

IN THE Rough

Independent research is in a difficult spot,
but some players still have a shot at success

BY JOHN RUBINO



A lot of people seemed to expect it. Still, when Prudential Financial closed its equity research group in June, the news sent a tremor through the investment world. “Pru” was a class act, with top-rated analysts, solid institutional connections, and global name recognition. But apparently, that wasn’t enough. “They had tremendous distribution yet were not able to monetize their research,” says Christopher Whalen, a former Pru investment banker and now senior vice president and managing director for Institutional Risk Analytics, an investment consultancy unit of Lord, Whalen LLC based in Hawthorne, CA.

Now for the questions: Was the problem with Pru’s model or the market? Will more brand-name independent research shops fold? And the big one: Are there independent research models that have a better chance of success going forward? In each case, the answer is a clear yes. Pru’s demise was the result of both its strategy and the market. And although good research is, if anything, more valuable today than ever before, many of today’s firms can neither produce nor monetize it. Put another way, the providers of independent research that will thrive in the coming decade won’t look anything like Pru or its peers.

To understand why, start at the beginning, which for our purposes is 1974. Prior to that time, brokerage commissions were fixed at a rich U.S. \$0.30–\$0.80 a share, and most sell side research was done by independent shops. Analysts helped money managers understand companies and industries, and money managers traded through their favorite analysts’ firms. Good research (and attentive hand-holding) generated commissions, known as “soft dollars,” in amounts sufficient to pay the best analysts reasonably well.

This cozy world ended in 1975 when trading commissions were deregulated in the United States. Falling rates presented brokers with a problem: how to finance research on a dwindling income stream. The solution was to merge brokerage, research, and investment banking and to make favorable research part of the investment banking package. This arrangement produced vast revenues in the 1990s bull market but also corruption on a scale not seen since the 1920s.

The inevitable backlash produced regulations that separated investment banking from research—and a promise by the major brokerage houses to buy outside independent research and offer it to their retail clients (a deal known as the “Global Settlement”). This pot of brokerage house gold caused a surge in the number of independent research shops in the United States and Europe. But instead of ushering in a new age of stability and rationality, the Global Settlement was only the beginning of a new, even more frenetic burst of evolution. Today, instead of just one or two industry-changing trends, there are at least six, all intersecting simultaneously:

Execution costs are plunging.

Electronic communications networks (ECNs) now make it possible to trade equities for next to nothing. As a result, “The pool of [soft dollar] cash available to fund research is down by half in the past few years,” says Michael Mayhew, co-CEO of Integrity Research Associates, a consultancy based in New York City.

The First Amendment has been suspended.

Once upon a time, an analyst’s job was to come up with unique ideas. He or she would meet privately with company managers or other industry insiders and use the resulting insights to build an investment thesis that was, ideally, both unusual and predictive. “In the old days it was always a wink and a nod; if you were good at channel checking or had relationships with certain CEOs, they would talk to you bilaterally. This kind of material non-public information was what researchers got paid for,” says Whalen.

But the U.S. Congress in 2000 imposed Regulation Fair Disclosure, or “Reg FD,” which criminalized the old way of performing and marketing research. “A line was drawn in the sand that said if you’re a member of the NASDAQ and a registered person, you have no First Amendment rights, so everything in your research product has to be part of a company’s public disclosure. If not, the regulators will come after you and your firm won’t stand up for you,” says Whalen.

Today, a U.S. CEO can’t legally meet with an analyst unless everything that’s said is already in the public domain. “In that straitjacket, it’s very hard for an analyst to differentiate himself or herself,” says Whalen. “All they can work with literally is what’s on EDGAR [the U.S. SEC’s database of corporate reports].”

Not surprisingly, the reports coming from both brokerage houses and traditional independent shops are now virtually interchangeable, and institutions see little reason to pay yesterday’s high prices for them.

Mutual fund revenues are falling.

At the same time that traditional research is losing value and execution costs are plunging, competition from low-cost exchange traded funds (ETFs) is siphoning money away from actively managed funds and/or forcing them to lower their management fees. Either way, it means less money to spend on research.

