The economics of equity research

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The old model of stockmarket research is changing

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EQUITY research is meant to benefit both providers and recipients. It ought to help investors to allocate money more profitably. And the banks that give their clients free access to research hope that it will help them generate revenues from equity trading. But neither party is much satisfied by the conventional model.

Start with the banks. A fall in trading revenues makes the economics of providing research less attractive. Between 2009 and 2013, total equity-trading commissions paid to brokers fell from $13.9 billion to $9.3 billion in America, and from €4.2 billion ($5.6 billion) to €3 billion in Europe, according to Greenwich Associates, a consultancy. The rise of passive investing and the spread of algorithmic trading have both reduced margins and dampened demand for research produced by and for humans.

Nomura recently slashed its equity-research division to focus on its electronic-trading business, Instinet. Other banks are also cutting back. Global sell-side research budgets fell from a 2007 peak of $8.2 billion to just $4.8 billion in 2013, according to Frost Consulting. Sector coverage has contracted: banks now concentrate on large-cap sectors like oil, where trading volumes and revenue potential are higher.

Work has been shovelled to cheaper places to save cash. Much of Citigroup's American equity coverage is now produced in Buffalo, New York. Deutsche Bank and J.P. Morgan have sent research work as far afield as India. Low-value-added tasks like data-crunching are not the only jobs being shipped out, claims Marc Vollenweider at Evalueserve, an outsourcing specialist. This process has its limits, however: client meetings still wholly happen face to face.

The attitude of asset managers is also hardening. With research expenses "bundled" into commissions for executing trades, brokers tend to flood their clients with research reports in order to try to grab a larger slice of trading revenues. Asset managers leave most of them unread. A survey by Britain’s CFA Society found that only 22% of its members thought this model best serves the interests of investors.

Independent research outfits offer an alternative. Though small, their share of the “research vote”, an estimate of market share produced by Greenwich Associates, has grown since 2011. They are untainted by the conflicts of interest that bedevil banks offering research on clients, and that led to a 2003 settlement enforcing stricter separation of investment banking and research in America. In Europe “commission sharing agreements” have grown in popularity since they were introduced in 2003. These unbundle brokers’ commissions into costs for executing trades and costs for research, which clients can use to buy services from third parties.

Independent providers do not have an answer to every problem: making research on smaller firms profitable is a perennial issue. But they do offer radically different services from the banks’ unimaginative valuation models. Bespoke services are in demand. Hedge funds now use research dollars to pay for ground surveillance on the progress of mining or oil projects in Africa, in order to value them better. Others take to the sky. RS Metrics, a satellite-intelligence provider, has reported strong demand from the financial sector for its aerial-imaging services. Some funds even hire former intelligence agents, from firms like Business Intelligence Advisors, to test whether corporate bosses are massaging the truth in investor meetings.

Old-style research is not about to die. Big banks retain 56.2% of the “research vote” (smaller brokers take another large chunk). Bank bosses still value the support research analysts can give their profitable investment-banking and corporate-advisory businesses. But with budgets under pressure and competition growing, the market is becoming more efficient.

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