The role of asset owners in the market for investment research:

Where are the fiduciary capitalists?

Fiduciary capitalists, such as leading pension plans and endowments, can be influential in aligning the interests of asset management firms with their clients. In the market connecting investment professionals with the information they need to meet client goals, we identify numerous conflicts of interest, but find little action has been taken by asset owners. Interest in the obscure practices surrounding the use of dealing commissions for research has heightened since 2014 due to regulatory scrutiny in the UK and the impending implementation of the second Markets in Financial Instruments Directive (MiFIDII) in Europe. The authors make recommendations to guide asset managers and asset owners through a complex information market during this time of dramatic change

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1. Introduction

Financial capitalism, the prevalent operating system behind global financial markets, has been highly criticized in the years since the 2008 financial crisis. Despite this we can find examples where the collective power of asset owners has succeeded in improving end-investor outcomes. Hawley and Williams (2000)[1] observe the emergence of an alternative system driven by asset owners acting as 'fiduciary capitalists' to improve alignment with end-investors' long-term goals.

Fiduciary capitalists select managers based on the efficiency of their research utilization and the total cost of management. As a result, they are in a strong position to call for transparent and objective research spending by asset managers.

We briefly review the forces of change in the information market connecting fund managers to external sources of investment research. Despite its obscurity this market provides an important link between investment management firms and thousands of research providers, such as brokers and independent firms, around the world. It is also large: estimated to turn over in excess of $20bn per annum[2].

Our ongoing work with firms, regulators, industry and professional bodies combined with evidence collected through surveys and interviews reveals little evidence of fiduciary capitalism in this particular market to date. Asset owners, who represent end-investors and therefore could be expected to reduce agency problems inherent in fund management, have been quiet in this debate. Regulators, entrepreneurs and indeed the buy-side and sell-side firms themselves, appear to be the agents of change.

2. Asset managers remain hungry for information

Rogers (2014)[3]cites the shift to lower cost index-based strategies as a result of fiduciary capitalism. Passive index strategies have grown since the introduction of index funds in the 1970s and now account for some 14% of assets under management (BCG, 2015)[4]. This does not include fast growing smart-beta innovations. Rogers notes the important role played by asset owners in shifting to such strategies to meet investor goals rather than overpaying for the hope of short-term performance.

Despite the ascent of index investing, active management remains the prevalent type of equity fund management around the world. Indeed it will do so even if passive management doubles in size. Active management is likely to remain an important segment of equity ownership for decades much as it prevails in most other asset classes.

Active managers need research in order to make decisions in the face of uncertainty to meet investor goals. Buy-side firms therefore have to either produce their own research or buy it from third parties. Most choose ingredients from both sources and the recipe will depend on the availability, quality, trustworthiness and cost associated with each source.

3. What exactly is research?

Investment research comprises much more than written analyst reports (CFA Society of the UK, 2014)[5]. Customised analysis, quantitative models and analyst time are just some of the services that investment managers value. Despite frequent claims to the contrary, most asset managers remain heavily dependent upon broker research.

In the US, fund managers can use commissions to purchase data and gain access to company management in addition to procuring financial analysts' research. In the UK, only the latter is eligible and buy-side firms must also pay for raw data and corporate access with their own, not their clients', money. Rules in other markets tend fall between the UK and US definitions.

Unlike some economic goods, research can be worth different amounts to different consumers. Consequently, by definition, there is no "right price". Regulators are in no position to tell an asset manager that a particular product or service is not "substantive" in relation to their investment process.

Many asset owners would also find it difficult to evaluate research efficiency, but this is largely due to lack of information. Research is procured to improve the chances of meeting investor goals. While this may be consistent with asset owners prioritising investor goals over short-term alpha (Rogers, 2014), it is perhaps puzzling that scrutiny on research costs, or at least demand for attempts to value research, has not been higher in the past. This puzzle can be explained at least in part by lack of understanding of this complex market, which is briefly explained in the following section.

4. How does the research market work?

The means of paying analysts for investment research is strikingly different to markets for most other professional services. Investment management companies can charge the cost of research to the funds they manage meaning that their clients pay for research. This is done using research commissions that are paid to brokers when shares are bought or sold. Unsurprisingly, most research has typically been purchased using commissions because this way the fund management company does not bear the cost. Additionally, it is most unusual to find contractual arrangements based on billable hours or specified deliverables.

