



## Outlook for Investment Research

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### Introduction

The past year and a half has seen a fairly dramatic shift in the landscape of Wall Street. Some of the Street's largest and oldest firms are no more. Lehman Brothers filed for bankruptcy last September, Bear Stearns was bought by JP Morgan in March 2008, and Merrill Lynch was acquired by Bank of America at the end of the year. The widely held belief is that the economy has been in a recession since December 2007. Major indices, despite a recent run up, are still down more than 30 percent from the highs reached in 2007. It's been a challenging time for both the research industry and the financial industry as a whole.

Looking back even further, Regulation FD passed by the SEC in 2000 and the Global Research Analyst Settlement in 2003 also have had far-reaching effects on the industry. Taken together, these events have all contributed to a transformation of the research industry over the past decade.

In order to better understand the current environment and also to predict where the industry might be headed, we need to look at how recent events have affected the industry. Changes in regulations, including Regulation FD and the Global Research Analyst Settlement, have changed how the research industry operates and helped level the playing field. Other contributing factors include how the economy has affected the sell-side, buy-side, and independent research providers.

### Regulation FD

In an effort to ensure that everyone had equal access to relevant information, the SEC approved Regulation FD, which went into effect October 23, 2000. One of the primary purposes of the regulation was to prevent industry analysts from gaining access to material non-public information from companies they covered and with whom they had established relationships. It mandated that publicly traded companies must disclose material information to all investors at the same time.

Prior to the enactment of Regulation FD, investment banks had largely exclusive access to information from companies for whom they provided coverage. Many times this information was material non-public information that represented a clear economic benefit to whoever possessed it. The exclusive information made reports from investment banks invaluable to their buy-side clients. By enacting Regulation FD and requiring that all material information be disseminated to everyone at once, the SEC essentially eliminated one of the primary advantages that Wall Street firms had over buy-side and independent analysts.

## **Global Research Analyst Settlement**

In April 2003, the SEC, NYSE, NASD [n/k/a FINRA], and 10 investment firms (later expanded to 12 firms) reached a settlement that, according to many, exposed a long-standing conflict of interest between the investment banking and securities research departments within brokerage firms.

In the settlement, it was determined that the investment firms had engaged in inappropriate practices that allowed the investment bankers to exert undue influence on the reports published by their research analysts to gain lucrative investment banking fees. For example, some firms published biased reports on companies with whom they had obtained agreements for initial public offerings. The terms of the settlement required the 10 firms to pay a total of \$432 million to independent research providers over the course of five years.

The goal of the settlement was to insulate the activities within the investment banking side from the activities within the research department. The budgets of the two departments were to remain completely separate, and research analysts were prohibited from going on “pitches” with bankers during advertising and promotion of IPOs. In addition, research analysts’ historical ratings must be disclosed and made available to investors.

Although there may have been previous speculation regarding potential conflicts of interest between investment banking and research decisions, the settlement confirmed these suspicions. Industry participants began to view research from a different perspective and discovered that in some cases it was not free of influence from other activities within a brokerage firm. Some firms began to question the source of their research, prompting a change in the structure of the research industry.

## **Evolution of the Analyst Role?**

In response to a changing industry and the needs of institutional clients, some bulge bracket firms have restructured the traditional role of their analysts. Some firms have moved away from producing analyst-written research reports, which could be viewed as commoditized and of little value to clients. Instead, their equity analysts now sit on the trading desk so that they can offer timely analysis that can be acted upon by clients.

Other firms relay short-term trading ideas—which were provided by analysts to their trading desk—directly to their preferred clients. The analysts still produce traditional research reports, but offer the short-term trading ideas to select clients who have expressed an interest in them.

Some will say these activities are a way to circumvent the written research requirement, while others will say it is just an evolution of the analyst role.

Because this activity might be construed as benefiting key clients—but hurting those who don’t have an opportunity to use the information in their investment decision-making process—there has been some disagreement about whether this activity is permissible. Additionally, some of the short-term recommendations differed from the broker’s printed research reports in that they were not always in line with their long-term outlook for a stock.

