recommendations	2.4

## EXECUTION: WHAT % SPLIT OF EQUITY TRADING IS CARRIED OUT BY PRINCIPAL BROKERS AND AGENCY BROKERS?

	%
Principal	55
Agency	45

## WHICH ARE YOUR TOP THREE PRINCIPAL BROKERS?

Bank	Score	%
UBS	24.0	19.4
Morgan Stanley	19.0	15.3
Deutsche Bank	18.0	14.5
Merrill Lynch	13.0	10.5
ABN AMRO	12.0	9.7

## WHICH ARE YOUR TOP THREE AGENCY BROKERS?

Bank	Score	%
Deutsche	13.0	25.5
UBS	13.0	25.5
Carnegie	7.0	13.7
CSFB	6.0	11.8
Merrill Lynch	6.0	11.8

## WHAT DETERMINES WHICH BROKERS RECEIVE COMMISSION, PROVIDING BEST EXECUTION IS MET? (MOST IMPORTANT BEING 1, LEAST IMPORTANT BEING 8)

	Average
Fund manager to analyst (broker) contact and quality of research	3.6
Quality execution	3.8
Salesman to fund manager contact and quality of research	3.8
Analyst (fund manager) to analyst (broker) contact and quality of research	4.0
Overall relationship with broker	4.2
Access to new issues and deal flow	4.4
Willingness to commit capital	5.1
Programme trading ability	5.1

kerage firm has reportedly ceased coverage of more than 100 major US corporations and cut its research staff by more than 30 analysts in the past nine months. How have asset managers responded to



# GLOBAL BROKERS SURVEY

## DO YOU EXPECT THAT YOUR USE OF INDEPENDENT RESEARCH WILL INCREASE IN THE COMING YEAR?

	%
Yes	43
No	26
Maybe	30

## DO YOU EXPECT TO PAY DIRECTLY FOR INDEPENDENT RESEARCH OR HAVE IT PROVIDED ALONGSIDE BROKER RESEARCH?

	%
Pay directly	39
Not pay directly	61

## WHICH ARE THE TOP THREE INDEPENDENT RESEARCH HOUSES THAT YOU USE? RANKING 1

Bank	Score	%
Sanford Bernstein	16.0	22.5
Bank Credit Analyst	13.0	18.3
Arete	11.0	15.5
ISI Group	9.0	12.7
Exane	6.0	8.5
Fox Pitt Kelton	6.0	8.5
Bridgewater	5.0	7.0
Smithers	5.0	7.0

## RANKING 2

Bank	Score	%
Exane	300.0	13.6
Fox Pitt Kelton	300.0	13.6
ISI Group	300.0	13.6
Arete	275.0	12.5
Sanford Bernstein	266.7	12.1
Bank Credit Analyst	260.0	11.8
Bridgewater	250.0	11.4
Smithers	250.0	11.4

## IN TERMS OF QUALITY OF RESEARCH, CAN DOMESTIC BROKERS COMPETE WITH INTERNATIONAL RESEARCH HOUSES?

	%
Yes	67
Yes, but only in marginal markets	21
No	12

## BEYOND YOUR OWN MARKET, DO YOU USE RESEARCH FROM LOCAL MARKET BROKERS?

	%
Yes	64
No	36

this? Many of them have reduced the number of broker relationships they maintain following firm-wide broker reviews. This is reflected in our survey, as 54% said the number of brokers they were using was falling. Nick Pink at UBS Warburg believes that this is only likely to favour the big global players. And this consolidating trend is likely to accelerate if the FSA goes ahead with its proposals, he argues.

"Clients are very conscious of what they are paying and whereas two years ago they might have had about 10 brokers on a sec-

tor, now they only want to deal with three to five. That will put pressure on the niche players, because in broker reviews, asset managers consolidate the feedback they get across each sector and it's the big firms who will be able to do well consistently."

Chris Wheeler, global head of equities at Fox-Pitt, Kelton, which specialises in financial services research, accepts that this is the case, but adds: "Clearly what we get paid for reflects how much value we are adding. If we don't make the top 10 in a broker review then we won't get in, and that's difficult if you don't cover all the sectors. But we do come top in areas like banking and insurance, and clients have told us that they will reserve carve-outs for specialist firms like FPK."

