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RESEARCH UNBUNDLING

REVEALING QUALITY AND FORCING CHOICES

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INTRODUCTION

The business of investment research is entering a period of profound change. From January 2018, MiFID II will require research to be priced separately from execution. This represents a major shift from today's practice whereby research is supplied as part of a bundle of services, with no explicit charge.

The priority for management teams over the rest of 2017 is ensuring operational readiness and negotiating new relationships and commercial arrangements. Our industry discussions suggest that there is a huge amount of ground still to cover to ensure a smooth transition, and that much is still to play for as firms jockey for position.

But over time this regulatory change is also likely to have strategic implications. The total amount of research consumed is likely to fall, and who bears the current $5 BN cost of research is also likely to change. The suppliers and providers of research must be prepared to respond to a market that is likely to adapt rapidly over 2018, and may move towards a competitive structure that is both more concentrated and more heterogeneous. Research unbundling looks set to increase the advantages of scale on both the buy and sell side, pressuring mid-sized players. Yet, it will also create opportunities for specialist models that can offer what the larger firms cannot.

IMPACT ON INVESTMENT MANAGERS

Because research until now has had no marginal cost for investment managers, they have had little incentive to ration their consumption. Now that they will pay for research, many investment managers plan to reduce the amount they consume. The research providers and investment managers we surveyed, on average, expect a reduction of 10–30% in spend. The reduction will not be uniform, however. Some investment managers expect little change, while others plan to reduce their research spend by 50%.

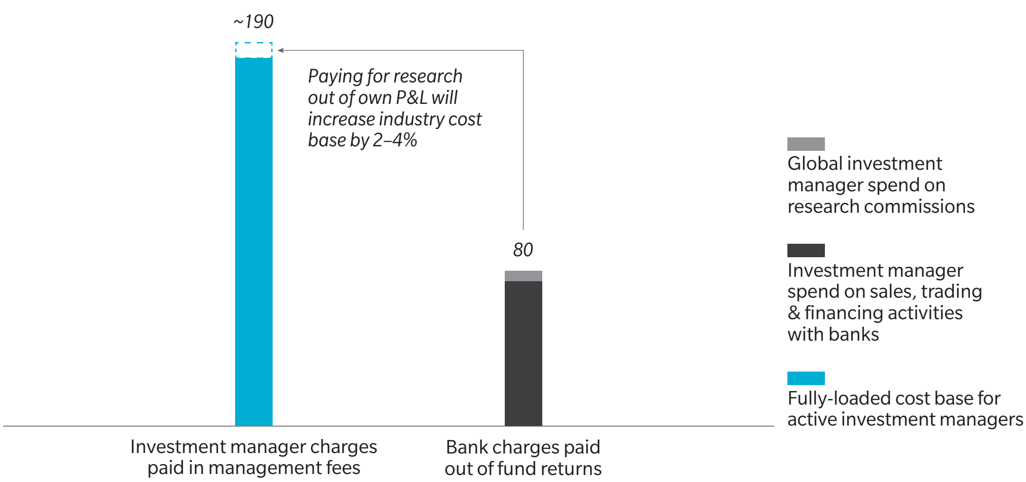
Investment managers are planning to cut lower quality providers, with many expecting to focus spend on a core of group of 4–6 global suppliers and a long tail of select specialists. While the MiFID II rules only apply to European investment managers, many plan to apply the same approach globally to reduce operational complexity, costs and compliance risks. Based on discussions with large global and non-European investment managers, we expect between 40% and 60% to apply this rule globally in the short term, with the number likely to increase over time.

Of course, supplier selection will also be guided by price. And we have started to see signs of a price-war emerging as research providers compete to retain clients. Investment managers will balance the trade-offs between cost, quality and complexity.

A key consideration for investment managers is whether they should continue to pass on the cost of research to their end-clients. This is a complicated decision.

While research costs represent only a relatively small proportion of the total charges paid by end investors, absorbing them is a material expense for a fund manager. Our estimates suggest that research costs make up on average only 1–3bps of the total charges of active managers of ~60bps that are ultimately bourn by end investors. Yet absorbing these charges could add 2–4% to operating costs for asset managers, equivalent to a 4–7% profit reduction. This is an unpalatable prospect in an environment where many fund managers are under pressure to cut costs.