If this activity is eventually deemed illegal, we will likely see increased scrutiny of this practice and possibly regulatory action. Whether either of these trends will take hold remains to be seen, but the shift showcases new ways in which firms are using their research staff.

## **The Volatile Economy**

To get an accurate assessment of the current state of the industry, we must also discuss the effect the economy has had on firms over the past year and a half. We are in the middle of arguably the biggest

economic downturn since the Great Depression. Many economists do not predict a recovery until at least the fourth quarter of 2009, but regardless of when we will start to see a recovery, the fact remains that the recession will continue to have a measurable effect on all firms in the near term.

The aforementioned bankruptcy of Lehman, the purchases of Merrill and Bear Stearns, and the sizeable write-downs of inflated assets have led both the sell-side and buy-side to take far-reaching action. For starters, most firms have had to find ways to reduce costs, often by cutting headcount across all departments. Many have also looked at other ways to lower costs: canceling redundant services, reducing research expenditures, etc. In addition, many have had to raise capital and accept government loans in order to simply survive as the decline in the value of their assets pushed some to the brink of bankruptcy.

On the buy-side, the stock market decline has led to a substantial drop in assets under management for nearly every firm over the past year. According to Pensions & Investments' annual money manager survey, the 500 largest money managers saw their assets reduced by 21 percent in 2008, which represented the worst drop in 30 years. At CAPIS, the custody data from our performance reporting group has shown a 10 to 40 percent drop in commissions from Q4 2008 to Q1 2009. The fourth quarter saw a lot of trading activity due in part to the extreme volatility in the market as the VIX rose to record levels, which presented trading opportunities. Additionally, many funds were hit with redemption requests, which led to more activity as firms sold positions to cover the requests. Recently the VIX has drifted back below 30 and the market has rallied sharply from March lows, but volume has been trending lower over the last few months. As we move through the typically slower summer months, trading activity will likely continue to be restrained.

What effects have these events had on the research industry? What is the outlook for the industry? We will first address the impact these events have had on the sell-side and then turn our attention to the buy-side and independent research firms.

## Impact on the Sell-side

As mentioned previously, Reg FD eliminated one of the primary advantages of sell-side research, which was arguably the one benefit that added the most value to their research. Eliminating this exclusivity reduced the perceived value of the research.

The Global Research Analyst Settlement also had a negative impact on sell-side research. As with Regulation FD, the settlement reduced some of the advantages that sell-side firms had by maintaining large research departments. The Global Research Analyst Settlement substantially reduced the revenue stream (obtained through investment banking) used to fund research efforts, resulting in reduced analyst compensation, which led many analysts to leave this side of the business.

Finally, the recession added to the problems the sell-side has faced over the past few years. As previously noted, the past year and a half have been especially challenging with revenues down across the board and many firms simply trying to survive by cutting costs and/or raising additional capital. Commissions are expected to remain down throughout the rest of 2009. Estimates range from a 20 to 40 percent decline in commissions year over year, which is in line with the drop we have seen in the first quarter. All of these events have had a measurable effect on the sell-side and have resulted in the following:

- **Reduced research department budgets** – The Global Research Analyst Settlement probably had the most pronounced effect on research department budgets. With investment banking revenue no longer able to help finance research departments, many firms drastically cut budgets. In addition, the recent drop in overall revenue at most banks has led to smaller budgets across the board. Since most sell-side research is still provided as part of a bundled commission rate, the decline in overall commissions will continue to strain research budgets.
- **Decline in analyst staffing levels** – Not surprisingly, the reduction in department budgets has caused a decline in analyst staffing levels. The recent consolidation of major sell-side firms over the past

18 months has also led to a reduction in analysts as firms move to eliminate redundant coverage. According to the Tabb Group, the total number of sell-side analysts fell approximately 42 percent between 2000 and 2006.

- **Fewer stocks covered** – The reduction in department budgets and an exodus of analysts from the sell-side have been primary reasons behind the reduction in both the number of stocks covered and the number of analysts covering a particular company. According to a recent Wall Street Journal article, between September 2008 and mid-May 2009, more than 2,200 analysts dropped coverage.
- **Decline in perceived quality of research** – For many on the buy-side, these factors have contributed to a decline in the perceived value in sell-side research. A recent survey by Greenwich indicated that 18 percent of buy-side analysts and 30 percent of all hedge fund analysts plan to spend less on sell-side research over the following 12 months.

