FrostConsulting

An ESG Framework for Asset Owner/Asset Manager Research Collaboration

Integrating ESG Approaches into the Asset Manager Research Process

Executive Summary:

- Both asset managers and asset owners are committed to integrating ESG principles into their investment processes. Yet neither have considered the ESG, Sustainability and Governance implications of non-transparent asset manager research budgets.
- Research costs for asset owners are far outweighed by the variance in returns between funds that do well and those that do poorly.
- Research budget cuts by P&L managers may endanger returns for asset owners.
- Asset owners that have not verified manager strategy/fund research budgets may have gaps in both their Fiduciary and ESG processes.
- Collaboration between asset owners and asset managers on research budgets maximizes the probability of the manager's investment product achieving its targeted returns by ensuring the sustainability of the agreed investment process.
- An ESG Research Process Rating Framework can give asset owners confidence that the manager's research budget is appropriate, sustainable and transparent.
- Asset Owners should be willing to fund manager research budgets (a small cost for them) in return for ESG-Framework manager research spending transparency.
- Asset owners that have made portfolio allocations to active managers have done so in full knowledge that cheaper passive options exist. In order for them to maximize the expected benefit from the desired exposure to active (non-indexed returns), their managers should be encouraged to execute the agreed investment strategy without the handicap of arbitrary research constraints, which undermine their process.
- An Asset Manager ESG Research Process can deliver the asset manager/asset owner alignment that MiFID II research provisions were originally intended to produce.

Introduction

This paper builds on work carried out by the CFA Institute, UNPRI, and Frost Consulting in conjunction with the CFA Institute, CFA UK, Stanford University and Evercore ISI.

This is a suggested schema for integrating the sustainability of asset manager strategy research spending into ESG frameworks and manager selection processes by asset owners and consultants.

The paper provides guidance to asset managers in terms of measures they may take to meet increasing investor demand for research transparency at the fund level.

It also suggests an ESG Framework for Asset Owner/Asset Manager Collaboration on Research with the objective of furthering the shared objective of maximizing the probability of the manager's investment product achieving its targeted returns.

This comes against a backdrop of ongoing regulatory change related to research spending. While MiFID II was an EU initiative, the impact has been global and has resulted in significant changes in asset managers research process and funding as a consequence of varying commercial strategies employed by managers in response.

This in turn has been a catalyst for asset owners to review managers fund-level research spending.

With both asset owners and asset managers seeking to integrate ESG criterion into their investment processes, the paper will examine links between ESG concepts and the impact of research spending and transparency, particularly as it pertains to the sustainability of strategy investment returns.

A critical consideration for asset owners is the fact that global regulation related to asset manager research spending is not congruent and likely won't be so any time soon. This is increasingly resulting in large gaps in research access between different asset managers, almost certainly acting as a risk factor for performance.

Global Regulatory Divergence

Regulatory Backdrop

The UK, via the FCA, played a significant role in the development of the research rules which were included in MiFID II. Yet, the global regulatory landscape continues to evolve, increasing the importance of asset owners better understanding manager research spending and related risks. We will consider three major jurisdictions.

UK

The FCA, which championed the aggressive interpretations of the MiFID II research regime, considers the regulation a success. In a recent report they noted limited evidence of a reduction in research supply, even in small cap names.

(In light of European P&L asset managers cutting research budgets by an average of 50% (Credit Suisse), the availability of research may be a red herring if manager research budget cuts restrict access to it, regardless of its availability).

The FCA estimated that MiFID II had reduced (primarily equity) research costs by an estimated £80 million in 2019. This was considered a good outcome by the FCA. For context, the UK Investment Association estimates that UK-domiciled managers run ~£2.2 trillion in active equity mandates.

The FCA's estimated research savings represent approximately 3.6 basis points of the active equity AUM. However, the cost side is only half of the equation. The FCA made no estimate of the impact of these research savings on performance.

The FCA must hope that any performance drag associated with the research cuts were less than 3.6 Bps. To put this in perspective, in 2019, a study by Frost Consulting and EvercoreISI determined that the gap between mid-1st and mid-4th quartile performance in UK equities was 1,939 basis points. The gap between the best and worst UK funds exceeded 6,300 Basis points. Both are obviously far greater than the estimated research saving.

The FCA will continue to study the effects of MiFID II. It is too soon to know whether a new UK (Conservative majority) government and a new prospective FCA CEO will have any bearing on the FCA's regulatory stance on this issue.

Brexit has also introduced a complex negotiation between the UK and the EU regarding "regulatory equivalence", which theoretically governs access to EU markets. Negotiations, however, have two counterparties.

France/EU

Post-Brexit, the AMF has assumed the mantle of the chief national securities regulator in the EU. Both the French and German governments/regulators were not supportive of the research "inducements" regime championed by the FCA in the MiFID II policy-making process.

The AMF recently released an independently authored (but AMF sponsored) review of the impact of MiFID II on research. Theirs was a less optimistic assessment of MiFID II's impact than the UK's, particularly noting pressure on the supply of small-cap research. The report made several interesting observations/recommendations:

1. French Asset Management association estimates that French managers cut research budgets by 52.5% to 75% from 2017 to 2019.
2. Underpriced research may be an "inducement". The report suggested that minimum price standards for some services could be developed at the European level.
3. Creation of a French Research Marketplace to encourage independent research.
4. That ETF providers/issuers should pay some of the active equity research bill. (No specifics on the mechanism. The AMF views passive funds as having no role in equity price setting yet benefiting from it.
5. The establishment of "representative prices" for research services. (Will this challenge the research unit consumption model?)
6. Possibly exempting small cap stocks, smaller asset managers and independent research producers (with no execution capacity) from MiFID II research requirements. ("Small" is not defined)
7. Review of "inducements" related to research at a European level by 2020.

The latter point could potentially represent a wholesale review of the key research provisions of MiFID II – which has profoundly affected the process of asset managers in Europe, and to some extent, globally.

At the pan-EU level, ESMA is conducting a detailed review of MiFID II and is expected to recommend alterations to it, although the timeframe for such action is unclear.

USA

US market participants and the SEC have been watching the unfolding events in Europe with great interest. The US has the "second mover" advantage in that it has been able to observe the evolving outcome for two years before changing any domestic regulations.

In fact, the SEC recently noted that part of its reluctance to emulate MiFID II, or to change any US policy as a result, stemmed from the fact that the European regulatory environment was still evolving.

Based on both public and private commentary, the SEC is believed to be cautious on many aspects of MiFID II, particularly in relation to the research funding model. In Europe the widespread move to P&L by managers has resulted in substantial aggregate research budget reductions.

The SEC fears that fi there was a widespread move to fund research via P&L in the US, it would have a negative effect on the US research ecosystem. They do not appear to be eager to make it operationally or legally simple for US managers to adopt the P&L model.

The net result is a very unlevel global playing field for asset manager research access.

The Importance of Research

Why does this all matter? Equity research plays a vital role in capital markets through influencing and enhancing:

Price formation that has a bearing on the cost of capital.

New issuance and capital formation.

Public/political awareness of the capital market function globally.

(A more detailed discussion of the points above in the Appendix)

Data presented later in the paper also suggests that research access very likely has an influence on investor returns.

A Collaboration Model for Asset Managers/Owners

The Frost Consulting/Stanford paper, "Transparent Alignment in Investment Research: From Unbundling to Relational Contracting" * examined the impact of MiFID II research provision from an asset owner perspective.