Exhibit 1: Active investment manager cost and spend with banks
$BN, 2016



Note: Based on active investment managers across fixed income and equities

Source: Oliver Wyman proprietary data analysis

Passing research costs onto clients raises its own challenges. MiFID II requires that investment managers justify any research costs to end-investors. This means they will need to develop new infrastructure to support the tracking, valuation and allocation of research consumption back to their funds. This is not a trivial exercise, especially for investment managers operating across multiple funds, asset classes and geographies. There is likely to be an incentive for investment managers with simpler fund structures and sizable trading flows to continue to pass the cost to end-investors.

A growing number of firms have elected to absorb the costs, partly reflecting this operational complexity, but also in light of broader strategic considerations. Many managers are keen to get ahead of the industry and regulatory pressure to pass fewer costs directly to clients, and are hoping to reap potential benefits in marketing and compliance.

Given the complexity of the decision, many investment managers are still undecided. A recent survey by the Financial Times of around 60 investment managers found half (measured by AuM) to be still undecided. Of those that had decided, 60% by AuM have elected to absorb the costs. This is further complicated by the fact that the operational regulatory burden only applies to European investment managers, potentially creating an uneven international playing field.

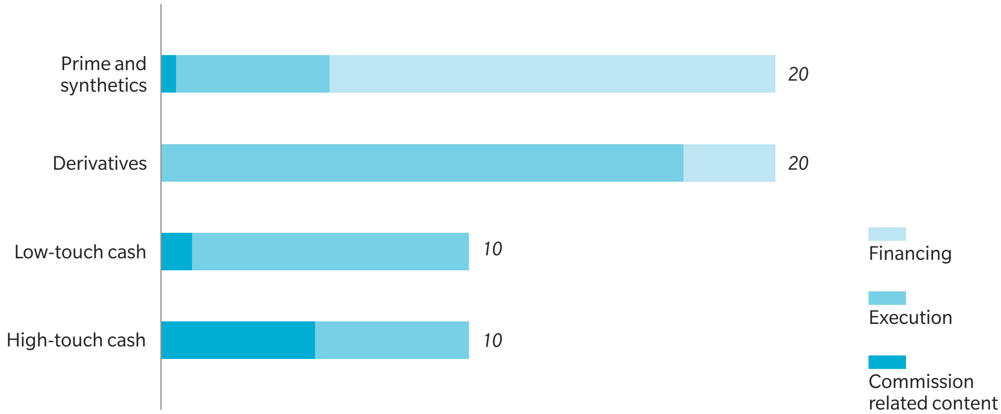
Absorbing research costs will be disproportionately burdensome for small and mid-sized investment managers, and especially those with diversified offerings. Research is one of the costs in investment management that does not increase in direct proportion to AuM, being more closely connected to the breadth of offering. As such, smaller firms will not be able to afford such a wide range of external research providers, nor will they be able to rely on the in-house research teams available at the largest investment managers. Small and mid-sized firms, particularly those focused on Equities, may need to substantially reduce their consumption of research or pass the cost to end-investors, which means being able to justify the use of research through differentiated performance.

Unbundling is also making many investment managers review the size and role of their internal research teams. Pressure to justify the value of external and internal research should encourage investment managers to explore advanced digital techniques and more systematically analyse the way information is used to drive better long-term investment strategies. Irrespective of who pays for research, those who optimise research consumption and invest in technology to better incorporate research into alpha generation can at least partially outweigh the incremental cost of research or return drag.

WHAT IS AT STAKE FOR THE RESEARCH PROVIDERS?

In Equities, about half the high-touch cash commissions and slivers of low touch and single-name swaps currently paid to banks are attributed to research and content. This represents $5 BN of revenues annually, or 8% of the total global Equities revenue pool. The rest of the $60 BN revenue pool is generated by financing, risk management and execution.