Soft dollars are dying. The combination of falling execution revenues, muzzled analysts, and impoverished mutual funds would be more than enough to kill off a big swathe of independent research shops. But now, the whole concept of soft dollars—the main revenue source for most independents—is endangered.

Concluding that “soft dollars can serve as an incentive for fund managers to disregard their best execution obligations, and also to trade portfolio securities inappropriately in order to earn credits for research and brokerage,” SEC Chairman Christopher Cox recently asked Congress to ban soft dollars altogether and henceforth to require money managers to pay for research with hard dollars—that is, by writing a check to the provider. A ban is not a done deal by any means, but if implemented, “It will put the last bullet in the head of a lot of independent research shops, because that’s how they get paid,” says Whalen. “The notion that you can support big-time research in a hard-dollar environment is quaint, but it’s not true.”

The sell side is consolidating.

Regardless of what Congress does with soft dollars, research payment methods are evolving in threatening directions. Client commission arrangements (CCAs), for instance, now let money managers trade through a given brokerage house, earmark specific amounts for execution and research, and then direct the broker to pay other research providers. A recent survey found that 43 percent of responding U.S. buy-side firms now use CCAs and another 12

percent intend to. The portion is even higher in the United Kingdom, where the concept is better established.

For the sell side, the CCA is an earthquake. It eliminates the need for mutual funds to trade through, say, 300 brokers to get each one’s research. Now, funds can trade through the 30 brokers with the best execution and simply buy the others’ research. That’s good for top-tier brokers and very bad for the smaller players. “If you’re one of the brokers that loses execution business, are clients going to continue to pay you the same amount of money as before? The answer is no, because there was a value to the execution services,” says Mayhew. He notes that second-tier execution providers (such as Piper Jaffray, Raymond James, Thomas Weisel Partners, A.G. Edwards, Morgan Keegan, and Friedman, Billings, Ramsey) have all seen a drop in commission revenue from their institutional equities businesses in recent quarters, while bulge-bracket firms (such as Goldman Sachs, UBS, Morgan Stanley, and Merrill Lynch) posted an average 30 percent increase in their equities divisions.

That, in a nutshell, is what killed Pru. Once money managers could get their research without having to trade through the firm, Pru’s execution revenues fell below research costs. And Pru is just the beginning. “We’re seeing a rapid consolidation among execution firms and suspect that many others will close their doors,” says Mayhew.

Capital is going private. One of Reg FD’s many unintended consequences is that it is easier to manage money on the unregulated side of the street. “If you know an industry well enough to get paid big dollars under the old system, you’re probably working for a private equity firm,” says Whalen. “Because they don’t sell research, they can still use privileged information to make money.”

Meanwhile, the sell side has found a loophole of its own. As Whalen explains it, “If you’re running a broker/dealer right now, having a

researcher is a loss leader and an excuse to get sued. So a lot of shops have started moving analysts onto the sales desk, where they don’t write any more, and just talk to clients. You become a salesman with opinions.”

Independent Research, Version 3.0

So, second-tier brokers are being squeezed out of research, private buy-side shops are proliferating, and research is increasingly being bought with CCAs rather than soft dollars. It’s a harsh environment, but one in which the need for quality research is higher than ever. “The big story for the independents is that there’s an opportunity there. I think we’re going to see the sell side increasingly just shutting down their institutional and retail research, with independents being asked to provide that research,” says Shane Smith, CEO of London-based Independent International Investment Research (IIR).

As for which independent research models match this new market, here are a few possibilities:

Big (cheap) independent. There will always be a role for basic research that presents publicly available information in an accessible format and makes a reasoned recommendation. Brokers need such reports for their retail clients, and money managers need them for background. But no one considers Reg FD-constrained research to be worth what brokerage house analysts used to charge.

The solution? Hire an army of modestly paid but competent analysts to do standardized fundamental research. Morningstar, for instance, employs about 100 stock analysts covering about 2,000 stocks. “We’re an old-fashioned subscription service; no soft dollars or paying by the drink. You get the whole package, which includes access to the analysts, the models, the reports, and the conference calls, all bundled in together,” says Catherine Odelbo, Morningstar’s president for securities research.