Asset managers also claim that they will look to use more independent research in the coming year, but 61% said they would not expect to pay for this directly. To some extent this merely reflects the situation in the US, where the global settlement firms are in the throes of appointing their three independent partners. But Tim Alward, president and chief operating officer of independent research house Ford Equity, says that independents are already seeing an increase in requests from asset managers, following general disappointment with the performance of the Wall Street firms. This predates the Spitzer settlement, and has more to do with poor stock picks than conflicts of interest – although that subsequently has had an impact.

"When the market moved down, asset managers started to look elsewhere," says Alward. "They didn't think the Wall Street analysts had done a good job and as a result, in a market that's been down, we have grown." Indeed, Ford Equity has seen double-digit growth each year for the last three years, with 98% of its clients being institutional money managers. "The advantage for asset managers in using independent houses is that these research firms tend to have good stock selection performance," he argues. "They put together systematic processes based on quantitative data and tend to perform consistently, and the asset managers have realised that this helps their overall performance."

## Settlement boost

The biggest boost to the independent houses, should, of course be the Spitzer settlement. As part of this settlement, the big banks have to partner with at least three independent research houses to supply stock reports alongside their own research. Alward says that since this was announced, he has had discussions with most of the investment banks concerned, but the settlement has not yet been signed off by the

## IS THE USE OF YOUR OWN RESEARCH GROWING, FALLING OR STAYING THE SAME?

	%
Growing	60
Falling	3
Staying the same	37

## HOW DO YOU FEEL YOUR IN-HOUSE ANALYSTS COMPARE TO THE SELL-SIDE IN THE FOLLOWING CATEGORIES? INVESTMENT IDEAS

	%
Better	70
Similar	23
Worse	7

## BUY / SELL / HOLD RECOMMENDATIONS

	%
Better	68
Similar	29
Worse	4

## DETAILED COMPANY ANALYSIS

	%
Better	25
Similar	29
Worse	46

## SECTOR-BASED ANALYSIS

	%
Better	34
Similar	34
Worse	32

## COUNTRY-BASED ANALYSIS

	%
Better	12
Similar	42
Worse	46

## STRATEGY / ECONOMICS

	%
Better	29
Similar	33
Worse	38

judge so no-one has revealed their chosen partners. Once it has been signed, the banks have 90 days to select their managers and six months in which to implement the changes.

However, there is no guarantee that we will see a broad range of independent houses being picked. Under the terms of the settlement, each bank has selected an independent consultant to choose the three independent research houses. This could lead to the same few names getting on the bank roster each time, as there is no overall co-ordinator of this process. Indeed, it has been suggested by some industry sources that Standard & Poor's, Morningstar and Value Line will gobble up a disproportionate share of the settlement simply because they are already working closely with the banks.

Sandy Bragg, executive director of S&P in the US, says that the majority of the 10

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# GLOBAL BROKERS SURVEY

## BEST PERFORMING RECOMMENDATIONS

Broker	RQ	Number of Recommendations	Top
Oddo Pinatton	3.66	105	3
CAI Cheuvreux	3.49	227	9
Smith Barney	2.71	265	12
JP Morgan	1.49	224	18
Morgan Stanley	1.35	246	6
Williams de Broe	1.17	138	15
Lehman Brothers	1.17	214	12
Exane	0.98	133	1
ESN	0.64	186	5
WestLB	0.11	184	7

## MOST ACCURATE FORECASTS

Broker	AQ	Number of Estimates	Top
Williams de Broe	42.96	134	12
Merrill Lynch	40.01	236	23
ING Financial Markets	37.88	147	6
Morgan Stanley	37.73	214	15
Smith Barney	37.36	252	14
Commerzbank Securities	36.79	127	12
UBS	36.61	242	9
HVB Corporates & Markets	35.56	76	1
JP Morgan	35.47	193	9
Dresdner Kleinwort Wasserstei	35.22	216	5

AQ (Accuracy Quotient) analyses the accuracy of brokers' estimates and recommendations to produce quantitative rankings of research. The RQ rankings are based on the performance of recommendations over the past 12 months. The results distinguish between sector and index relative houses and those which make absolute recommendations. In the 12 months from July 2002 to June

2003, the sector and index relative houses scored better.