Fund managers decide how to reward analysts for various research services on an ex post basis i.e. after consumption. A typical broker vote process would involve fund management staff deciding how to allocate commissions at the end of each period, (typically six months) on a percentage basis. For example an equity fund manager might pay a given brokerage firm 7% of her firm's total commission allocation as payment for research. This information would be translated into a target allocation for the buy-side dealers to execute in the coming period. As a result, research would be paid in arrears. Detailed analysis of a US broker vote process can be found in Maber et al (2014)[6] but such processes no longer comply with UK regulation today or European regulation post MiFIDII. In 2006, UK regulation created a payment mechanism which allowed research commissions to be paid away to other research providers, thus ending the one-to-one mapping between execution and research relationships. It also paved the way for hundreds of independent research providers. This mechanism, analysed by Haig and Rees (2016)[7] and usually called the Commission Sharing Arrangement (CSA), has equivalents in the US and other markets. Figure 1 shows estimated CSA adoption aggregated across US and European markets.

5. Problems associated with the broker vote

The traditional broker vote process has a number of problems (CFA Society of the UK, 2014). First, because the vote payments are percentages of commission paid, which outside the US is typically determined by the trade value rather than number of shares, the price of a certain service in dollar terms can fluctuate from year to year due to changes in funds under management (which is affected by market prices of underlying securities, fund performance and fund flows) as illustrated in Figure 2. The fund manager would be charged more for exactly the same research just because of an increase in stock prices or fund inflows. Second, the fund manager needs to trade in order to pay commissions to the broker, which creates the incentive to trade even if transactions are not required. Traditionally only the executing broker could be paid for research and brokers competed for bundled commissions on the strength of their analyst research. Third, broker votes have often failed to provide useful feedback to brokers regarding the services required. We have strong evidence (Extel, 2011)[8] that the process has been lacking in detail, accuracy and timeliness. The UK FCA view the broker vote as “inherently flawed”[9].

6. Current Status: a Market in Flux

Some 15 years after the influential Myners[10] report, which proposed a ban on research commissions in the UK, the UK regulator has finally succeeded in elevating the importance of the research market. The FCA’s 2011-12 thematic review and subsequent consultation lead in 2014 to clarification on the definition of research and the requirement for the CEO of the largest 200 asset management firms operating in the UK to make a personal attestation regarding the use of commissions for research. By interpreting research as an inducement to trade under MiFIDII, it also supported further restrictions on research commissions commencing in 2018.. As a result of London's scale in global investment management, research payment has ascended the "to do" list for asset management firms around the world. The regulatory spotlight on this area has intensified and is unlikely to diminish.

The UK and some other European regulators have sought to break the link between turnover and research payments. Rising equity markets led to larger assets under management, higher share prices, and often increased turnover typically result in larger research commission payments even if most asset management organizations consume similar levels of research service from one year to the next. Going forward, payment for a similar service level is likely to vary much less over time.

The FCA is expected to require investment management firms to create Research Payment Accounts (RPAs) based on a research budget that is to be set in advance. The research budget must be independent of trading thus removing any incentive for fund managers to trade excessively in order to purchase research.

By mandating finite monetary (rather than percentage-based broker vote) research budgets, and encouraging managers to adopt board-level research budget approval processes, the regulators have largely achieved their aim of breaking the link between equity turnover and research payments. The outcome echoes Myner's (2001) call for fund management firms to compete by using research efficiently to meet client objectives. Yet the impact is now far wider than Myner's UK remit. Research consumers and producers around the world have tightened up policies in this area.

Given the vast change in regulatory environment, and the resulting change in the economics of the research industry, asset owners should now question how their underlying managers are responding to these industry changes. Most asset owners routinely and systematically measure the impact of their managers' trading decisions via Trade Cost Analysis. The efficiency of execution commissions has been regularly reported to asset owners since MiFID (2007) or before. In contrast, research commissions have typically not been reported. Ironically, the performance impact of sub-optimal execution, which could exceed 100 basis points in only the most extreme cases, is dwarfed by the impact of sub-optimal use of research: poor asset allocation or stock selection decisions could easily lead to underperformance of 100bp per annum or more depending on the strategy.

Many investment management firms have collected insufficient information on their use of research commissions and as a result have been unable to measure the return on investment of their research spend. As a result few have been able to present such information to end-investors. Senior officials at investment management firms consistently report that clients remain generally uninterested in valuing research.

