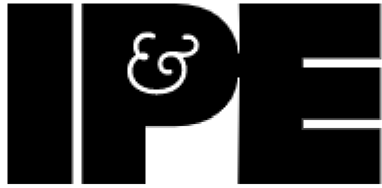


CURRENT EDITION

IPE magazine
February 2021

Briefing: The sum of all fears

BY NEIL SCARTH FEBRUARY 2021 (MAGAZINE)

Three years on from the onset of MiFID II, market participants, governments and regulators are assessing its outcomes and considering adjustments.

- MiFID II has led European managers to fund sell-side research from their own P&L, lowering transparency on research spend
- The SEC will not adopt the European style of research spending
- This has led to funding gaps between European and US asset owners with US managers potentially at an advantage

Overall, well-intentioned attempts to introduce transparency into the investment research value chain may be resulting in unintended consequences that work against the long-term interests of asset owners such as pension funds.

European asset owners and their consultants should undertake a transparent and apolitical 360-degree review of whether their current manager research approaches, including encompassing the research processes of their underlying managers themselves, are designed to deliver their long-term objectives.

MiFID II: 20/20 hindsight

From an asset owner perspective, MiFID II research provisions were designed to:

● Increase asset owner research spending transparency;

● Reduce asset owner performance risk stemming from asset manager ‘overspending’ on research.

As a result of the widespread move to fund research budgets through P&L (profit and loss) by European asset managers, the contribution of European asset owners to European manager research costs has plummeted to near zero. In contrast, US asset owners continue to fund over 90% of US manager research budgets, an approach endorsed by the US Council of Institutional Investors, the CFA Institute and the SEC Investor Advisory Committee.

In Europe, some outcomes have been the opposite of the regulator’s intentions:

● Manager research spending transparency has been eliminated (P&L managers have no requirement to inform clients of changes in research budgets);

● Significantly greater risk to asset owner returns, as any research 'savings' from P&L managers have been overwhelmed by manager research budget cuts leading to significant variance in fund returns.

European asset managers and consultants could be missing these trends.

MiFID II and the emergence of ESG have posed the biggest challenges in generations to the investment processes of active equity managers. Yet most asset owner/consultant manager evaluation approaches remain designed for an environment that no longer exists.

This comes down to an elemental understanding of the components of equity returns. European asset owners universally analyse manager trade costs but are routinely ignorant of large changes in research spending that can have a far greater impact on returns.

If asset owners believe that research adds no value, the question remains as to why they have spent more than $100bn (€82bn) on it over the past decade alone by our estimation. If they believe it does add value to returns, they should be keenly interested in changes to research budgets as a significant forward-looking performance risk factor – questions they have not systematically asked.

Equities return about 700bps per annum over the long term. In a severe outcome, poor trading results may result in portfolio drag of about 40bps. The potential impact of research spending is far larger.

"Most asset owner/consultant manager evaluation approaches remain designed for an environment that no longer exists"

A Frost Consulting/ EvercoreISI study found that the differential between mid-first and mid-fourth-quartile equity performance in 2019 averaged over 2,000bps in a sample of 5,400 US and European funds over 15 equity categories.

The relationship between asset owner and asset manager relative research costs was not fully understood or considered by the authors of MiFID II.

Research expenses for asset owners are low but when this cost is transferred to the P&L of the asset manager it is frequently the second-largest expense, just behind staff compensation. The inverse relationship between research budgets and manager profitability likely explains manager research spending cuts frequently (far) exceeding 50% of pre-MiFID II levels.

Research spending differentials

In the US, the Securities and Exchange Commission (SEC) will not encourage managers to fund research via P&L (under either party), owing to concerns about the impact on the research ecosystem and manager competition.

This has fostered huge gaps in research spending between US funds (using the client-money model) and most European funds (the P&L model). The FrostDB research spending database illustrates that the largest gaps are in the most research-intensive fund categories including emerging markets and small-cap

equities, where managers require dozens of globally dispersed research sources rather than just a small number of large banks (figure 1).

For example, in global equities, managers using client money are spending more than four times as much as P&L managers. While the nominal research spending numbers are small (6bps versus 1.5bps) the differential is large enough to result in a significant information advantage for the managers with larger budgets. There are also large gaps (up to 15-fold) between P&L managers themselves in certain categories.