The AQ rankings are based on the accuracy of brokers' eps forecasts for 2000, 2001 and 2002. They also take account of the number and size of revisions to forecasts for 2000, 2001, 2002, 2003 and 2004.

For more background on the methodology of the AQ rankings, consult [www.aqpublications.com](http://www.aqpublications.com)

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firms in the settlement already access S&P research. It has sought to capitalise on the restructuring going on in the industry by ploughing resources into its independent research arm both in the US and Europe and has already signed an outsourcing deal with Nordea to provide the fund manager with research services for non-Scandinavian equities. However, it failed to figure in our survey, suggesting asset managers do not value it overmuch.

Hoping to squeeze S&P out of the settlement picture is John Meserve, president of BNY Research, commission and payment services. BNY's Jaywalk platform provides users with access to some 70 independent research firms. Originally designed for the buy-side, Jaywalk is now positioning itself to help the settlement firms comply with Spitzer's demands.

Meserve comments: "We acquired Jaywalk in March 2002 with the idea of providing a service for asset managers looking for independent research providers. The problem for them was that it was a very fragmented, cottage industry so it was dif-

ficult to find the best of breed whilst the research providers wouldn't necessarily know where best to pitch their business."

Jaywalk offers asset managers a choice of specialist research houses in every sector, with a variety of methodologies including fundamental, technical and quantitative services as well as forensic accounting, patent portfolio valuation, and social responsibility analysis. "Jaywalk basically separates the wheat from the chaff," says Meserve. "Independent analysts now face the same pressures to perform – it's not just enough to be independent."

In July, BNY announced that Jaywalk would offer a new plan called The Independent Research Meritocracy to sell-side brokerage firms now required to procure and distribute independent equity research as part of the global settlement. The plan offers each settling firm the chance to create a process for the ongoing selection of independent research reports from a pool of providers. The independent consultants can use the Meritocracy to customise their selection of research providers according to parameters that may include research qual-

## RANKING METHODOLOGY

200 asset management firms responded to the questionnaire, asking how important they considered independence in research, and which banks supplied the best research. We asked the respondents to rate the importance of independent broker research on a scale of zero (irrelevant) to five (fundamentally important), and also how independent the research they receive is. The scores are represented as an average of all respondents. They were also asked to quantify the influence broker research has on investment decision-making as 0-20%, 20-40%, 40-60%, 60-80%, or 80-100%. The sum of votes in each category was added and expressed as a percentage.

They were then asked which of these banks were the best at providing independent and useful research overall by region, best local houses regionally, best international research house and top principal and agency brokers. For these questions, the bank that ranked first scored three points, and the second ranked scored two points, etc. The final scores are all points added together and represented as a percentage of total points.

We also examined some of the questions from a qualitative perspective. To qualify for this section a bank needed to receive a minimum of three responses. Out of their total number of responses we then looked at what percentage were placed first, what percentage second and what percentage of respondents voted them third place. These percentages were then multiplied by three, two or one point respectively. The final score is a percentage representation of each bank's total score.

Results were also weighted by size of assets using the following weightings:

- 1 = Assets less than US\$1bn
- 2 = Assets between US\$1bn and \$25bn
- 3 = Assets between US\$25bn and \$50bn
- 4 = Assets between US\$50bn and \$100bn
- 5 = Assets between US\$100bn and \$250bn
- 6 = Assets over US\$250bn

Average total assets under management: US\$61bn, of which 42% is invested in equities.

The average number of broker firms that each respondent deals with: 23

## REGIONAL BREAKDOWN

	Percentage
Europe	71
North America	19
Asia	7
Rest of World	3



## CITIGROUP RETURNS FROM THE WILDERNESS

*The changes that Citigroup has instituted following its numerous humiliations seem to have paid off. This year it has leapt back into the top 10 for independence, suggesting that hiring Sallie Krawcheck was worth every cent. Claire Milhench reports.*

Citigroup was the most severely punished of all the Wall Street banks taking part in the global research settlement – it had to pay US\$400m, the largest civil penalty ever exacted by securities regulators. It was also accused of helping Enron disguise the extent of its debts, denting its reputation further. Recognising that it had some radical reforms to make, Citigroup brought in Sallie Krawcheck, the erstwhile queen of independence, from well-regarded research house Sanford Bernstein. She now heads the newly-created equity research and private client brokerage services unit, which has been spun out from the corporate and investment banking business and goes under the Smith Barney name.

