Post-MiFID II Global Research Spending Asymmetry: Will It Lead to Wider Asset Manager Performance Dispersion?

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Neil Scarth
Frost Consulting

As European asset managers adjust to MiFID II unbundling rules, data reveals significant research spending divergences depending on whether research is paid for by the asset manager or the asset owner. Will these research spending differences be reflected in the (already wide) dispersion among active asset manager returns?

Frost Consulting has been building a comprehensive research spending database/benchmarking product – FrostDB. The platform measures research spending by investment strategy across dozens of variables including investment style, geography, and critically, whether research is paid for by the asset manager or the asset owner. The exercise has revealed startling early indications of significant research spending divergences. What are the implications?

Key Observations:

- Average research spending by managers using client money is multiples of the spend by managers using their own P&L.
- These multiples vary significantly by strategy.
- There are very wide ranges of research spending between P&L managers.

As summer draws to a close in Europe, MiFID II is in full swing, and a soon-to-be oft-repeated seasonal pattern is unfolding again. MiFID II managers are now preparing for their second set of research negotiations: with asset owners, with research suppliers, and for the many managers funding research via their P&L, with their CFOs.

This requires an eye to the future, but also one to the recent past, as senior management begins to assess the long-term impacts of the MiFID II policy decisions they made in the run-up to January 2018. The longer-term impacts of those policies won't likely be clear for some time.

And, for all the finality of the MiFID II deadline, there are still substantial uncertainties for senior managers and investment teams to consider going forward:

- *The regulatory enforcement regime is unclear.* In the UK, the FCA has started a Thematic Review of asset managers' responses to MiFID II research regulations, but it remains to be seen when this will conclude and what, if any, enforcement actions will be taken. How does the requirement for ex-ante research valuation criteria square with the fact that many managers have signed low-priced platform access fees – with prices determined by banks?
- *Research 'price discovery' is far from complete.* Assumptions made by both asset managers and research producers about levels of product/service consumption have been suspect, meaning that research pricing is not likely stable.

- *The impact of manager MiFID II research policies on investment teams and their performance is not yet clear.*

  A recent survey of European asset manager CFOs and COOs highlighted these uncertainties, as 80 percent said their MiFID II research processes were not set in stone. Chief concerns included:

- Impact on the investment process/insufficient research
- Impact on PM/analyst time (counting documents for research valuation)
- Regulatory enforcement
- Inability to answer client research questions at a fund/product level (as many P&L managers have reverted to a firm-wide research budget).

Ironically, for all the attention devoted to research payment mechanisms, it was notable that 97% of the respondents thought that asset owners would not be more tolerant of manager underperformance because they were no longer being charged for research.

So what can we discern at this stage?

The FrostRB Research Database/Benchmarking project is in the process of compiling research spending data from hundreds of investment managers running thousands of funds/investment products across numerous variables. Early analysis suggests a significant divergence of research spending, with the major variable appearing to be whether managers are funding research via asset owner charges or via their own P&L.

Most observers expected the widespread move by European managers to fund research via P&L to lead to lower research budgets at P&L managers, given the direct link between research spending and profitability. (Credit Suisse estimated that the average European P&L manager would reduce the research budget by 50%).

This is a function of "research cost asymmetry." The cost of research to the asset owner is very low – usually low single-digits basis points versus long-term equity returns of ~700 Bps. However, when the cost is transferred to the P&L of the asset manager, it is frequently the largest cost after salaries (explaining the research budget cuts by P&L managers)

The Frost database exercise has illustrated the stark divergence in the levels of spending between P&L and client money managers. This leads to the wider question of whether these research spending differences will be reflected in the (already wide) dispersion between active asset manager returns? A limited sample below imparts a flavour of magnitude of these divergences.

Initial High-Level Results

Managers using client money heavily outspending P&L managers.

Huge spending range amongst P&L managers.

Wide performance variance before the impact of MiFID II.

Equity Fund Type	Res. Spend: Client Money vs. P&L	P&L Budget Range (H-L)	Diff. 1st/3rd Quartile Performance (Bps)* 1 Year	3 Years
North America	2.7 X	125 X	1083	330
Europe	3.8 X	33X	608	456
Emerging Mkts.	7.5 X	101 X	859	2491**

*Sources: * SPIVA – Dow Jones ** FE Trustnet (Fourth Quartile)*

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The sheer magnitude of these spending differentials – at a time when margin-strapped research producers (both investment banks and independents) have to move research capacity toward clients that can pay – raises serious questions about whether the already large performance differentials between quartiles will widen further.

Given the significant performance differentials between the return quartiles, the elimination of a small research charge might represent a false economy for asset owners.

US asset managers, almost entirely funded via client money, currently appear to enjoy a substantial research spending/information advantage relative to their European competitors.

A question is whether they will a) recognize this, and b) attempt to lock in this competitive advantage by convincing regulators and asset owners that the current research spending mechanism is in their best interest.

The SEC "No Action" Letters allowing US banks to accept hard dollar payments from MiFID II clients will expire in April 2020. This will likely spur a debate about whether the US should follow the European lead. This in turn may be influenced by the performance of funds where research spending has been significantly reduced.

Depending upon those return outcomes, asset owners may also develop a more nuanced view of the research spending question. Pension funds frequently pay large management fee premiums to gain access to products like alternatives. They may conclude that a minor research charge is a small price to pay in conventional investment products to ensure that the strategies in which they're invested have the research access that has generated the product's historic return.

Performance differentials may be a large multiple of research costs.

Key Questions

- Asset Managers Using Client Money: Are we a statistical outlier?
- Asset Managers Using P&L: Are our research budgets competitive?
- Asset Owners: What potential performance risks stem from disparities in research spending?

At this critical juncture of industry change, research spending data will be of significant interest to asset managers, asset owners, consultants and regulators.