7. Why have fiduciary capitalists not been more vocal?

We believe that the following reasons have impeded asset owners from demanding clear and transparent information on the cost and efficiency of research purchased with their money.

First, other regulations aimed at improving alignment with end-investor goals such as the 2012 UK Retail Distribution Review have been taking effect. Investment managers and advisers have been right to focus on implementation of these high-profile regulations.

Second, the opaque nature of the payment mechanism made it hard to see the costs involved. Limited awareness even of the existence of research commissions is perhaps understandable given that few buy-side firms presented research costs at all.

Third, low awareness of the mechanics of research commissions provided media and the public with limited understanding of the issues. The UK FCA's 2013 Thematic Review changed this and specialists within the financial press now keenly study the issue on both sides of the Atlantic and elsewhere.

Fourth, the 2008 financial crisis and resulting gyrations in equity markets required asset owners to focus on other priorities in order to survive long enough to consider this issue of longer-term consequence.

It remains unclear whether asset owners have a fiduciary responsibility to monitor their managers' research spending and its relationship to fund returns. CFA members will recognise their responsibility to meet CFA soft dollar standards which provide guidance on how to use client brokerage ethically. The standards recognize the possible conflict of interest between the buy-side firm and its clients that arises from the opportunity for an investment management firm to offset some fixed costs through the use of services paid for via client commission. The standards seek to require members to manage that conflict appropriately through their own actions and by providing clients with the information that they might need to monitor their managers' behavior.

Note that fund managers can buy whatever research they want if they pay with their own money and asset owners should also consider procurement in their evaluation.

8. What creates the best outcome for investors?

Is the lowest possible research cost in the best interest of the asset owner if it results in sub-optimal research provision and investment decision making? We believe that efficient use of research spending is the key. Asset mangers should be expected to align the research budget with the investment strategy, investible universe and expected returns at the fund level.

As always, there are likely to be costs to regulation as well as benefits. Close relationships with sell-side analysts provided fund managers with tailored information thus allowing the best shot at market outperformance and this is entirely in the end-investor's interests. Cross-subsidies between business units at banks provided a model that allowed fund managers to benefit indirectly from expertise and services beyond research. Investment banks struggled to limit the dissemination of research and much was often available to smaller fund managers, thus helping them to compete against larger firms. Given the social complexity and economic dynamics of the interface between buy-side and sell-side experts, it seems unlikely that more rigid regulation could not come without costs to the end-investor. This key point is frequently lost in the debate.

The original MiFID II proposal to require asset owners to approve their asset manager's proposed research budgets would directly involve asset owners in the research funding discussion. UK pension trustees are frequently not investment professionals and therefore not usually qualified to judge complex and variable research budget proposals from widely differing investment strategies. They face the following questions: Is the same research budget appropriate for a distressed debt fund and a highly leveraged emerging market equity hedge fund? What is the "right" price for research? What is the relationship between research budget spending and end-investor's outcome (expected returns)?

It is likely that multiple answers will emerge. This need not be a poor outcome. Different firms representing different sets of asset owners should be encouraged to articulate the best practice to suit their end-investors. The UK National Association of Pension Funds has recognized the need for a principle-based approach balancing the appropriateness and alignment of the research budget with the underlying investment strategy and expected returns.

9. How might asset owners effect change?

While acknowledging that there are different ways to succeed in aligning research procurement with client interests, we identify several ways that influential asset owners such Sovereign Wealth Funds and pension plans could effect change.

First, fiduciary capitalists will lead the efforts to compare research costs to investment goals and will demand information to be presented in their preferred format and frequency. Asset managers will then be required to provide such information in the course of client reporting and when competing for mandates. International regulatory co-ordination on research procurement has typically been limited. Major asset owners have the power to improve the practices of investment management groups worldwide. This could avoid damage to competition between geographic investment management hubs due to regulatory arbitrage. Although MiFIDII provides the opportunity of consistent regulation across one continent, therefore reducing the risk of regulatory arbitrage, a relatively stricter interpretation of the delegated acts in some European markets could discourage fund managers from operating in there. Reduced competition has also been argued to result in a loss of high quality fund management jobs in countries where research payments are most restricted.

The likelihood of differing national interpretations of the same MiFIDII text presents a key risk to the entire process if it creates an un-level playing field across Europe. If all or any part of Europe bans the use of commission for research, this will represent a significant trans-Atlantic non-tariff barrier in international capital flows. At the time of writing, European regulators have stepped back from such draconian plans. The use of commission for research is enshrined in 28(e) of the Securities and Exchange Act of 1934. This venerable Federal statute is unlikely to change.