It concluded that MiFID II has been a sub-optimal outcome for asset owners as it has reduced research transparency. The paper challenged the inherent European regulatory position that asset managers and asset owners were adversaries. It favoured a more collaborative model.

Key Observations:

- Managers funding research via P&L hurt the short- term interests of both Investors and Managers. It may also dilute some long-term benefits of unbundling for Investors.

*Ashby Monk, Dane Rook, Neil Scarth – June 2018

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3209952

- Finding ways to encourage research transparency and reduce incentive misalignments between asset managers and asset owners should be encouraged by regulators.
- The bundled commission model raised cross-subsidization issues that may not be in the interests of asset owners.
- MiFID II regulations pertaining to asset owner approval of manager research budgets (when managers use client money for research) significantly increases research spending transparency.
- The risk to asset owners stemming from managers funding research via P&L stems from manager underspending, and the lack of a regulatory requirement for managers to disclose changes in fund research spending.
- MiFID II has had the opposite impact of its objectives. It has reduced manager research spending transparency and increased asset owner performance risk.
- Part of the widespread European manager move to P&L was based on the mistaken assumption that all asset owners would prefer that approach. That is not universally true, and a better outcome for all concerned could have been achieved through greater asset manager communication (research transparency).
- Asset owners should have the ability to benchmark manager research spending.
- Managers moving to P&L (and cutting research budgets) will make historical product returns less indicative of future performance.
- Reduced manager access to research may reduce market efficiency and be detrimental to price formation. It will also likely result in less external research being produced.
- Asset owners should be able to determine that the manager's research budget is appropriate for the strategy.
- Based on the principal of "Trust but Verify" asset owners should have visibility into manager research budgets. (This is available to asset owners whose managers are using client money for research, at least in Europe, but not for managers using P&L). In the former case, this may allow asset owners to detect manager style drift.
- Asset owner/asset manager discussions of research budgets may enable the former to pursue ESG goals.

Asset managers and asset owners should collaborate on research budgets because both parties share a common interest in ensuring that the manager's investment product has the best chance to achieve its targeted return.

New Perspectives on Fiduciary Responsibility

The UNPRI, through its work on Sustainability has updated the definition of Fiduciary Duty. The report "Fiduciary Duty in the 21st Century" * highlighted the importance of ESG in the process. (Elements apply to asset owners *and* asset managers). Key points included:

- ESG issues are financially material. Neglecting ESG issues may cause mispricing of risk and poor asset allocation decisions and is therefore a failure of fiduciary duty.

*https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century/244.article

- Investors that fail to incorporate ESG issues are more likely to face legal challenges.
- Fiduciary duties exist to ensure that those who manage other people's money act in the interest of beneficiaries and do not serve their own interests.

(Author's note: this could clearly apply to asset managers dealing with potential conflicts between buying optimal research for investment strategies and maximizing the profitability of the asset manager. Equally, it could apply to asset owners that make no effort to ensure that (undisclosed) manager strategy research budgets are sufficient to support the investment product's targeted return and/or that the agreed strategy investment process is intact).

- In the 2019 PRI Reporting and Assessment Framework, 69% of asset owners stated that they include ESG-related factors when appointing asset managers and 62% stated that they consider ESG-related factors in all stages of asset manager selection, appointment and monitoring.
- There have been fundamental changes in the expectations of fiduciaries. They must incorporate financially material ESG factors into their investment decision making, consistent with the timeframe of the obligation.
- Fiduciaries should act honestly and in good faith in the interests of their beneficiaries or their clients and should impartially balance the conflicting interests of different beneficiaries and clients.

(Author's note: This can relate to cross-subsidization issues in research).

- Fiduciaries should disclose their investment approach to clients and/or beneficiaries including information on how preferences are incorporated into the scheme's investment strategy and the potential risks and benefits of doing so.

(Author's note: This should include the disclosure of strategy/fund research budgets).

ESG Considerations: Europe and North America

In 2019, the CFA Institute and UNPRI jointly published two papers on ESG Integration:

- ESG Integration in the Americas: Markets, Practices and Data
- ESG Integration in Europe, the Middle East and Africa: Markets, Practices and Data

The reports found that in both regions, asset managers felt the impact of ESG factors was growing in importance.

Impact of ESG on Share Prices*

Affected In:	2017	2022
Governance	51.0	62.0
Environmental	22.0	44.0
Social	21.0	42.0

** Average of the two groups.*

https://www.cfainstitute.org/en/research/survey-reports/esg-integration-americas-survey-report

https://www.cfainstitute.org/en/research/survey-reports/esg-integration-emea

The reports also considered the key drivers of ESG integration by region.

Drivers of ESG Integration in Western Capital Markets (%)		
	North America	Europe
Risk Management	64.0	62.6
Client Demand	55.5	54.6
Fiduciary Responsibility	23.5	18.2
Alpha Generation	19.0	20.4
Regulation	16.5	18.2

Empirical Evidence on Research Spending and Performance Post-MiFID II

The central tenant underpinning the UK FCA's approach to research spending, later reflected in MiFID II, was that asset managers were less careful with research spending using client money than they would have been if they were using their own funds.

The FCA believed that this research "overspending" was reducing asset owner returns as the research charge (via equity commissions) was deducted from the asset owner's return.

The key MiFID II research objectives were to:

- Increase research spending transparency as managers using client money would be required to attain asset owner approval for the research budget at the fund level.
- Improve returns for asset owners through more disciplined and targeted research spending by managers.

There were numerous factors that European regulators failed to anticipate, which lead to undesirable outcomes.

There was no attempt to quantify the apparent risk to asset owners and analyse this in the context of the other side of the equation – asset owner returns.

Equities return ~700 basis points per annum over the long-term. Research charges to asset owners (pre-MiFID II) likely averaged a single digit handful of basis points. If there was "over-spending" how large was that likely to have been? 2 Basis points? 5 Basis points?

The regulators failed to anticipate that, for apparent competitive reasons, most asset managers in Europe would opt to fund research via their own P&Ls. Because the regulation focussed primarily on managers using client money, there was no requirement for managers using P&L to disclose changes in research budgets to their clients. This vastly <u>reduced</u> research spending transparency for asset owners in light of the widespread move to P&L in Europe.

There was little appreciation of the research cost asymmetry between asset owners and asset managers. A very small research cost for asset owners (a handful of basis points of AUM) was frequently the second largest cost to managers (after staff compensation) when transferred to the P&L of the asset manager.

For asset managers, this created a vexatious conflict of interest between buying an optimal amount of research for the strategy (benefiting the client) and maximizing the

profitability of the firm. The result was a significant potential misalignment of interests between the clients of the asset manager and the shareholders of the asset manager, raising the fiduciary issues referred to earlier.

Few asset managers and asset owners have discussed this openly. (A shared ESG commitment may provide a framework to do so).

Two years on from the start date of MiFID II, there is no debate that P&L managers have cut research spending sharply. Some examples:

- Credit Suisse has estimated that in 2018 (the first year of MiFID II), P&L managers cut research budgets by an average of 50%.
- A Liquidnet survey of P&L managers indicated that they had cut between 20% and 70% of their research counterparties.
- The AMF report suggested that French asset managers had cut research budgets by 50 -75% since MiFID II.

