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Observations on Equities

European
Research Trip

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Frontier regularly conducts international research trips to observe and understand more about international trends and to meet and evaluate, first hand, a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high-level assessment on the key areas and observations unearthed during this recent Equities trip. We would be pleased to meet with you in person to provide further detail on these observations.



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Background

Members of Frontier's equities team recently visited global and emerging market equity managers over a two-week period, both in the UK and Europe. This was an opportune time to discuss the regulatory reforms of the Markets in Financial Instruments Directive II (MiFID II), which is scheduled to come into effect on 3 January 2018.

MiFID II effectively regulates firms in the EU who provide services to clients linked to "financial instruments" (including equities investment managers) and the venues where those instruments are traded.

While MiFID II covers a broad range of requirements, the focus of our meetings were the reforms relating to procurement of research produced by investment banks,

brokers and independent research providers by investment managers. These reforms will impact the way investment managers engage with the sell-side, and it will have a significant impact on both buy/sell-side business models.

What is MiFID II?

MiFID II is a piece of legislation originating from the European Commission and seeks to provide a European-wide legislative framework for regulating the operation of financial markets in the EU. MiFID II represents a major overhaul of the existing law, building on and extending the scope of the first Markets in Financial Instruments Directive, which originally came into force in November 2007.

The legislation has several core objectives, including: (a) increased investor protection; (b) alignment of regulation across the EU in certain areas; (c) increased competition across the financial markets; and (d) introduction of reinforced supervisory powers. In seeking to achieve these objectives, MiFID II contains a broad range of complex provisions.

While MiFID II impacts many areas, including trade execution, transaction reporting, client reporting, distribution and governance, one of the most controversial provisions of the MiFID II reforms relate to the methods of payment by

investment managers for external research. MiFID II will result in investment managers either having to absorb the cost of the research themselves (impacting profit margins) or passing the cost onto clients as a direct cost. Previously, the cost of this research was largely unseen by clients as it was bundled within stock broking commissions. The move to an unbundled model limits the long-held use of commissions, it changes how investment managers consume and evaluate research and it is a form of disruption for the industry globally.

How are investment managers responding?

The regulatory uncertainty created by MiFID II, inconsistencies with well-established regulatory schemes in the U.S. and in other jurisdictions, and differences in opinion on how research should be consumed and paid for, have led to a variety of different responses by investment managers.

Interestingly, the investment managers we met with were almost unanimous in their view that sell-side research will continue to be procured (a sign that it is still viewed as a valuable service). However, managers will now be adopting a more judicious approach and will only pay for research that is viewed as representing value-for-money.

As it stands, US SEC rules restricts US brokers from accepting research payments from EU firms, and this makes it impossible to satisfy both the US regulatory requirements and MiFID II requirements. US brokers remain in discussions with the US SEC to resolve the clash with MiFID II, and most managers were hopeful this would be imminently resolved, likely via the US SEC adopting similar rules that align with MiFID II.

Determining which MiFID II provisions apply to any given global investment manager is complex and depends on the manager's specific circumstances.

On our trip, we met with managers which are largely unaffected by MiFID II (these were mainly US-regulated firms). We met with EU-regulated managers where the impact of MiFID II is both significant and wide-ranging. We also met with a group of managers that fall in the middle of these two groups – these tend to be US-regulated managers with multiple strategies, managed in different jurisdictions, for clients falling inside and outside MiFID II. For these investment managers, the impact of MiFID II is most complex.

Our key takeaway from our meetings is that inconsistencies between regulatory schemes in the EU, US and in other jurisdictions is providing a challenge for investment managers, and how MiFID II impacts a firm's operations will vary significantly from one investment manager to the next.

How will research be paid for?

Most EU-regulated managers we met with have elected to absorb the cost of research.

A small group of managers have yet to disclose their intentions or are currently undecided. It was clear that some would like to pass on external research costs to clients but would only do so if market forces allowed them to. We did not meet any managers which have declared their intention to pass on research costs in such a manner, although some we met with had changed their position in recent quarters due to industry pressure. We are aware of a minority that have decided to pass research costs on to their clients and interestingly, some of these are very large managers – by funds under management and investment team size – bucking the view of most investment managers we met with that felt it would be the smaller managers which would find it most difficult to absorb this cost. As mentioned, some of the firms that initially declared they would pass on all research costs to clients have since made a u-turn on their original decision.

We think this is a clear illustration of the competitive environment these managers operate in and the expectation that passing on research costs (historically within brokerage commissions) is a thing of the past.