The aim was to rebuild investor confidence and restore credibility, and if the results from this year's survey are anything to go by, this seems to be working. Overall, Smith Barney Citigroup (SBC) came third for most improved international research house, with US respondents rating it fourth in this area and Asian respondents, third.

Bill Kennedy, global head of research, said this reflected the sweeping changes that the bank had made since Krawcheck came on board. "We have put a completely new team in place and dramatically changed the way we service our clients," he claimed. "One of the most significant changes is the appointment of three associate directors to supervise the sectors. That meant taking the best analysts we had and making them managers, so that they could replicate their best practices across the group."

Secondly, the bank put more emphasis on product quality and the accuracy of the

advice given. This meant implementing its 'minimum global standards' which form a template for analysts' recommendations. "This incorporates a much greater focus on risk – now we take into account balance sheet risk, funding and cashflow risk and try and make more realistic assessments," said Kennedy. He agreed that if this approach had been applied in the past, especially in the case of TMT companies, it might have led to more accurate assessments.

Finally, analysts are being asked to incorporate a greater global context into their local product, especially when assessing risk and competitiveness in the global marketplace. "We've invested in a global research database and we intend to launch some products off that particularly for our European and UK clients because they're the ones that tend to manage money on a global sector basis," he said.

SBC came fourth and third in Asia for most independent research, good results that Kennedy attributes to the bank's long-standing commitment to the region. Citigroup's joint venture with Nikko gives it a strong platform in Japan, the Australian franchise remains very profitable and the bank is well-represented across the region with offices in Taipei, Hong Kong, Bangkok and Singapore. "Some of our competitors have gone for a sector model only but we use a country and sector matrix because of the demand from institutions. That gives us a fairly broad footprint," said Kennedy.

Indeed, competitors like Morgan Stanley have recently integrated their Japan coverage into the overall Asia-Pacific unit, due to tightening margins. But although SBC has reduced headcount in the region, Kennedy said this was simply because markets had been so weak in H1 this year: "We like to have that local depth, so we are very committed to servicing clients in those markets. What we do want to see is more co-ordination across the region, especially where there are sector overlaps."

SBC's good score for independence in this region may also reflect the fact that Asian analysts are not afraid to go negative on deals that Citigroup's investment bank is involved in. Overall, SBC's sell recommendations now account for 25% of the total. Of that 25%, some 39% are investment banking clients.

In terms of usefulness, SBC's research was rated second in the US and fourth and fifth in Europe. Kennedy said this was due to a conscious effort to cut down on the level of 'noise': "Wall Street has been guilty of raising the level of noise coming out of research departments over the last few years, and that's part of the demand for newsflow. But it seems like some firms were trying to compete with Bloomberg and CNBC at times! Now we are trying to raise the value added content as a percentage of the total research we put out."

SBC is also rolling out its new rating system, which at first glance, may seem a lot like the old buy/sell/hold mechanism, but Kennedy stressed that the fundamentals behind determining those recommendations were different. "Most of Wall Street has been using a new rating system whereby you rate the stock relative to the coverage universe that you have, but we've found that's a problem both for asset managers and the private client business because they find it hard to understand. Instead they want a clear, concise, snapshot recommendation."

So from the middle of September, the bank will go back to buy/sell/hold. "But this will be a more robust ratings system because it will be based on expected total return, including dividends, and puts a new emphasis on risk," Kennedy argued. "It's a very disciplined, quantitative approach, looking at liquidity risk, volatility, trading volume, credit ratings and stability of earnings. Also, it allows me to see how our investment advice is doing because it makes it accountable."

ity and accuracy, customer usability and recommendation performance.

Meserve says that he has had several discussions with the settlement firms and they have been very receptive. "The advantage is that if they use the Meritocracy, one independent provider does not receive an outright contract that might create the perception of complacency or conflicts of interest that may arise from significant payments for research product without a dynamic mechanism for quality control.