Is this data that would be useful to European asset owners as they review existing managers and consider new ones? What is the impact of changes in strategy research spending on the relevance of historic returns – which are frequently the central factor in product purchase decisions?

Performance impact?

Frost Consulting and EvercoreISI analysed four years of performance data (starting in 2016 – pre-MiFID II) from about 5,400 transatlantic equity funds with cumulative AUM of about $9.3trn across 15 equity categories. The key findings were:

● Over eight annual observations (measuring funds by arithmetic and weighted AUM averages annually), US managers outperformed in seven of eight instances and captured 80% of the cumulative outperformance;

● In 2019, US managers captured over 90% of outperformance;

● In 2019, US managers outperformed by $245bn versus a research cost of $6bn, illustrating the fact that research costs are dwarfed by performance differentials;

● This relationship has held regardless of market direction (2018 MSCI World -8.26%, and 2019 +28.4%).

Even if this performance data does not denote linear research causality, there is enough evidence to suggest that differences in category research spending are almost certainly a performance risk factor.

COVID impact

Post Brexit, EU regulators have been re-examining the impact of MiFID II. The COVID market drawdown added urgency and a new critical data point to their deliberations.

In Q1 2020, equity index levels rapidly dropped by 20%. This immediately reduced asset manager AUM levels (and revenue) by a similar amount. Given the operating leverage of the asset management model, European manager Q1 pre-tax profits fell by about 50%. This is the pool from which the research budget is derived.

European regulators suddenly faced the alarming realisation that, the lower markets went, the less research P&L managers would be able to access, given diminished manager profitability.

Had markets not rallied, European P&L managers would have had to drastically cut research budgets from already-depressed levels.

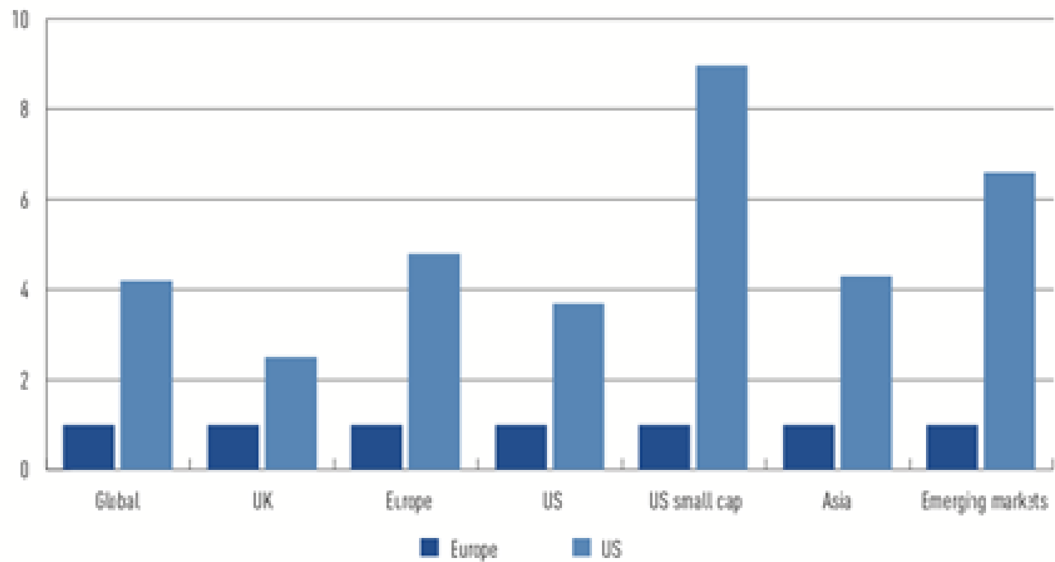
This accelerated the post-Brexit MiFID II review in the EU. The European Commission’s Emergency Pandemic Financial Package suspended MiFID II research rules for small-cap stocks with a market cap of up to €1bn. These limits may remain under review. The UK FCA is considering how it will respond to this change.