Risk/Reward

European regulators were possibly correct that asset managers pre-MiFID II may have "over-spent" to some degree on research. But, the quantum of that overspending is likely a small percentage of the subsequent research budget cuts that have taken place amongst P&L managers. This balance has significant implications for asset owner returns.

There are some indications that the reduction in research spending (a supposed "benefit") may have actually increased risks for asset owners, even net of the diminimous research savings from managers moving research to P&L.

The first is the scope of those research cuts. Beyond the absolute percentage decline in research budgets (which may be partially offset by lower external research prices) the Liquidnet observation related to the decline in the number of research providers used is ominous.

Most asset managers run a variety of strategies/funds/products that do not use identical research. Specialist categories including, for example, Emerging Markets and Biotech, may have extremely particular research inputs.

P&L managers that have reduced the number of research providers by 20% to 70% have very likely damaged the research supply of some strategies. In many cases, managers have arbitrarily eliminated the bottom half or long tail of their research suppliers.

While individually, these research providers may not have been important to the manager as a whole, they are frequently critical to individual strategies. This, combined with the lack of transparency about research budget changes, has significantly increased performance risks to asset owners.

By definition, asset owners are invested in individual investment products, not the asset manager as a whole. Consequently, asset owners have a fiduciary responsibility to ensure that their investment products have sufficient research budgets.

Asset managers in Europe using client money for research are required to provide budgets at the fund level for asset owner approval. Managers using P&L do not. In the absence of fund-specific research budgets, P&L managers eliminating research counterparties may be inadvertently disadvantaging some of their investment products – another fiduciary consideration.

Not all investment products require the same amount of research. Typically, investment products targeting higher returns take greater risk, and more complex risks, frequently requiring higher research budgets and specialist inputs.

Consider the following example in fixed income:

STRATEGY RESEARCH RISKS: NOT EQUAL

US Treasury Bond

Expected Return: 1.8% – Volatility: 5.0

Research Requirement: Low

Issuer (US Government) well known

Security (10 Year Treasury) well understood

EM Local Currency Distressed Credit

Expected Return: 8.9% – Volatility: 19.3

Research Requirement: Very High

Insolvent company about to re-organize under the Bankruptcy Laws of Sri Lanka

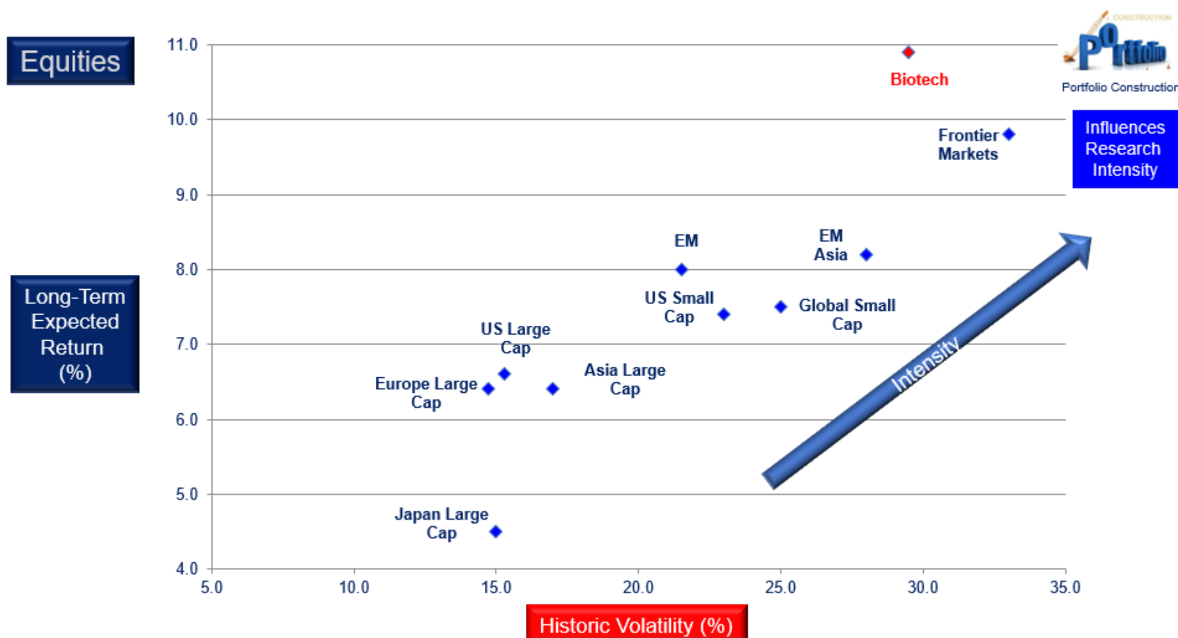
Multiple Risks

Research budgets should reflect "Research Intensity"

These strategies have very divergent expected return and volatility characteristics – as well as very different research requirements.

Similarly, in equities …….

ASSESSING RESEARCH INTENSITY: EQUITY STRATEGIES



…. expected return and volatility can be a guide to the "research intensity" of different strategies.

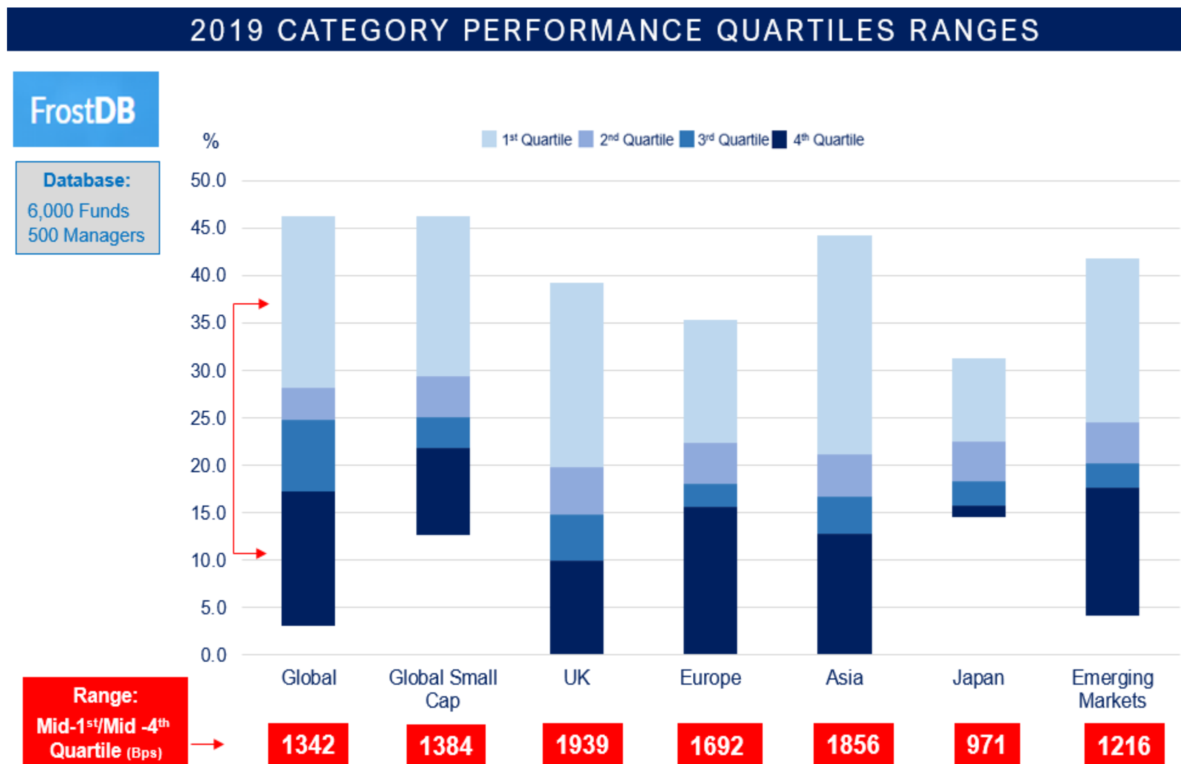
P&L managers that have assumed a central research budget level across all strategies at the firm may be creating greater research risks for higher risk/return strategies – where the need for higher research budgets and specialist research access is greatest. This creates the additional fiduciary risk that the investment process agreed by the asset manager and asset owner at the time of investment, may be compromised.