Instead all eligible independent houses have the opportunity to earn revenue for distribution of their qualified analysis on a merit basis."

In the UK, the Eden Group provides a similar service for asset managers seeking independent research. Eden identifies, screens and monitors over 100 research firms, then tries to match the firms to the asset managers. "It can be difficult for asset managers to try and find the right independent house for the specialism they

need, so Eden acts as a kind of intermediary," explains Jamie Stewart, head of institutional marketing and research.

Eden has also been very innovative in developing solutions for payment of this research, although Stewart is naturally coy about giving away too much, for commercial reasons. "We try and find ways for the asset manager to fund the payment of the research out of commission," he confirms. "But we don't revenue share or take fees from either side – instead we look



He adds that he has seen an increase in requests from asset managers for independent research, but the problem remains the fee: "It's difficult to pay for this stuff out of revenues when your margins are already under so much pressure. That's why we specialise in finding out of commission income to pay for this, which is not soft commission."

Whilst the FSA would like to see softing go, it is arguably much more pernicious in the US, where softing practices have been entrenched for years. One Wall Street veteran says he can remember some examples of softing that made his hair stand on end: "There was one asset manager where it seemed we were paying for their entire IT set-up, and it was actually costing us to do business with them. In the US softing is certainly more egregious than in the UK."

But John Meserve argues that softening is not necessarily a bad thing, because soft dollars allow asset managers to get best

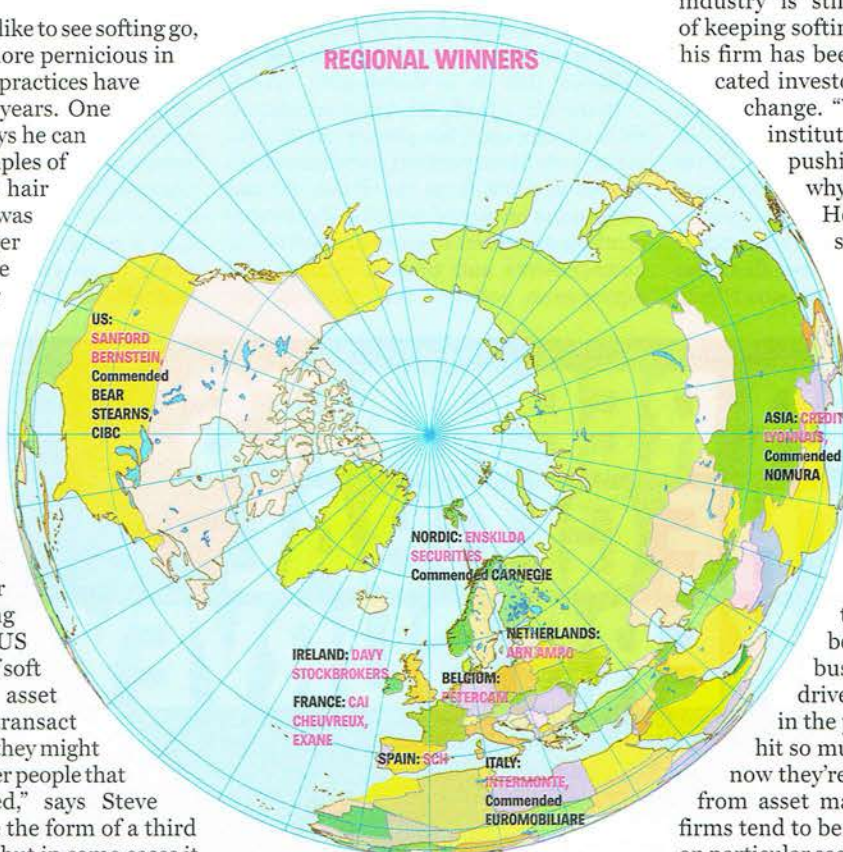
Ted Aronson, principal of Aronson, Johnson and Ortiz, and incoming chair

He adds that the US investment industry is still very much in favour of keeping softing and bundling fees, but his firm has been blessed with sophisticated investors who have pushed for change. "We're totally focused on institutions and they've been pushing us to do this, which is why we're leaders in this area."

He adds that whilst Aronson, Johnson and Ortis may be unusual in its approach, he believes that the 'perfect storm' that has occurred in the financial sector in the last three years will create wider pressure for change.