Exhibit 2: Breakdown of total global equities sales & trading revenues
2016, $ BN



For Fixed Income there was no designated spend on research as bank revenues were captured in the spread. Given this starting point, the majority of price decisions have taken longer and have resulted in much lower prices than Equities. While for banks this is all upside, few expect unbundling to generate more than single digit millions in revenues. For investment managers, the impact will be a minor additional cost burden.

Some banks have responded to the prospect of intense price competition by deciding to publicly distribute research for free. This option is allowed under MiFID as long as it is available for general consumption. While this would enable them to retain the benefits to the group, it poses risks for the industry. Investment managers would need to ensure there were no inducements to trade on this research. And banks would need to ensure compliance by not linking execution pricing with the provision of research and not, therefore, benefitting from this free distribution.

The largest unknown is the effect of execution-only prices. The need to reward a wide panel of research houses through execution commissions has effectively capped the market share possible in execution. By removing this effect, and putting increased emphasis on the cost of execution as a service in itself, the new rules could lead to significant fee pressure and consolidation of flows around the most cost-effective providers. Specialist execution houses offering technology-driven platforms see this as an opportunity to take share, while the largest banks may look to capitalize on their scale advantages and push for further market share gains. Yet some banks are sanguine about these risks, hoping that the increased transparency will allow a more honest conversation with investment managers on fees and the value provided across execution, access and financing.

We could also see a fight for talent emerge as the best analysts and sales people start to get a dollar number associated with their performance. This is likely to benefit larger providers who can afford the costs and are less at risk of losing individual star-performers.

The table below sets out a range of scenarios for how the industry could evolve. Our base case estimates a combined reduction of spending on research and execution of ~$1.5 BN. If a full-blown price war emerges under pressure from investment managers, and content-leaders are unable to retain pricing power, this could rise to ~$3 BN.

Exhibit 3: Response to unbundling – 3 Scenarios

SCENARIO	SCENARIO DESCRIPTION	INVESTMENT MANAGER PREFERENCES	IMPACT ON BANKS AND RESEARCH PROVIDERS
Base-case 2–3% reduction in EQ revenues[1]	• Select banks start a price war, but leaders don't compromise on price levels • Low-Middle quality research providers see sizeable reduction in spend and market sees flight to quality	• Selection of 4–6 global full-scale providers based largely on quality and competitive pricing • Tail of >10 specialist providers including independent research houses, select parts of water-front providers, and domestic/asset specialists	• Investment manager revenue reduction of 3 to 5% to $29 BN[1] – 20–30% reduction in research spend – 50% take-up globally – Compression and consolidation of 10–20% of impacted execution flows – Independent research houses able to justify higher price points and capture revenue
Significant price-competition 4–6% reduction in EQ revenues	• Investment managers prioritise cost reduction • Banks start a significant price war, with leaders forced to lower prices to compete • Specialists/independents unable to justify cost • More banks start to provide for free and public consumption	• Selection of 2–3 global full-scale providers based on quality • Selection of 3–7 low-cost providers to supplement/challenge global quality providers • Smaller tail of providers given cost-pressures from price war • Asset managers believe price war not an inducement risk	• Investment manager revenue reduction of 8–10% to $27 BN[1] – Significant and global take-up of unbundling with reductions >30% – Reductions in high-touch commissions as ~30% compress and consolidate – Narrower selection of specialists given need to justify outsized spend
Moderate rationalisation <1% reduction in EQ revenues	• Investment managers continue to demand access to majority of content/advice • Limited reduction in spend from investment managers	• Majority of investment managers retain access to 8–10 global providers • Some price negotiation but value of relationship important	• Investment manager revenue reduction of 1–3% to $29 BN[1] – 10–15% reduction in research spend – Global take-up limited to large Global IMs – Compression and consolidation of execution spend limited to EMEA with <5% impacted