It seems unlikely that research budget cuts of 50 – 75%, or a reduction of research counterparties of 20 – 70%, would have zero impact on any strategy run by a given asset manager.

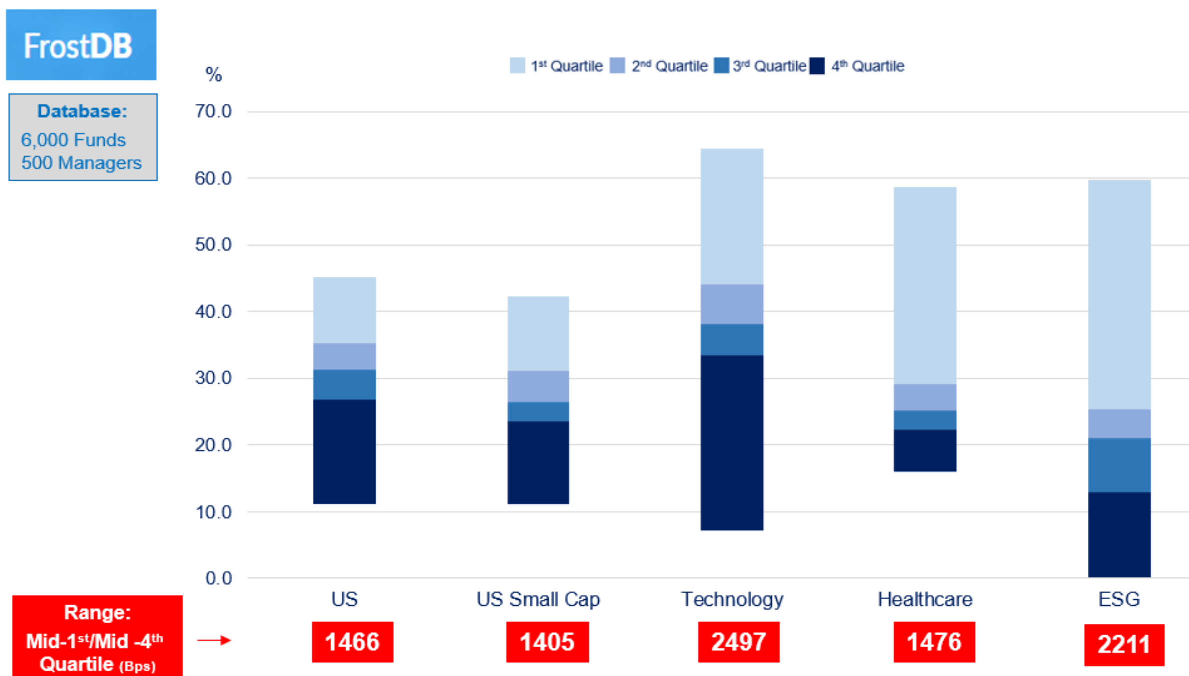
Investment teams at asset managers, who, for all the right reasons, want to consume as much information as possible to optimize investment decisions, are certainly not the ones demanding cuts in research budgets. If decisions to eliminate existing research suppliers are not made by investment teams concerned, this presents further risk to asset owners.

Another factor in the risk/reward consideration on research spending that is beyond debate, is the fact that research spending is completely dwarfed by the variance in returns between funds that do well and funds that do poorly.

Frost Consulting together with EvercoreISI has compiled the following quartile analysis of returns by equity category in 2019 based on a sample of ~5,300 funds with AUM of $9.3 trillion. The red boxes below the categories represent the basis point spread between mid-1st and mid-4th quartiles.



2019 CATEGORY PERFORMANCE QUARTILES RANGES

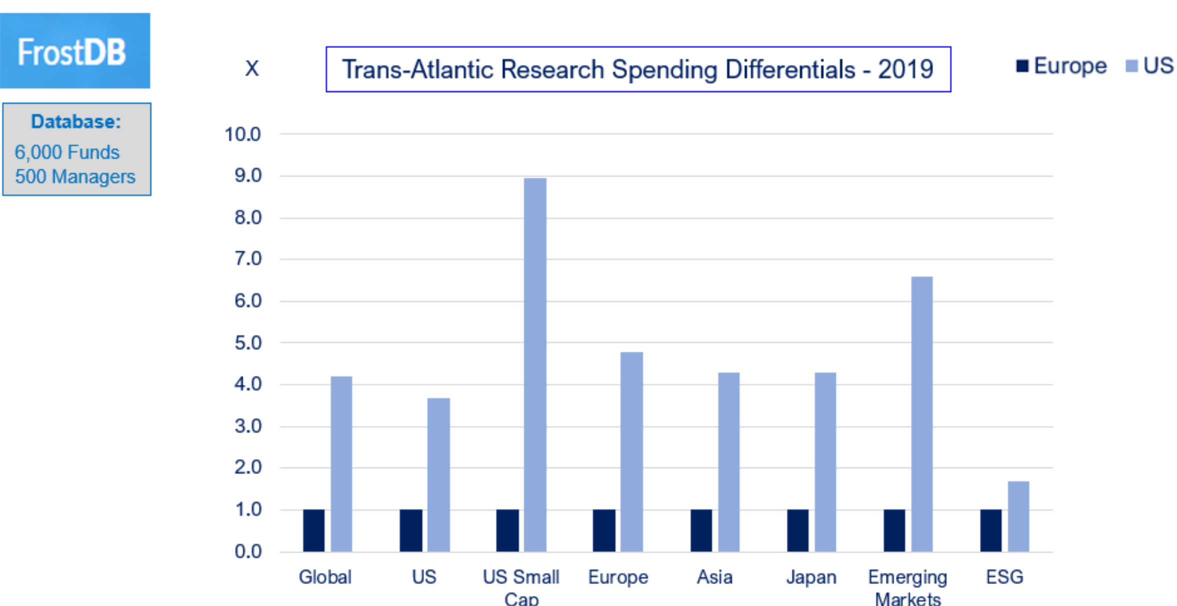


These spreads are huge multiples of any conceivable research budget. They are also widening. The average mid-1st to mid-4th quartile spread across 16 equity categories in 2019 was 1,500 basis points. This compares to an average of ~1,300 basis points in 2018.

This may be a result of significant divergences in Trans-Atlantic research spending. P&L managers, almost entirely in Europe, have cut research spending sharply. US managers, (most using client money) have done so to a much lesser degree.

The FrostDB research spending database suggests that in 2019 US managers outspent European managers on equity research between 2/1 and 9/1 depending upon the category.

