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Research Retrenches as Sell-Side Retreats

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It's a common expression: A rising tide lifts all boats. On the other hand, a falling tide leaves many treasures for those who are willing to do the legwork. As sell-side research coverage continues to decline, there are many opportunities for fund managers that are willing to look at under-covered names, and there is an emerging set of tools that can facilitate that process.

The latest factor in the ongoing transformation of the research industry is the 2018 implementation of the European regulations known as MiFID II. These regulations are having a domino effect and ushering in global changes in the way research is produced, consumed and paid for by everyone involved. However, MiFID II is only the latest shakeup reshaping the industry.

[Related: "Decoding the Effects of MiFID II's Research Rules"]

The market of the past decade was defined by lower trading volumes, decreasing trading revenue, an increase in passive allocations and a resultant drop-off in sell-side coverage of small- and mid-cap stocks. As banks and broker-dealers pull back, opportunities have revealed themselves in the information void that has emerged. This includes new sources of data, including third-party financial models which are usually more consistent, more detailed, available across a broader universe of equities, and conflict-free. The fund managers that can best pivot to this new landscape may emerge as the alpha winners going forward.

15 Years of Sell-Side Contraction

That neglect is the result of years of eroding sell-side coverage, set in motion by the Global Research Analyst Settlement finalized in April 2003. That (finally) recognized the conflict of interest in having analysts produce favorable research reports on investment banking clients while also being compensated by the same entities. Besides instituting a number of firewalls between research and banking, the order mandated that research departments' funding would have to come from commissions on trading, and not from underwriting. That started the sell side's contraction, now compounded by decreasing equity trading volumes, a long period of lower volatility and a decline in the number of publicly traded companies – capped off by the implementation of MiFID II.

The number of U.S. publicly traded companies has dropped over the past 20 years. From a high of 8,000 in 1996 to 4,330 at the end of 2016, lower IPO issuance and higher M&A activity has driven a large number of firms to go – or remain – private (EY paper: "Looking behind the declining number of public companies - An analysis of trends in US capital markets," May 2017). Abundant capital from private equity and venture firms allows portfolio companies to stay private longer, unbound by the restraints of a public listing. Acquisitions are also rising, as corporations flush with cash pursue strategic takeovers of both private and public companies.

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As the sell side pulls back coverage, information dislocation increases, particularly with small-cap stocks. Less sell-side coverage means more companies with no or minimal coverage, increasing the chances of security mispricing. The number of companies in the Russell 2000 with no sell-side coverage jumped 30% in the past three years.

Passive Investing

No trend affects the investment industry more than the re-allocation of investors' assets from active to passive strategies. Outflows from active-managed mutual funds have topped $1.2 trillion since 2007, with $1.4 trillion going into index-based strategies over that same period. ETFs now represent almost a quarter of all trading volume. In 2016, seven of the 10 most actively traded shares on U.S. markets were ETFs.

These flows have put additional downward pressure on the ability of investment banks to invest in research. Estimates have shown that research budgets at major investment banks have fallen, from a peak of $8.2 billion in 2008 to $4 billion in 2016.

[Related: "Unintended MiFID II Consequences: 'Information Asymmetry' and the Sudden Need for Research Spending Data"]

The concentration and correlation produced by this flood of capital reduces alpha opportunities for many major indexed stocks. However, when viewed correctly and backed by reliable data, managers may find alpha in neglected equities.

A Model, Upended

While MiFID II is a European directive, it affects U.S.-based fund managers too, given the cross-trading nature of the business and the presence of large Euro-based banks in North America. The requirement for asset managers to pay for research directly or to pass the cost on to their customers (vs. from trading commissions) is upending the entire relationship, with significant ramifications for both parties:

- **Asset managers** – They must justify their research spend carefully. Many smaller and mid-sized firms, faced with dwindling options for external research, will have to seek new sources for industry analysis and financial model coverage. Human capital and technology will have to be leveraged to stay ahead of the information flow in order to seek out new ideas and confirm existing ones.
- **Investment banks and broker-dealers** – Faced with shrinking buy-side demand, low-value commoditized research will need to be transformed into more specialized output (e.g., by sector or geography) that clearly adds value to alpha-generating opportunities. The sell-side research function will need to adjust staffing, coverage and delivery models to run as an independent profit center amid a new reality.

As the sell-side focuses on its largest clients, smaller fund managers are being shut out from access to data and analyst conversations. A dearth of external models to verify internal analysis may lead to other errors. As gaps in information related to company-specific drivers grow, forecasting projected outcomes (operating metrics, earnings) gets harder, due to a lack of verifiable inputs.

Dislocation and Opportunity

A gap in available information means there may be hidden gems for managers willing to turn over some rocks and be patient with their positions. The number of companies in the Russell 2000 with no sell-side coverage has jumped 30% in the past three years. The end result? Greater alpha potential for those managers that can leverage their internal resources more effectively.

Managers that take advantage of this changing opportunity set must re-evaluate their proverbial research arsenal and determine what information sources are the most valuable, what can they pay, where can they get it and its impact on portfolio performance. Alternative data providers, focused on quantifying patterns across reams of data, can provide needed insight into both macro and company-specific trends that can affect an investment thesis.

However, managers will still need access to clean, unbiased company models that serve at the heart of the investment process. External providers in this space will need to be able to offer fund managers:

- Access to fundamentals for a wide range of companies, across market capitalizations and across industries;
- Timely updates to best reflect changes based on corporate events and earnings;
- Clean data and forecasting tools, without relationship bias

Sell-side research has always and will continue to serve a useful function in the capital markets. A few superior analysts will have commanding knowledge into a particular industry or company and that will always be coveted by the buy side. However, the research producing operating model is clearly going through a period of upheaval that started long before the introduction of MIFID II. The new regulation only pushed down on the gas pedal, exposing research's true value to the asset management community.

Managers, for their own part, are going to learn how to navigate this new world order. Already being squeezed by the outflows from active to passive strategies, many firms will be unable to afford the information and data points from the sell side, leading to the adoption of new sources for investment thesis construction. The managers that can most effectively re-make their internal research efforts with new sources of data and models might very well find themselves staying on the right side of the trade.

James Rife is the head of equities and co-founder of Canalyst, an independent equity analysis platform for investment professionals based in Vancouver.