Before we move on to the impact to the buy-side, it should be noted that some sell-side firms are either continuing to expand their research offerings or moving to start new research groups. Regional firms in particular have taken advantage of turnover in analysts from bulge bracket firms to expand their research departments.

International firms are also looking to expand in the current environment. After acquiring Lehman last year, Barclays Capital is working to build out its research group. Also, as reported in Traders Magazine, Nomura has recently added staff in New York to sell its European research and plans to establish a U.S. research staff in the fall.

## Impact on the Buy-side

With sell-side research perceived to be less valuable by some and certainly less prevalent in the breadth of its coverage, the buy-side has had to make key decisions in this new era. As it pertains to generating and obtaining useful research, the buy-side has essentially three options: to generate all investment ideas internally, to supplement internal research with that of outside providers, or to utilize outside providers only. The option each firm chooses depends on a variety of factors: firm size, investment strategy, cost structure, etc.

### Internal/Primary Research

The recent trend toward internalizing research has likely been somewhat subdued as firms continue to look for ways to reduce expenses. In recent years, the buy-side has used regulatory and legal industry developments to attract some of the sell-side's most talented individuals in order to generate their own research. This trend will likely continue for select firms as street analysts continue to look for new opportunities and move to the buy-side.

Many of the firms adding analysts to their research departments have been the large fund complexes that can justify the expense and spread the cost across a large number of funds. For example, Integrity Research Associates noted that Fidelity has added more than 120 analysts since 2005; Janus Capital Group has increased the number of equity analysts by 25 percent over the past few years; Franklin Templeton Investments increased investment professionals by 70 percent between 2001 and 2007; and MFS Investments has also increased equity research teams by 25 percent during the past few years.

Additionally, as the buy-side analysts have gained greater access to corporate management and meetings, they are relying more on their own internal research capabilities. Buy-side institutions now assign 50 percent or more of their research commission dollars for management meetings, according to Inside Market Data. A report titled "Attitudes Sour as Dust Settles on Reg FD," published a couple of years after the

enactment of the regulation, found that more than half of portfolio managers and equity analysts believed that the value of broker research has declined. Sell-side research is now viewed as raw materials that have to be fine-tuned internally to create a finished, actionable idea.

As appealing as internally generated research can be, the recent drop in assets under management may cause many firms to re-evaluate how cost-effective it is to build out full-fledged research departments. In March 2009, Integrity Research published an article entitled "Are Large Buy-Side Research Departments Justifiable?". The article questioned whether buy-side research departments are truly cost-effective. It suggested that they may not be, "particularly when asset managers have a large number of alternatives like sell-side and alternative research providers that have considerably more economies of scale than they do."

The pressure for the buy-side is to continually come up with the next big alpha-generating strategy. To achieve their goal of increased returns for their clients, access to unencumbered, not widely distributed information is crucial. Some firms will meet this need by investing in their own internal research efforts. They are willing to pay top dollar to attract and retain highly rated analysts in an effort to find new profitable investment ideas. However, as mentioned earlier, many firms are re-evaluating this option and are looking to other opportunities that might be available.

## **Impact on Independent Third-party Providers**

The growth of the independent research industry can be partly attributed to both the passing of Regulation FD, as well as the Global Research Analyst Settlement. Reg FD clearly helped level the playing field for independent analysts as the sell-side analysts lost one of their primary advantages. The benefit to the industry as a result of the research settlement is less clear-cut.

While the research settlement funneled \$432 million to the independent research industry over the past five years, much of that money went to a relatively small number of firms. Standard & Poors, Morningstar, Argus Research, and Zacks Investment Research were among the approximately 70 firms that benefited the most from the settlement. Settlement terms required that an unaffiliated consultant ensure that independent research was provided for each of the stocks the firms covered. The question is, now that firms are no longer required to pay for independent coverage, how will the firms that benefited from the settlement be affected?