One of the beneficiaries of this upheaval may be the specialist and small to mid-sized brokers, believes Steve Klein. "Their businesses haven't been driven by investment banking in the past, so they haven't been hit so much by the regulators and now they're attracting more interest from asset managers," he says. These firms tend to be regional in nature, focus on particular sectors and also tend to have more flexibility at the commission level. Examples include Leerink Swan, which specialises in healthcare, Fox-Pitt, Kelton, which focuses on the financial services sector, and Robert Baird, a relatively large regional firm in the US.

American Century uses virtually no independent research firms because it would have to write a cheque to do so, rather than use commission revenues. "Instead we are using more of the mid-sized firms," says Klein. "We take a research vote



of AIMR, takes a more ambivalent view: "There's nothing necessarily wrong with soft dollars but there's nothing necessarily right with them either," he says. "They're difficult to audit and nail down. But it's also fair to say that these practices are fine if they're disclosed – softing and bundling are standard industry practices, it's just that it's impossible for a fundholder to know what they're paying for." Aronson's own firm has been something of



## GLOBAL BROKERS SURVEY

among our investment professionals as to which products they find most worthwhile and there's been an increasing number of votes for those smaller firms. It looks like they're doing a better job and that the bulge bracket firms have less to offer."

This is music to the ears of Chris Wheeler at FPK. "We stick to our knitting, and try to offer clients a very focused service," he comments. "We didn't get sucked into the conflicts of interest issue because we don't lead IPOs. Right now the bulge bracket Wall Street firms are slashing their research budgets and that's forcing asset managers to look elsewhere."

However, UBS's Tom Hill is sceptical as to how much share these specialist stock analysts are likely to pick up. "The macro stuff, such as economic and strategic thinking is probably boutique-able, but company stock analysis is a natural scale business, because of the synergies with stock trading and stock issuing," he argues.

Whilst it is still unclear what impact any revised FSA regulations will have on the market, the general feeling is that there will be more disclosure going forwards. This is thought likely to work better than any attempts at unbundling. "There's huge concern in the industry – not about the concept of placing value on research but about the practicality of how it will work," says Nicola

Ralston, a business adviser with CSTIM. The FSA has said that if a fund manager's clients agree, they can continue paying for research via commissions, but problems will arise if half assent and half refuse. "Apart from the fact that it would be difficult to split the trade, some clients would, in effect, be subsidising the others," she points out. Also, UK-only firms will be at a disadvantage to global firms who will be getting the research anyway, regardless of what they have to do in the UK.


### Transparency

Ralston believes that the industry wouldn't mind identifying and managing the cost of research, but it would be very difficult to disaggregate it from the commission. Stuart Paul, CIO of First State International, agrees: "The point here is transparency – the client wants to see what you are paying and why." First State already discloses such costs to interested institutional clients and he believes this is a developing trend.

In the US, AIMR, the trade association for fund managers, has already published a set of Trade Management Guidelines which recommend that firms clearly disclose and explain the impact of actual and potential conflicts of interest in areas like soft dollar arrangements and trade allocation and aggregation policies. Ted Aronson, the

incoming chairman of AIMR, says that they decided to throw out the term 'best execution' because it was meaningless out of context. His feeling now is that the SEC may use AIMR's guidelines as their own standards. "The UK set the pace on this issue and put the US to shame. But the guidelines have taken some of the pressure off the whole issue of trade execution, which makes me think that if there's any movement it will be towards greater disclosure."

But what of the investment banks, who did so well this year? Commission rates aren't getting any bigger and there's a question mark over how long some of the second-tier players can continue to offer blanket coverage. Rick Levitt, from DrKW's research management team believes that a good number of brokers may have to specialise if they can't get paid for research in some sectors. "In many houses there will be a distillation of coverage, but not every house will give up a blanket coverage."

Klein foresees the major brokerage firms offering execution-only services and rates more aggressively. "Until now they've been concerned that that might cannibalise some of their full service business, but they don't really have any choice and I think they'll recognise that these issues aren't going to go away," he says. Fasten your seatbelts, it's going to be a bumpy ride. 

# FOR REPRINTS OF THE GLOBAL BROKERS SURVEY

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