FROSTDB RESEARCH SPENDING DATABASE - IMPACT OF MIFID II



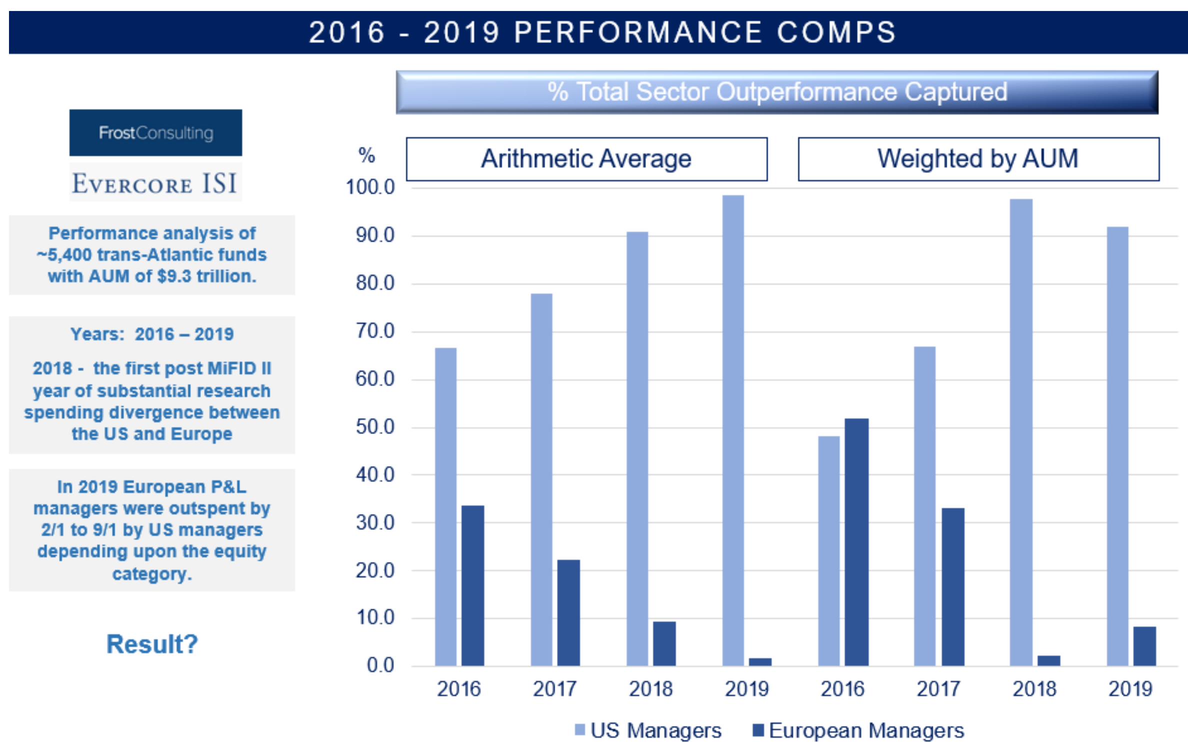
While the differentials between the groups look large, the absolute number of basis points of differential may be small (sub – 5 Basis points in most cases). However, it is a) sufficient to have a significant impact of the amount of information received by the respective manager groups and b) still a tiny fraction of the basis point performance spread between funds that perform well and those that don't.

The biggest gaps were in the most research-intensive categories including Small-Cap and Emerging Markets.

Frost and EvercoreISI has also been tracking performance of the fund sample divided between US managers (90%+ client money) and European managers (90%+ P&L).

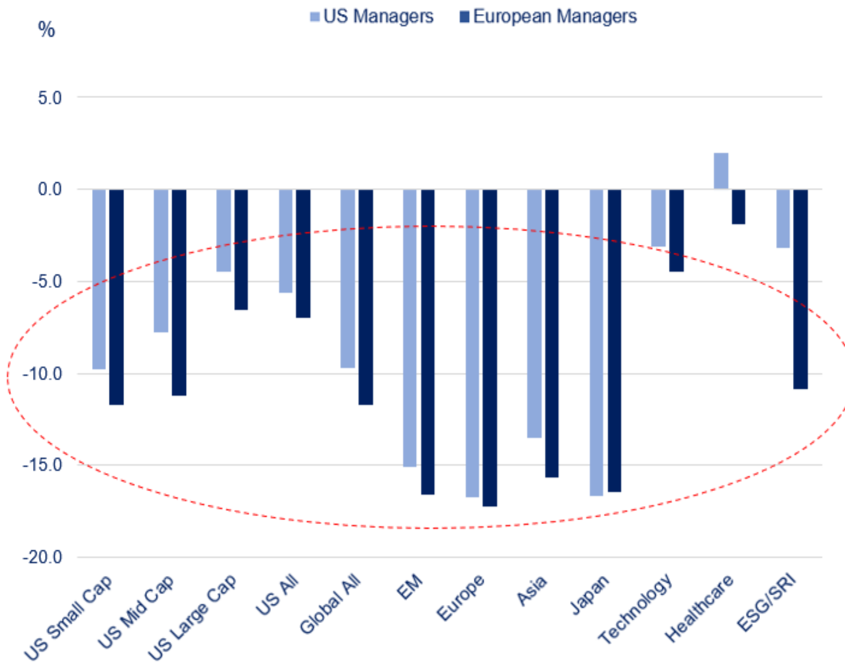
The table below calculates the quantum of outperformance across the equity categories and determines which percentage is attributable to each group of managers from 2016 to 2019. (2018 was the first year of MiFID II when research spending diverged substantially between the two groups).

This is done on both an arithmetical average and AUM weighted basis. While there are obviously many factors that influence fund performance, we believe that research is one of them.



We provide further detail below on an equity category basis for 2018 and 2019 – years with very different directional outcomes.

2018 US VERSUS EUROPE – AUM WEIGHTED*



Sector Outperformance:

US: 11
Europe: 1

% Outperformance Capture:

US: 97.8
Europe: 2.2

Avg. Sector Outperformance

US: 252 Bps
Europe: 19 Bps

Total US Outperformance

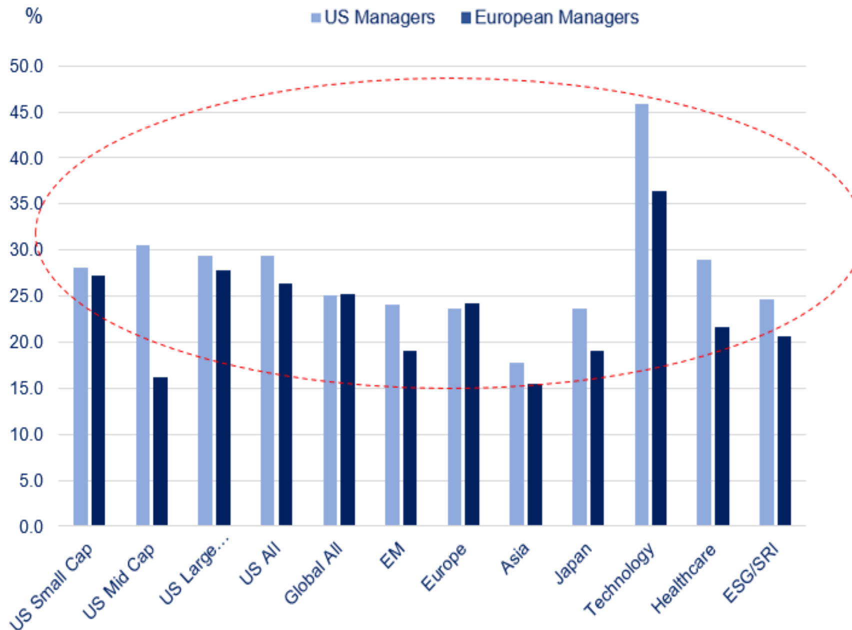
$139 billion – 220 Basis Points

US Research Spend**

Client Money: $6.4 Billion

** Indicative Categories: (Not all displayed) Sources – Frost Consulting/EvercoreISI ** Integrity Research*

2019 - US VERSUS EUROPE – AUM WEIGHTED



Sector Outperformance:

US: 10
Europe: 2

% Outperformance Capture:

US: 91.1
Europe: 8.9

Avg. Sector Outperformance

US: 468.9 Bps.
Europe: 138.3 Bps.