## **Filling the Gap in Coverage**

Because many institutions are only interested in or able to purchase larger cap companies due to liquidity issues, the sell-side has been inclined to focus coverage on these larger cap companies in order to attract profitable investment banking business. Buy-side demand for additional coverage of many large cap companies is not likely to be great enough for firms to continue to provide alternative coverage for all current stocks. We suspect that some of these resources will be directed to providing coverage of small and mid-cap companies that are traditionally underserved by the sell-side firms.

The lack of research coverage of some companies has not gone unnoticed. Morningstar announced in early June that they had reached an agreement with Nasdaq OMX Group to provide some form of research coverage for all companies listed on the Nasdaq exchange. The coverage stops short of providing full research on companies, including earnings forecasts and buy/sell/hold recommendations, but enables investors to get at least some information on all Nasdaq companies, including almost 900 that are currently not covered by analysts. The NYSE Euronext had previously announced a similar deal with Virtua Research to produce independent research for select NYSE and AMEX securities. These deals are both indications that independent research will continue to help fill the void left by the sell-side.

## Customized Analysis

Performance of their individual picks has traditionally been the metric by which many research providers are measured. While there will always be a market for what is considered traditional fundamental research with buy, sell, and hold recommendations, the buy-side is now demanding more customized information. Many firms are in search of data to assist them in making their own decisions. This is something that the independent providers have been better equipped to provide over their sell-side counterparts, and represents one of the biggest opportunities for independent research firms going forward.

Independent research providers have experienced growth because they can offer institutions more diverse, specialized offerings. Buy-side research has begun to demand more of a customized approach to research requests. Managers want data provided solely to them based on the specific needs of a project and many view individualized expertise to be much more valuable than standardized research.

Providers that offer services such as channel checks, expert networks, fundamentals, etc. are usually attractive to the buy-side since they are able to add value to their primary research. Firms that can also coordinate regular management visits are usually able to win business from the buy-side.

## Growth in Client Commission Arrangements

Unbundling of commission charges and the ability to pay for research via client commission arrangements (CCAs) has also fueled the growth of the independent third-party research providers. As the sell-side is pressured to separate execution costs from research costs, the buy-side is offered a more transparent view of their commission charges. CCA programs allow the buy-side to execute trades with one firm while generating credits to pay other firms for research, often a third-party provider. The most recent SEC interpretive guidance on client commission practices ("soft dollar" arrangements), released in July 2006, provided additional guidance on what was permissible under 28(e) and also reiterated its stance that 28(e) covers both proprietary and third-party research.

## Bulge Bracket Firms and Alternative Research Partnerships

Even the bulge bracket firms have recognized the demand for independent research. Many have implemented partnerships and even economic investments in independent research providers (outlined below).

Bank	Independent Research Product
UBS	Integrity Research
Goldman Sachs	Hudson Street
Merrill Lynch	Merrill Open Minds
Morgan Stanley	AlphaWise
Credit Suisse	Research Exchange(Rx)

These products have been a way for the bulge bracket firms to offer their clients access to independent research that can complement their proprietary research products, which have been declining in demand. At the same time, many of these investment banks have started to offer their own CCA programs in hopes of capturing a piece of the estimated \$3 billion in equity commissions used to pay third-party providers. Without a primary need for their research, much of the sell-side experienced a decline in their execution trade flow. CCA programs offer a way for these firms to retain execution commissions as their research departments endure heightened scrutiny for conflicts of interest. In the view of many people, keeping research separate from execution promotes a conflict-free approach, something that the Global Research Analyst Settlement set out to accomplish.

So, how much growth has the third-party research industry experienced? It is estimated that the \$1.5 billion independent research industry will grow 15 to 20 percent a year in the coming years according to CFA Magazine. Since 2000, the number of independent research firms in the U.S. has expanded by 46 percent as 167 new firms have opened for business according to Market Mine. Part of this growth could be attributed to the \$432 million that the global settlement mandated banks to pay to independent third-party providers, but many feel that the recent growth is beyond that. As the buy-side re-evaluates the type of research that is worthwhile to them, independent providers seemingly become more attractive sources. According to a survey conducted by Bloomberg in late 2008, 65 percent of respondents indicated that they planned on increasing their use of independent research in 2009. So the growth exceeds that which was perhaps artificially created through the Global Settlement.