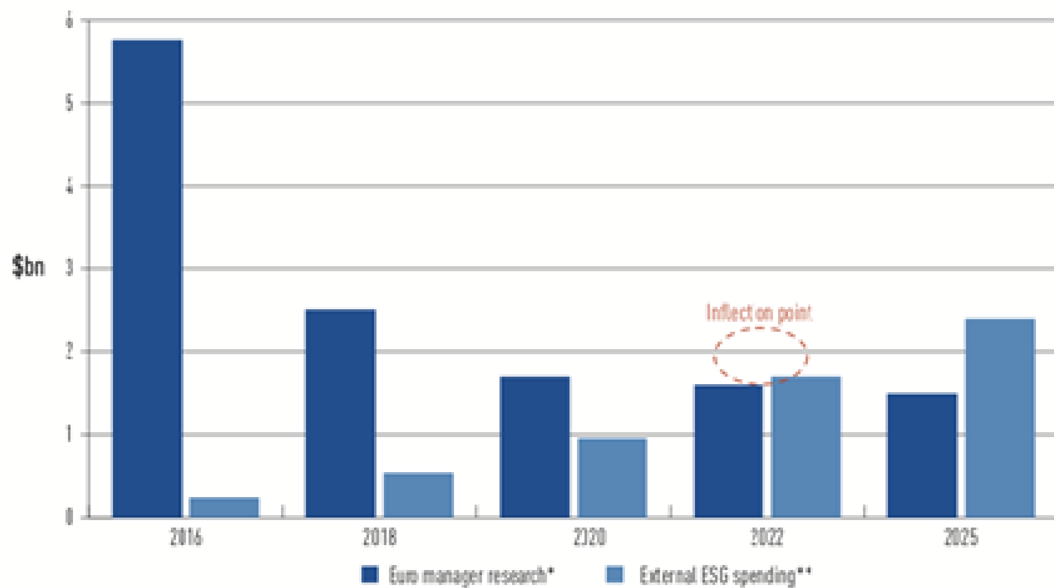
ESG implications

While active equity managers in Europe have benefited from the AUM growth in ESG strategies, this has required more complex research inputs. Additionally, European regulation (SFDR) will soon require European managers to integrate ESG variables into all fund products.

Managers must incorporate expensive ESG inputs including databases/proxy advisers to serve both ESG and traditional fund strategies. The cost of these inputs are rising steadily.

UBS estimates that managers spent $2.1bn globally on ESG research/data in 2020, rising to $5bn in 2025. This suggests that ESG spending will soon substantially eclipse existing European manager fundamental research budgets. Something has to give. Combined with declining fund fee levels, European ESG objectives may not be ‘sustainable’ (figure 2).





In addition, manager internal research spending, including ambitious stewardship goals, far exceeds external ESG spending.

The ironic position

European asset owners expect their managers to integrate ESG variables. Yet, as a result of the move to fund research via P&L by European managers, asset owners make no financial contribution to the maintenance of the research ecosystem (both ESG and non-ESG).

With liabilities stretching decades into the future, pension funds have a vested interest in the sustainability of the research ecosystem. But in attempting to minimise their short-term costs (by avoiding minor research charges), they may be contributing to negative long-term outcomes.

European ESG objectives are subject to a massive funding duration mismatch. Europe is attempting to finance long-term goals such as carbon neutrality through asset manager research budgets set annually, based on profitability determined by AUM levels set quarterly. A sustained equity bear market would be fatal for these ESG objectives given the current funding model – unless asset managers become not-for-profit social enterprises.

In view of the lack of manager research spending transparency, ESG research budgets could already be falling at some asset managers, which asset owners likely do not expect.

The MiFID II regulatory approach has unhelpfully positioned asset managers/asset owners as adversaries. Yet both parties share one critical common interest – that the investment manager's product achieves its targeted return for end-beneficiaries. Our ESG Framework for Asset Managers/Asset Owner Research Collaboration report from May 2020 offers a simple solution to the funding dilemma. If asset managers are willing to be transparent about (benchmarked) research costs, asset owners should be willing to contribute to research funding.

It would be a cruel irony if, when the world finally begins to focus on sustainability, the research inputs required to create those outcomes were not in themselves sustainable.

Similarly, if stewardship and fiduciary duty standards are applied only to external companies considered for portfolio investment, (ignoring the internal processes at asset managers and asset owners themselves) – the European investment complex, and millions of beneficiaries, may be missing the forest for the trees.

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