With this kind of basic research,

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MICHAEL MAYHEW
Integrity Research Associates

They can also benefit from much wider distribution of the research to members of the investment community not serviced by the main investment banks, such as smaller fund managers, private client brokers, competing sell-side analysts, and sales teams.” Edison’s 28 London-based analysts now cover over 200 stocks on a contract basis.

Outsourcing. Mix strong demand for high-quality, low-price research with a growing pool of Indian MBAs and CFA charterholders, and many things become possible, according to IIR’s Smith. His firm employs a group of Mumbai-based analysts who turn out fundamental research, which the company makes available in a variety of forms. Some brokers now simply buy IIR’s “white label” reports and add their firm’s name at the top. Others, says Smith, are considering replacing their entire research staffs with outsourced product.

Then there’s the “notional hedge fund,” which is basically a shell that contracts with IIR for its research and trading strategies. “We manage notional positions, and the hedge funds then mimic the trades,” says Smith. “They have no internal research function. They simply pay us to filter through all our research recommendations we derive and just give them the best ones.”

Unbundled research. Good research involves several discreet steps, including gathering proprietary information, analyzing it, and making the results comprehensible to money managers. Top sell-side analysts used to do it all themselves. But that’s increasingly not the case. “The services that have been really successful in the independent

space are the ones that have taken the traditional Wall Street research process, unbundled it and sold it separately,” says Mayhew.

Consider SRI, or socially responsible investing. Issues such as corporate governance and environmental practice were once a fairly minor part of the average company’s investment profile. But for a growing segment of the buy side, they are becoming paramount, which creates a profitable niche for an SRI specialist such as Boston-based KLD Research & Analytics.

Back in the 1990s, KLD’s founders created the Domini 400 Social Index of companies with good citizenship records. “The idea was to encompass some social restriction ideas and mirror an existing benchmark to see if they could outperform that benchmark. Since then, [the Domini 400] has generally outperformed the S&P 500 Index,” says Randy O’Neil, KLD’s managing director for global sales. Along the way, says O’Neil, KLD “realized they were doing a lot of research on companies in order to maintain the index, and decided to start marketing the research.” KLD now has 25 analysts serving nearly 400 clients that license its various indices, databases, and screening services.

Channel checking, meanwhile, has morphed from grunt work to high-tech specialty. Back in the old days, “A channel check used to mean calling up 10 store managers or sending your intern to walk the isles of an apparel retailer to see how they are discounting and what their inventory looks like,” recalls Tony Berkman, executive director of New York City-based Majestic Research. But, he notes, supercomputers and advanced search algorithms have automated the process, enabling firms like Majestic to offer “channel checking on steroids.”

Majestic seeks out distributors or other middlemen with data containing unanalyzed industry intelligence. “We approach them and say, ‘Hey, we’d love to monetize this data for you,’” says Berkman. Majestic then mines the data

broad coverage is a major selling point. “A large group of analysts following a standardized approach allows for quality control and cross-pollination of industry groups,” says Odelbo. “It creates unexpected outcomes and knowledge that a single analyst sitting in a cubicle might not come up with.” Take IPOs, for example. “Any company coming to market we can slot into our industry coverage, tell you how it lines up in its industry, and give you a preliminary fair value estimate,” says Odelbo. “That’s impossible to do with any level of detail or critical thought with a staff of 10 people.”

Contract research. “An unanticipated effect of CCAs has been for investment banks to dramatically tighten up on who can receive their research,” says Fraser Thorne, managing director of London-based Edison Investment Research. “Only by restricting access to research can they realistically charge for it.” That’s not a big deal for the Googles of the world that are covered by dozens of analysts, but for small- and mid-cap companies followed by only a handful of brokers, says Thorne, “research on them will now be available to only a small percent of professional investors.”