Total US Outperformance:

$245 billion – 265 Basis Points

US Research Spend**

Client Money: $ 6.2 Billion

** Indicative Categories (not all displayed): Sources – Frost Consulting/EvercoreISI ** Source – Integrity Research*

It is interesting to note that in 2018 US managers outperformed by $139 billion versus an external (client money) research cost estimated at $6.4 billion. In 2019 US managers outperformed by $245 billion versus an estimated research cost of $6.2 billion.

This reinforces the point that research spending is dwarfed by differences in returns. This raises the possibility, that for asset owners, the diminimous research "savings" stemming from managers funding research via P&L may be a false economy.

A further consideration for asset owner research funding strategies relates to the risk of exogenous shocks, either market-wide or manager specific, and their impact on P&L funded research budgets.

The P&L method inexorably ties manager (and fund/strategy) research budgets to the profitability of the manager as a whole. An asset owner could be invested in a Japanese equity fund run by a manager with a very large multi-asset product that produces the bulk of the manager's revenue/profitability. If performance issues at the multi-asset product resulted in significant AUM outflows, the firm's profitability would be affected and research budgets (funded by P&L) might be cut across the board, irrespective of product.

By paying a few basis points for research, asset owners can insulate themselves from this risk. (Cheap insurance? A small premium to pay for access to managers with better information? Greater transparency?)

In a market-wide context, for instance, the recent Corona Virus induced sell-off could result in substantial reductions in AUM (and profitability) for all managers. The research budgets of P&L managers would be at greater risk given the operating leverage of the economic model of active equity managers and research budget linkages to manager profitability. (Modelling a 30% decline in manager AUM could easily lead to further 50%+ cuts to research budgets for P&L managers – beginning at already depressed levels and further widening the spending gap with managers using client money).

Given the forgoing, it is reasonable of European market participants (including asset owners) and regulators, to review whether the post-MiFID II research market structure is creating benefits for those investors it was intended to aid.

The US Market and the "Second Mover Advantage"

US market participants and regulators have had the luxury of the "second mover advantage". They have been able to observe the outcomes (many unexpected) of watching MiFID II and commercial reactions to it to unfold for over two years, without having to guess about the aftermath.

The potential impacts on performance, research spending and research transparency have likely played a role in the SEC's lack of enthusiasm for funding research via P&L.

It may also have influenced US asset owners and other industry organizations.

<u>US Asset Owners</u>

MiFID II has been a wake-up call for US asset owners particularly on the research payment issue as many US managers pay for research via P&L for their European clients but still charge US asset owners for it.

Last summer, a series of US Asset Owner and Industry organizations made recommendations to the SEC on US research funding issues and manager research transparency.

These included:

- The Council of Institutional Investors (135 US pension funds: AUM ~$4 trillion)
- Healthy Markets.org (Asset Owner and Asset Manager members)

- CFA Institute
- SEC Investor Advisory Committee (Created by Dodd-Frank)

They recommended that:

- the SEC should retain the research commission model.
- Managers should not be required to pay for research via P&L – *even for those US managers doing so for European clients.*

In return, Asset Owners requested that managers inform them of the research charge (on a per client or per fund basis) and demonstrate that their research commissions were not subsidizing other investors (no cross-subsidization).

It seems that US asset owners (and the SEC) were taking a deeper look at the impact of research spending – beyond the short-term cost considerations. It would have been understandable for US asset owners, whose asset managers were paying via P&L for European clients, to demand reciprocity.

This is likely a win for the US asset management industry as it provided a blueprint for manager's continuing to use billions of their clients' dollars for research, supporting client returns, manager profitability and global competitive advantage.

To meet asset owner transparency demands, US managers will have to budget at the fund/strategy level in order to inform asset owners of their specific research charge. They will then have to map research services to those funds to avoid cross-subsidization.

While this represents an adjustment to the process for the vast majority of managers, this must be weighed against the estimated $6.2 billion of client money spent by US asset managers on external research in 2019* - which otherwise, all things being equal, would have to be funded by asset managers rather than asset owners.

Healthy Markets, one of the organizations to make recommendations to the SEC on research transparency, is in the process of rolling out a Manager Research Transparency Questionnaire for their US asset owner members asking specific questions about the manager research process at the fund level – regardless of research funding mechanism.*

European asset managers resisted research transparency. The result was MiFID II. US asset managers have both a mechanism, and 20/20 MiFID II hindsight, to be in a position to make better-informed decisions.

Providing additional research transparency seems a small price to pay given the alternatives.

The SEC has not as yet formally responded to the research recommendations of the asset owner and industry organizations. Regardless of regulatory fiat, asset owners and asset managers who are committed to ESG principals should consider how research transparency might be viewed through an ESG lens.

*https://healthymarkets.org/product/research-practices-questionnaire

ESG Framework for Asset Owner/Asset Manager Collaboration on Research Budgets

The central DNA of the contract between the asset owner and the asset manager is the investment product's agreed investment process.

The vast majority of active equity strategies use external research to some degree. This is part of the investment process that the asset owner is seeking exposure to. External research access likely played some role in generating the historic product returns that formed part of the basis for the asset owner's product purchase decision.