Some of the investment managers we met with complained about the increased operating costs and the pressure this puts on margins. As one manager crudely put it: “regulators should not be allowed to play with the economics of our business”. It’s fair to say that these managers were in the minority, with general acceptance by most investment managers that the cost of research is immaterial in the context of these highly successful, high margin businesses.

There was some concern, especially among the larger firms, that smaller investment managers may struggle, leading to less spending on research. But we caution not to read too much into comments like these, given the motivations and vested interests involved.



How are the banks positioned for MiFID II?

Most investment managers we met with had a similar view on how banks would be impacted by the requirement to unbundle research from execution spending, and how this would impact their investment management businesses.

The common view was that this would most likely cause banks to streamline their research offerings. Larger banks, which can cross-subsidise research and offer a wider range of ancillary services, are expected to continue operating in a more competitive market, along with established, reputable smaller providers. On the other hand, most managers we met with believe those in the middle could be more at risk. Broadly speaking, most managers expect the quality of research to improve, given investment managers will not be interested in paying for generic or commoditised research. This would clearly be one of the positive effects of MiFID II for investment managers.

While many primary broker-dealers do not offer unbundled pricing for their research, most managers we spoke to expect these broker-dealers to embrace the changes required under MiFID II – for example, by transparently pricing research and agreeing to accept payments for such research directly from investment managers (where regulatory regimes allow it).

However, the investment managers we spoke to expect, and in some cases, have observed some broker-dealers resisting change by seeking to limit unbundling to only those investment manager clients who are subject to MiFID II. This clearly has a bigger impact on the investment managers which are unaffected or partially affected by MiFID II.

It was noted by most investment managers that there does not yet exist a functioning market for research with a sizeable gap in the value between what investment managers and research providers ascribe to the research. Almost every investment manager we spoke with commented that prices have been falling and it will likely continue on this path. This is to the point where many of the “bulge bracket” brokers are almost giving away their research, according to some investment managers. The diminishing cost of research is clearly positive for investment managers and asset owners.



What are some of the other consequences of MiFID II?

In addition to separating research and commissions, under MiFID II, the sell side must unbundle a menu of related services – calls with analysts, corporate access, conferences, etc. Rather than paying for these services through trading commissions, these services will only be permitted when paid for by a manager out of its own resources or if the service is a minor non-monetary benefit (which will typically not be the case if the access is exclusive).

Most managers did not view this as a significant impediment. Firstly, they have relationships with the management teams of investee companies. Secondly, they do not attach much value to calls with analysts, as it's rare to learn something that is not available in a research report.

According to some managers, the sell-side can be useful in arranging introductions with companies, and some analysts are worth meeting with more than others. These services will still be available, and the investment managers we met with suggested they would be willing to pay for them where it was deemed to add value.

Most managers we met with have established sizeable teams to manage the full integration of the MiFID II rules (this paper has focussed on a small subset of the changes that have the most bearing on the investment function).

The level of resourcing requirement appears extensive, with some managers having established multi-year project teams, steering groups etc. with up to 80 people involved in some instances. From a broader perspective, the MiFID II directive is an indication of how burdensome the regulatory framework is becoming for the investment management community. Several of the boutique investment managers we met with commented that it would be far too onerous and costly to establish an investment management organisation in today's environment. We expect the increasing regulatory burden to increasingly stifle evolution in the industry favouring incumbents or those with strong capital support. This could be a headwind for the industry over the long term and possibly lead to a scenario in the future where fewer investment managers result in higher overall fees.

The final word...

As implementation of the European Union's Markets in Financial Instrument Directive II (MiFID II) draws near, unbundling – the separation of research and trading – is taking greater hold. What is clear is that MiFID II regulations will have global reach, it will change how investment managers consume and evaluate research, and overall, it is a form of disruption for the industry.

There is little evidence at this stage to suggest that investment managers won't continue to augment their in-house research, as they have for many years.

What will change is how they procure and pay for external research. The question of cost – whether investment managers absorb it or pass it on to clients – is playing out publicly.

We think managers electing to pass on research costs to clients are on the wrong side of the debate. These are high margin businesses and research costs are relatively small in the context of their overall cost base. We think managers which are raising fees to compensate for this change are acting greedily. Competitive pressures have forced some managers to make a u-turn on their original decision, and we expect this will continue.

The final watchpoint is what happens in other parts of the world. This is currently an EU initiative, but we foresee this becoming more global over time. In the interim, it creates an odd environment where rules are set to be different in different parts of the world.

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

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