Second, asset owners need to be aware that unbundling could lead to potential concentration in the investment management industry. Bundled commissions supported smaller buy-side firms: effectively they were subsidised by larger buy-side competitors. Although undesirable in terms of fiduciary responsibility, this acted to level the playing field. Start-up investment management firms would often seek access to investment bank research in their early days while operating on seed funds. Unbundling therefore presents a higher barrier to entry to new fund managers and may encourage a further shift in power to large investment management groups.

Third, asset owners should demand that investment managers adopt the following practices.

i. Research budgets should be set based on an independent review rather than by portfolio managers. Aggregate research commissions should require board approval. Ongoing internal consistency checks under the oversight of the investment management firm's Chief Financial Officer or equivalent should be reviewed in an annual audit.

ii. The firm's compliance team, *not the portfolio management team,* should manage the process. Portfolio managers may, however, shape the design of the policy within their firm.

iii. Appropriate records of research consumption should be maintained to the highest regulatory requirements globally. In most firms this will require improved accounting practices.

iv. Provide clear and consistent feedback to research providers as to what products/ services are valued.

v. In time, research budgets should be monitored against quantitative benchmarks. Such benchmarks are likely to emerge and become available by the end of the decade. In the interim a clear comparsion with previous years will allow asset-owners to evaluate research efficiency.

MiFIDII delegated acts, released in April 2016, can be interpreted to include fixed-income research where commission is not paid and therefore has been sheltered from regulation on research payment.. Moves to bring fixed income markets into line will present a major change for many bond fund and multi-asset managers who were not able to use CSAs but will be required to initiate RPAs as they move to price research. In particular, multi-asset managers may be asked to present research costs for equities, bonds and other types of investments. We believe that asset-owners may be more effective that regulators in non-commission markets.

10. Conclusion

Research procurement has seen a murky past. Ten years after the 2006 introduction of CSAs in major equity markets, transparency is improving. Investment managers are moving towards better practices.

Significant improvements in the first half of this decade largely stem from the responses of research consumers and producers to UK regulatory change. Such practice has been mirrored around the world to varying degrees. The spotlight has been directed to research procurement and as a result the topic has moved up significantly on the "to do" list for those managing investment firms. The issue is here to stay. End investors stand to benefit.

Yet fiduciary capitalists appear to remain largely silent on the issue. Like other participants, asset owners will have been watching the interplay between regulators, government agencies, firms and bodies representing industries and professionals in the lead-up to MiFIDII. The interpretation by regulators in Europe and other important markets and the response from firms developing global policies will take longer to emerge. In the coming years, from 2017-2018, research valuation information will become more available for asset owners who will then aggregate and compare research costs to custodial and other costs. More informed asset owners will become more vocal and will perform an important monitoring function.

In this paper we provide recommendations to assist them to make this important change. We expect the current level of scrutiny of research procurement will reach a higher bar. Compliance, transparency and fiduciary responsibility is likely to increase and compliance departments the world over will by busy ahead of MiFIDII taking effect, which is widely expected to be during 2018.

The impact has spread well beyond the UK. The CSA mechanism allowed independent research providers to enter the market. Buy-side research budgets are expected to fall as poorly justified elements of bundled research are removed. However, despite the challenges to research budgets, there is sufficient commercial demand for independent research to fuel innovation both directly and indirectly.

Rather than acting to minimise the cost of research, we recommend aligning the research budget with the investment strategy, universe and expected returns at the fund level.

Asset managers have fiduciary responsibility to act in their clients' interests. When paying for research there should be a clear demonstration of the expected value of that research in obtaining the investors goals. Research consumers and producers have been vocal in providing feedback to proposed regulations. Asset owners, in contrast, have been watching quietly. Given that they may have a fiduciary responsibility to evaluate research spending, we expect this group will be the next to take action to further improve the lot of the active investor. Most likely this shift will occur once MiFIDII has been integrated into member state regulations. Fiduciary capitalists will then use their power to improve alignment of investment manager action with end-investor goals.