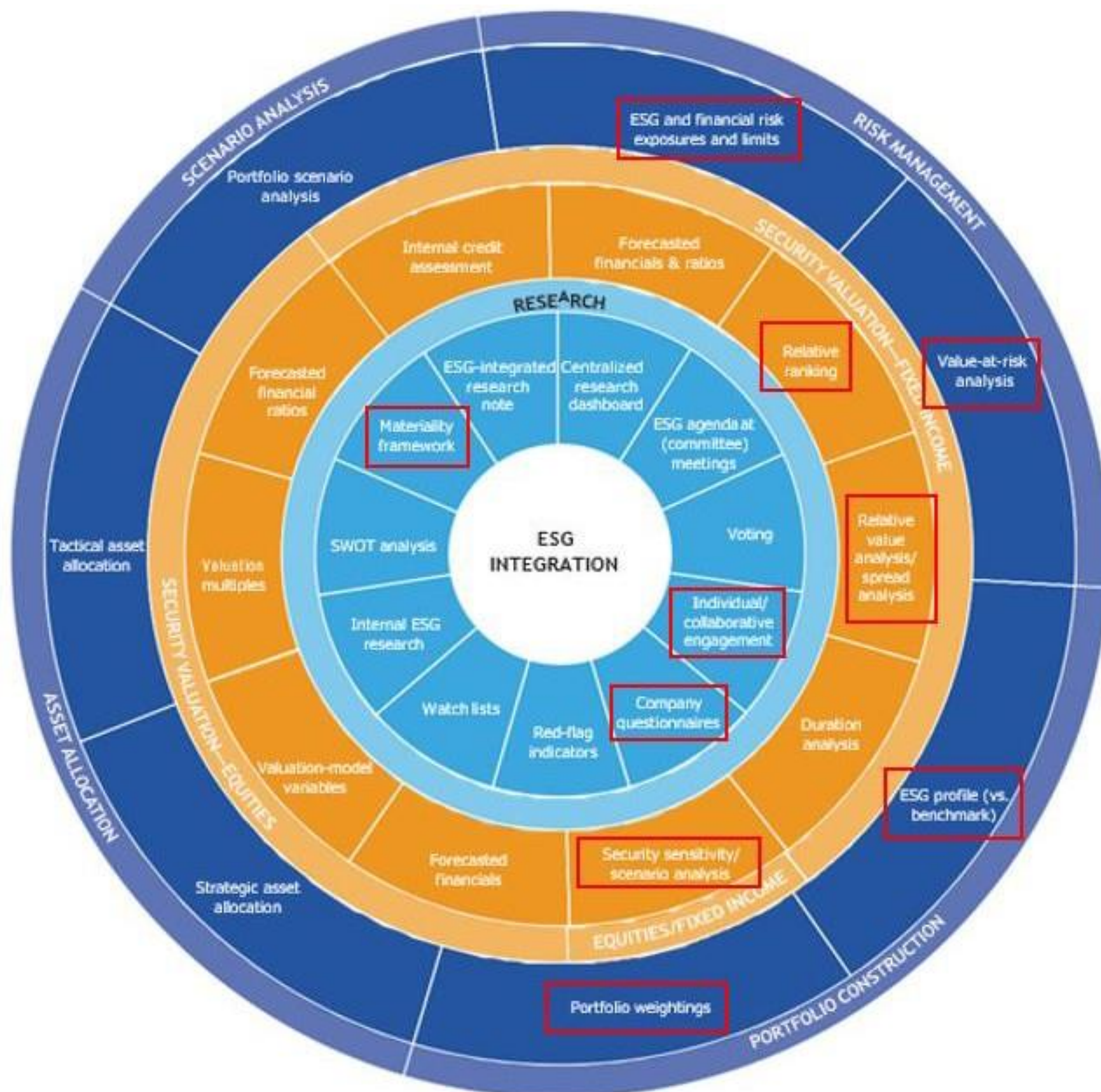
If one of the other central components of the manager's investment process were altered or removed, the PM or the analyst team, for instance, this would spark immediate concern from asset owners/investment consultants. Yet the unprecedented disruption in manager external research procurement has drawn very little attention – (by contrast with manager equity execution risk which is frequently measured via Trade Cost Analysis – TCA).

How can asset manager research spending/budget issues be viewed through an ESG context?

The CFA Institute/UNPRI publication, ESG Integration in the Americas: Markets, Practices and Data, proposed a multi-level ESG analysis framework (below):

CFA Institute PRI Principles for Responsible Investment

ESG Integration Framework



Portfolio Level ■ Security Level ■ Research Level ■

Research transparency is certainly a "stewardship"/Governance issue. Asset Owners that are ignoring these variables may have an extremely large gap in their ESG process – and one that poses material (and potentially short-term) performance risks to their beneficiaries.

We have put red boxes around those ESG variables in the framework above that relate to research sustainability and transparency, together with explanation of potential toolsets to assess risk.

Outer Circle – Portfolio Level

ESG Financial Risk Exposures and Limits: Sets limits and tolerances for research budgets by strategy.

Value-at-Risk Analysis: Models to quantify potential performance risks from changes in research process.

ESG Profile (vs. Benchmark): Benchmarks research spending. ESG composite score. Portfolio Weightings: Can assess composite ESG risks across portfolios.

Middle Circle – Security Level

Relative Ranking: Of ESG Research Transparency Risks

Relative Value Analysis: Models to calculate Research ROI by strategy/fund, based on research intensity.

Sensitivity/Scenario Analysis: Impact on research sustainability stemming from exogenous shocks.

Inner Circle – Research

Individual/Collaborative Engagement: "Trust but Verify" confirmation of agreed investment process.

Company Questionnaires: Deep dive into changes in research process.

Materiality Framework: Incorporating research intensity into the analysis.

Potential ESG Research Rating Framework

At its core, the key objective is to encourage asset managers and asset owners to collaborate on research budgets to create transparency and facilitate the sustainability of the investment process/product. The overriding objective is to maximize returns for asset owner beneficiaries.

In line with the recommendations of the US Asset owner organizations referred to earlier, along with the CFA Institute and the SEC Investor Advisory Committee, we believe asset owner should be willing to fund manager research budgets as long as the budgets are:

- Transparent
- Constructed at the product (or related strategy) level
- Benchmarked against strategy peers
- Suitable for the investment strategy
- Able to demonstrate a lack or cross-subsidization

Funding manager research budgets is a minor financial commitment on the part of the asset owner, with discernible benefits, foremost amongst them avoiding the potential performance risk and lack of transparency inherent in the P&L model.

There is no evidence to suggest that reducing the profitability of manager mandates (through research via P&L), adds to asset owner returns – even net of diminimous research costs. To the contrary, the fund performance analysis described earlier may represent emerging circumstantial evidence that this reduces asset owner returns.

Given the commitment of both asset owners and asset managers to ESG issues, we believe that an ESG approach to research transparency represents a "safe space" in which

they can jointly contribute to the investment process. (Absent the adversarial positioning implied by European regulators).

We propose an ESG Research Process Rating to give asset owners the verification of the manager's strategy research process. This will give asset owners the confidence and transparency to provide the research funding, simultaneously creating certainty that the strategy will have the required research resources from a fiduciary perspective.

AN ESG FRAMEWORK FOR RESEARCH COLLABORATION

Objective: Both asset managers and asset owners want the manager's investment product to achieve its targeted return.

Approach: Collaboration to achieve the best result. Asset owner research funding combined with manager research transparency.

Sustainability:

Are budgets sufficient to maintain minimum-viable strategy research access?

Quantum vs. Peer Average | Post-2018 Sustainability | Key Research Access

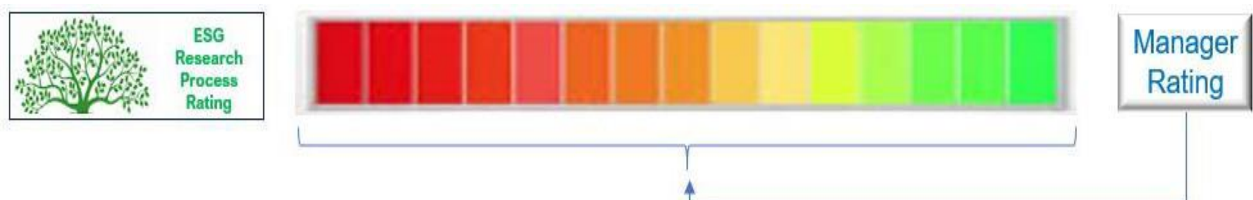
Returns:

"Active Share"/portfolio diagnostic validates agreed investment process.

Transparency:

Are CII/CFA research transparency "Best Practice" standards being met?