## Benefits of Independent Research

In light of industry changes to the traditional sell-side research model, the independent research providers are poised to offer distinct benefits to the buy-side customers. The business model of an independent provider capitalizes on what most viewed as the flaws in recent sell-side research. Some of those benefits are as follows:

- **No conflict of interest** – With the absence of investment banking interests, independent providers have no outside influence over the sentiment of their research, which creates an objective, unbiased product.
- **Increased coverage** – With the reduction in sell-side staff, fewer stocks now receive analyst coverage. The increase in the number of independent research companies offers more resources for analyst coverage on the less active, more obscure stocks and sectors that were otherwise overlooked.
- **Specialized research** – The sell-side research is sometimes standardized in its approach. It was designed for mass distribution. With more and more independent companies providing research, the information is trending toward more specialized products that better fit the needs of the buy-side.
- **Increased competition, more choices, higher value research** – Independent research providers have brought to the industry additional options and increased competition, which has rewarded consumers with higher value products.
- **More diverse product offerings** – The independent research companies' non-standardized approach has resulted in more varied product offerings for the buy-side. The product offerings are customized and can fit the needs of a larger population with specialized requests.
- **Better value proposition** – Independent research can usually be purchased at a fraction of the cost of producing the research internally. The reduced cost allows firms to purchase a number of different research products in order to cover a broader spectrum of companies and/or viewpoints.

Independent research providers will need to focus their efforts on areas typically underserved or even ignored by the sell-side. As previously mentioned, the perceived value of sell-side research has eroded over the past few years. Oftentimes the buy-side uses the sell-side research to test their own research, as opposed to making investment decisions based on the information. The sell-side generally excels at gathering relevant information about a large number of firms in a cost-effective way. Whether the actual recommendations continue to be biased is a topic that is open to debate, and beyond the scope of this discussion. However, the basic principles of supply and demand hold true: because sell-side research is available to a large group of the firm's clients it is often deemed less valuable.

This is where independent research providers can add value to the equation--for firms with large internal research departments, those that depend on third-parties for all their research, and for firms that fall anywhere in between.

## Short-term Outlook

The rest of 2009 will likely continue to be a challenge for everyone in the financial industry. As previously noted, lower asset levels and commissions will cause margins to remain tight for the sell-side, buy-side, and independent research firms. Forecasts generally expect a full-fledged recovery to start sometime in 2010. However, it could take a number of years for the market to regain all that it has lost. This means that asset levels and commissions may not return to peak levels anytime in the near future. Today's environment creates an opportunity for firms to grow and expand as the downturn forces weaker firms out of business.

The research industry has gone through dramatic changes over the past decade as sell-side research coverage has been cut back and new independent firms have stepped in to fill the gap. The demand for customized and unique research from the buy-side over the past few years has benefited the independents, who are now uniquely positioned to take advantage of these opportunities. The industry has evolved to a point in which both sell-side research and independent research have their respective places in the investment decision-making process. They are not mutually exclusive but rather viewed as complements to one another. The need for research is still fundamental. But suffice it to say, the new evolution in how research is obtained will require adaptation from the traditional players and innovation from the start-ups.

Some buy-side firms will elect to ramp up their in-house capabilities. For other firms that look to outside research providers for a portion of their research needs, the opportunity for growth exists for those companies that can fill the need. Many of these organizations will have to use innovation to differentiate themselves and compete effectively in the research arena. Institutional investors will expect innovation in areas such as method of information distribution, timeliness and accuracy of information, and information management. A dependence on and desire to seek independent research should also facilitate the growth of CCA programs. The buy-side will continue to seek best execution venues while maintaining the autonomy to choose their research providers, the fundamental premise of a CCA program.

With tools to effectively gather, decipher, and manage unbiased conflict-free research, professional money managers and institutional investors have the appropriate means to weather the changing global economy and do what they do best: make money for their clients.



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