Meanwhile, the number of companies going public continues to rise. “Approximately 600 companies have joined the two main U.K. markets in each of the last four years,” says Thorne. “The universe of sub-£300 million quoted companies is now approaching 2,500.”

The only way for a company in either of these camps to get broad coverage is to pay for it. Such “contract research” is already the norm in the debt market, where issuers of corporate bonds pay Standard & Poor’s or Moody’s Investors Service to provide them with a credit rating. And Thorne sees this pattern becoming common for equities, where it offers several advantages. “Companies can guarantee a regular flow of research and control the timing of it to match their needs rather than the investment banks’ timetable.

to yield useful, proprietary insights.

An example is a firm [unnamed for contractual reasons] “that has a large business serving oncology clinics,” says Berkman. By monitoring the company’s sales data, Majestic extracts a real-time picture of which drugs are being prescribed in what quantities and then

draws inferences about pharmaceutical company revenue and earnings streams. Because Majestic doesn’t issue buy/sell recommendations and doesn’t rely on statements from company executives, it bypasses Reg FD. The result is intelligence of the type that the buy side can act on and that once justified top sell-

side analyst salaries.

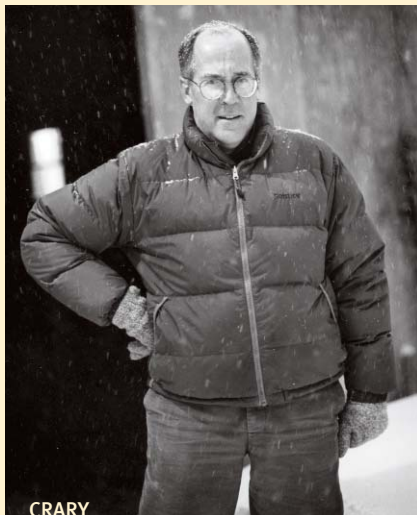
And CFA charterholders take note: The skills required for this kind of work may not be found in a traditional MBA program. An ad on Majestic’s website for an “equity research analyst” seeks candidates who are “equally comfortable with establishing a data part-

ONE-MAN Shops

Small, traditional research shops are being squeezed by the big generalists on one side and sophisticated specialists on the other. That means two things: First, having one or two guys doing fundamental research at the kitchen table is probably not a viable business model. And second, the small shops that survive will offer unique services that the typical money manager needs but can’t justify keeping in-house. Some examples:

The Litigation Analyst

Litigation risk rarely factors into the average company’s investment profile, but when it does, it can be a wild card. Because of its technical nature and infrequent occurrence, “it’s a waste of money for hedge funds and brokerage houses to try to get expertise on litigation. It’s not cost-effective for them to have one person who does what I do,” says Calvert Crary, a veteran legal analyst who now runs Litigation Notes, a litigation research shop in Westport, CT. “This is one of those



things it makes sense to contract out.”

Consider, for example, the U.S. Supreme Court’s recent decision in *KFR vs. Teleflex*. “This has a potentially revolutionary impact on pharmaceutical stocks,” says Crary, but few investment firms understand what it means for any individual company. So, Crary went through a list of pharmaceutical stocks and explained the potential impact, company by company, for his clients. “I don’t make buy/sell recommendations, but a lot of what I say is action-oriented,” says Crary. “It’s up to the client to figure out what to do.”

The Country Specialist

Big brokerage houses dominate Asian research in part because most of the markets are relatively new and partly because language and cultural barriers make a single, large regional operation more efficient than a bunch of local ones. But as Asian financial markets mature, that situation is changing, which is creating country-specific niches.

In 1997, former Morgan Stanley broker Paul Renaud noticed that Thai stocks were being ignored. “It was at the height of the Asian crisis. A lot of smaller and



mid-sized companies had been neglected for many years, and when the crisis came, I felt that these underappreciated companies were a great refuge. Many were export oriented and were going to benefit greatly from the devaluation of the Thai baht,” recalls Renaud. So, he founded a website called *Thaistocks.com* and posted an article titled “What Crisis?” that predicted Thai small caps would soar in value as their export sales were boosted by a plunging local currency. He was right, and his subscriber base has been growing ever since.