1. Based on $60 BN total industry Equity revenues

Source: Oliver Wyman proprietary data and analysis

STRATEGIC IMPLICATONS FOR BANKS

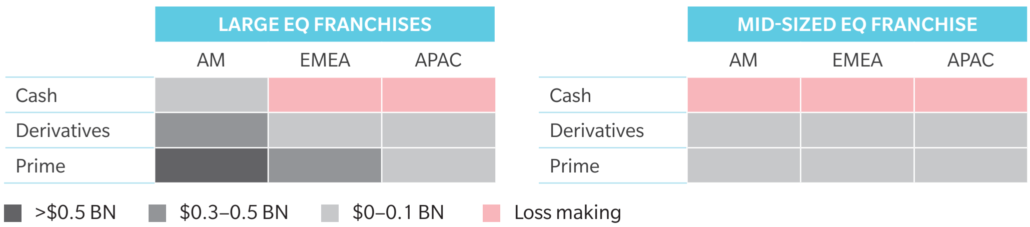
The immediate focus for banks is to sign up clients, agree commercial terms and implement the operational enhancements needed to track usage and receive payments. Beyond these client-facing imperatives, we see three near term priority internal levers to help adapt to the new model:

1. **Continue to refine the research model**. Banks have already been working to leverage new technologies and shift their efforts from low value activities, such as commoditised stock reports, towards more valuable research activities, such as providing investment managers with proprietary data sources and access to analysts and the corporates they invest in. Unbundling will accelerate this trend, in part by requiring research teams to better articulate and demonstrate their value to end-clients.
2. **Putting in place new sales and coverage processes**. In both Fixed Income and Equities, there are concerns that unbundling could affect client coverage models. Banks without a research agreement in place with clients could find it difficult to service them more broadly, as sales people will have difficulty in providing advice without overcoming additional compliance and operational hurdles. Unbundling could fundamentally change the role and dynamic of sales interactions.
3. **Re-orienting towards other user groups**. Research is consumed and valued by many other parts of the Group, such as IBD, Wealth and Corporate. Yet the economic contribution to the cost of research today varies widely across these areas and across banks. As more focus is placed on the "P&L" of research, some banks are likely to revisit these economic arrangements. More fundamentally, where these user groups are seen as critical, banks may need to adapt the nature of their research output to focus more on the needs of those clients groups, rather than institutional clients.

These initiatives should help defend the economics of the research platform. Add to that the strong internal and brand value associated with research and it seems unlikely that unbundling will drive large scale exits from research in the near term. But over time it could help accelerate shifts in the competitive structure.

The revenue pressure from unbundling will be a further challenge to profitability in Equities, in an industry that has become heavily scale-driven. We estimate that over the last three years the largest four banks have captured 70% of all profits available, up from 50% in 2012. With high fixed costs, growth is the surest way for mid-sized players to boost returns. Yet it is impossible for all banks to increase their market share and build scale. It may well be the mid-sized players that lose the most as unbundling plays out. Some may be better off moving towards a more focused model, for instance built around balance sheet or risk provision, execution partnerships, or realigning the division to support other elements of the group.

Exhibit 4: Profitability of Equity divisions
$BN 2016



For independent research houses unbundling is a game-changer. Unbundling will have limited effect on the operations for those that already explicitly price their services, such as Autonomous and Capital Economics, but for many others they face the same pricing questions as the banks. However, unbundling eliminates a pricing advantage banks had over them and forces banks to adopt the model that many independent research houses are already well-experienced in operating. The unbundling of research spend presents an opportunity for independent research houses to capture a previously trapped revenue source if they can demonstrate superior quality and service. However, they will come under considerable pressure if prices and spend levels drop significantly given the punitive fixed costs and scale challenges of running the platform. Similarly, independent providers able to offer lean technology driven models in execution look set to gain share.

CONCLUSION

Research unbundling comes at a time of heightened pressure on investment manager fee structures, with many managers looking to build scale and drive cost efficiencies. Research providers offering broad access to quality content at competitive prices will be well placed to meet their needs. Investment managers are also redoubling efforts to demonstrate differentiated performance, and this will accentuate demand for access to insightful content from providers with true edge in their chosen areas.

Banks can respond to unbundling with tactical changes in the way they produce research, cover its cost, and approach sales coverage across FICC and Equities. But with $1.5 BN in potential lost revenues and a new jockeying for position across banks and independents, research providers are entering a critical phase. With many operational steps to be worked through and uncertainty about how far and how fast the change will run, few will make bold strategic moves before 2018. Yet with the environment likely to evolve rapidly, executives would be wise to prepare a playbook and think through a range of strategic options.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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