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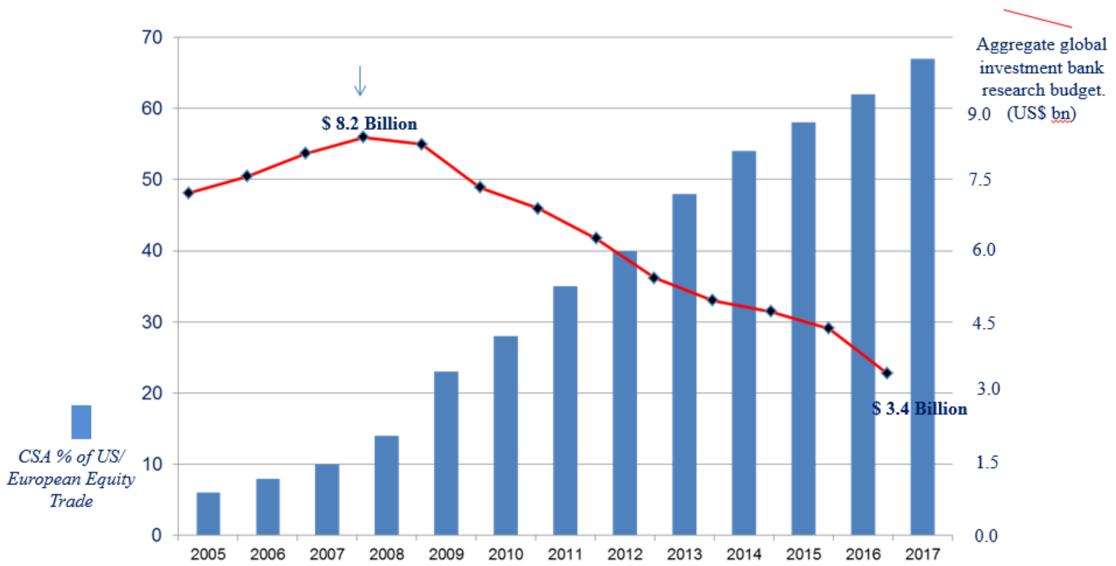
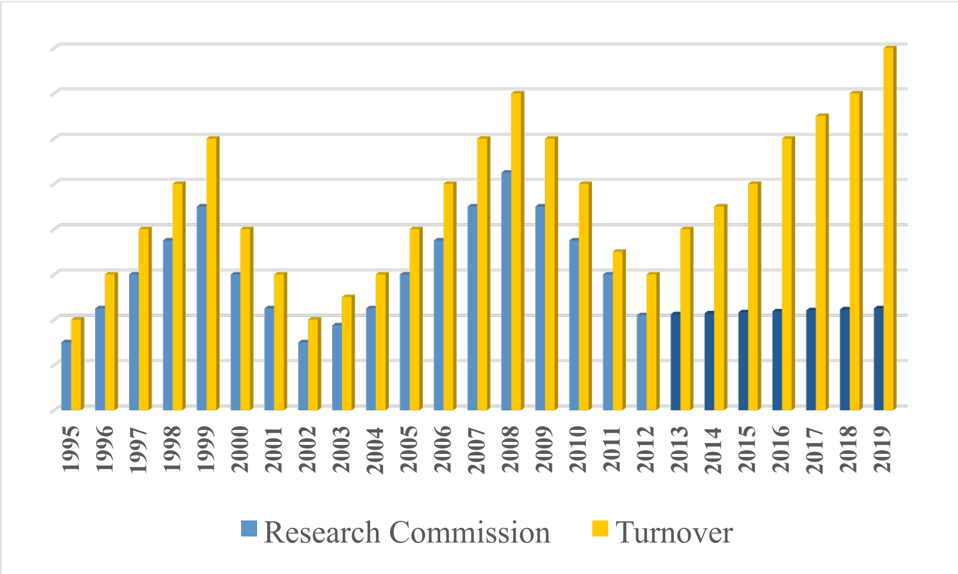
Figure 1: Adoption of Commission Sharing Arrangements (CSAs) and Investment Bank Research Budgets 2005-2017



CSA adoption (bars; LHS axis) was relatively slow but now accounts for more than half of commission payments for research. Investment bank research department budgets (line; RHS axis) have more than halved since 2008.

Source: Frost Consulting

Figure 2: Research commissions before and after the introduction of research budgets



Asset management firms, particularly those operating in the UK, have been moving from percentage-based broker votes to dollar-based budgets. The effect, stylized in Figure 2 is that research spending is no longer tied to the volume of dealing commissions as portrayed by the dar

Source: Frost Consulting