These days, Renaud travels Thailand visiting emerging Thai companies and drawing on local sources of information, some proprietary and some as straight-forward as local papers. “The Thai newspapers write about growing companies that never get into the English language newspapers,” he says. And he notes

nership and querying the partner's database with SQL [structured query language] calls."

The Coming Roll-Up

If a fragmented industry is put in an environment of cost pressures, economies of scale, and rapid technological

change, a consolidation is inevitable. That's clearly the case for independent research, says Shane Smith, whose company aims to be a buyer rather than a seller. "We're actively looking for firms that can be scaled up by leveraging their intellectual capital with our Indian resources." He expects to be

joined by many other roll-up players in coming years. "Everyone will be trying to achieve critical mass." **■**

John Rubino, a former financial analyst, is the author of How to Profit from the Coming Real Estate Bust and Main Street, Not Wall Street.

ThaiStocks.com, which was originally aimed at high-net-worth investors, is now attracting institutions from Europe and the United States. If business in Asia in general—and Thailand in particular—keeps growing, the influx of institutional money appears likely to continue. "Liquidity is getting better," says Renaud. "A lot of these formerly small-cap companies are suddenly large cap."

The IT Guy

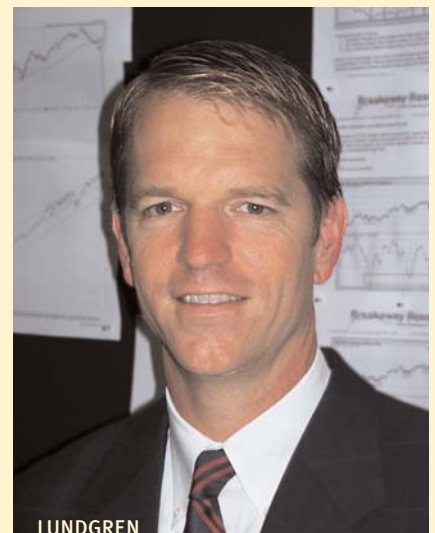
Money managers may not be in the market for generic research from one-man shops, but they do occasionally need customized analytical work. That's where Bellaire, TX-based analyst Alan Brochstein's AB Analytical Services comes in. "I'm a free agent, a generalist analyst with buy-side experience who's

used to analyzing a situation and assessing the likelihood of outcomes," says Brochstein, a CFA charterholder.

"The idea is to be like the IT guy. Lots of firms aren't big enough to have their own internal computer expert, so they outsource it." Brochstein's target market is the smaller shops with too few analysts to handle every challenge. "They might have an interest in a given industry and need an analyst to narrow the field down to the best candidates. Or they might need a write-up on a specific company or industry or work on a given model. Pay me by the project or by the hour. It's a customized service that offers access to a really good analyst for a fraction of what it would take to have one full time."

The Master of Mean Reversion

In a decade on the buy side, Dave Lundgren, CFA, developed several screens that seemed to be good predictors of trend changes. "They highlight the pockets of the market where there are high odds of mean reversion either upward or down," he says. Armed with this set of proprietary tools, Lundgren "started fresh" to market his models on a subscription basis. "I went to the contacts I'd developed over the years, folks who knew new my research already," he recalls. Then, he contracted with Independent Research Consulting, which markets the work of small shops to money managers, doing direct marketing and putting together e-mail campaigns.



LUNDGREN

So far, so good. "With the first campaign, we were hoping to get 10 or 12 qualified trial subscribers," says Lundgren, "and we ended up with 26."

Lundgren's firm, Breakaway Research in Marblehead, MA, generates customizable results for each client. "I try to figure out how each portion of the momentum curve works and what overlaps with their investment styles, and I give them those ideas." His subscription fees vary according to the number of users and the method of payment, but in any event, Lundgren believes the fees are lower than those of the bulge-bracket competition. "I'm trying to encourage my clients to just write a check," he says. "Ultimately, the market is going to come around to this pricing structure."



BROCHSTEIN