Ex-ante Fund-Level Budgets | No Cross-Subsidization | Research Benchmarking



Asset owners that do not consider the sustainability of the manager research funding of their strategies have a significant gap in both their Fiduciary responsibilities and ESG process.

For asset managers this framework can deepen relationships and understanding with clients and provide optimal research support for their investment strategies. Managers will have to

construct research budgets at a fund level incorporating the “research intensity” of the strategy as well as benchmarking it to peers. They will also be required to map specific research services to the strategy/fund budgets to assuage cross-subsidization concerns.

The CFA UK/CFA Institute report “Investment Research Valuation Approaches: a Framework and Guide for Investment Managers and Asset Owners” * illustrated a methodology for:

- Aligning research budgets to specific investment mandates
- Optimizing top-line research budgets
- Valuing research services based on expected returns
- Eliminating cross-subsidization.

This additional manager research transparency is a small price to pay in return for having research budgets sustainably supported and funded by asset owners.

Many managers claim to be integrating ESG variables into their investment process. A commitment to the ESG Research Framework illustrates that asset managers are applying ESG principals to their own internal processes, as well as to the companies their investment professionals are analyzing.

Given the risks of the P&L research funding model, asset managers and asset owners should take their shared commitment to ESG principals as an opportunity to redress the unintended research consequences of the European post-MiFID II experience.

This can easily reside within the MiFID II legal/regulatory framework which allows managers to use client money for research, with suitable transparency assurances. Manager research budgets could be funded by the “accumulation” or “Swedish” model with no need for complex transaction-based RPA arrangements.

Asset owners that have elected to allocate to active managers have done so consciously, in full knowledge that less expensive passive options exist. For them to derive the benefits of active management, (non-indexed returns), the manager’s investment professionals must be allowed to access the research services required by the strategy.

As the data in this paper has suggested, the cost of research is completely dwarfed by the range in quartile returns by strategy. Compromising the ability of active managers to access necessary external research may jeopardize targeted returns, likely by margins (possibly hundreds of basis points) that far eclipse the asset owner’s research cost.

Asset owners and asset managers owe it to themselves, each other, and society at large to maximize returns for fund beneficiaries in a sustainable fashion. An asset manager ESG Research Process may deliver the objectives that MiFID II research provisions were originally intended to produce.

*https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/3-research-and-position-papers/research-valuation-approaches.pdf

About Frost Consulting:

Frost Consulting creates solutions to help asset managers and asset owners maximize the value and transparency of investment research through:

Research Valuation Platforms: Highly customizable software solution that enables asset managers to align research budgets to client mandates down to the fund level, and solve complex cross-subsidization issues.

Research Benchmarking: Database that allows both asset managers and asset owners to benchmark equity strategy research spending.

Research Process ESG Ratings: Providing verified assurances to asset owners that manager strategy research spending is sustainable and transparent.

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Appendix

The Importance of Research

Price formation

Equity research allows investors of all types to make more informed investment choices by increasing their understanding of the absolute and relative attractiveness of investment alternatives, based on asset classes, geographies, sectors, industries and individual companies.

While research produced by a wide variety of manufacturers may be useful in investment decision making, investment research produced by investment banks and other investment-oriented research firms is particularly relevant to institutional asset managers. This is because it fuses industry analysis with company analysis, and ultimately the analysis of the securities of that company with a view to an investment conclusion. Industry journals, for example, may inform on industry fundamentals but are not designed to analyse the investment merits of particular companies operating in that industry on either an absolute or relative basis.

Investment research plays several vital roles in price formation:

Establishing market context, by creating consensus for industry and company earnings and valuation expectations. They consider current and future conditions in light of historical ranges of valuation and earnings volatility.

Context allows relative valuation, by comparing sectors/industries/companies to one another and to their joint and individual respective histories.

Capturing operating leverage, at the individual company level and analysing changes over time.

Ultimately, to the degree this research informs investors, it creates more efficient (and

liquid) markets by disseminating (1) information and (2) expectations. In the absence of those two factors more events would be a surprise, thus increasing equity volatility, and likely lowering both equity valuation and confidence in the equity markets. Equity valuation (and volatility) determines the cost of equity capital, with significant implications for the operation of the economy as a whole.

New issuance and capital formation

The new issuance of equity, and the cost of it, is critically dependent on the market context described above. More efficient equity markets are likely to have higher levels of valuation and liquidity, thereby lowering the cost of equity capital and easing the task of capital formation.

This is most readily illustrated by comparing the valuation and market characteristics of open, liquid, developed markets with frontier markets (examples might include countries such as Nigeria and Iran) where valuations, liquidity and new issue activity is low. This explains why many Russian companies, despite a high level of investor interest in their industries, have chosen to list in London rather than in Moscow. Obviously, the transparency of the legal system and protection for minority investors is also an important consideration

Efficient markets are central to funding growth industries. Of all the asset classes, equities are by far the best suited to funding new (and sometimes) speculative ventures.

Fixed income, given its necessity for regular and recurring pay-outs, is very unsuited to the needs of capital consumptive growth companies, whose prospects may be open-ended, but whose immediate cash flow does not lend itself to bond payments, particularly when the alternative is to reinvest in their rapidly growing businesses.

This tendency remains even after (historic) growth companies are effectively self-financing, which explains why companies such as Microsoft, Google and Apple, despite ample (apparently unneeded) cash on their balance sheets, pay de minimis dividends.

Equity markets, in which there is a historic context for growth stocks and valuation techniques to balance short-term losses with long-term company valuation, can lower the cost of capital for growth companies.

Research plays a vital role for growth companies, particularly in new industries whose characteristics and future potential may not be well understood by all investors. For investors to take the risk of investing in loss-making growth companies, research provides critical perspectives on the ultimate reward (market size/profitability) that may balance the short-term risk.

Even in developed markets, long-term attitudes to the ‘price of growth’ can have a significant impact on the cost of capital.

In the US the five largest companies by market capitalization were founded on average in 1989, with the most recent, Facebook, established in 2004. By contrast, the five largest European companies were founded, on average, in 1876.

Public awareness of capital markets' function

Efficient, transparent and regulated equity markets increase wealth by lowering the cost of capital and funding growth in both corporate profitability and the economy as a whole, and ultimately, employment. The role of research in this process cannot be understated.

The transformation of the world economy since 1979 has been staggering. At that time major components of today's global economy (China, Brazil and Russia) were essentially outside the world economic system. Capital markets have been a key mechanism by which these economies have been integrated into the global system. Policymakers in these countries ultimately recognized the central role of liberalized financial markets in fostering the growth necessary to transform their economies.

The capital required to fund this growth, at least in the early stages, had to come from abroad. Again, research played a vital role.

Forty years ago, the bulk of equity investments were benchmarked against a series of domestic equity indices whose constituent companies were well known to local analysts and portfolio managers. The move to global and emerging market indices was a quantum leap in terms of the amount and complexity of information and investment factors that asset managers had to digest. Not even the largest asset managers can economically provide continuous internal coverage of more than 10,000 companies in over 100 companies without external research input. External research from a multitude of providers (global/regional/local) created an investment a research eco-system that allowed managers to make investment decisions in a far more complex global investment environment.

External research creates significant efficiencies for asset managers and asset owners. If it did not exist, the cost base of asset managers' internal research efforts would be much higher. This would be a barrier to entry for new asset managers, and both raise costs and reduce returns for asset owners.

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