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How MiFID II Threatens European ESG Outcomes: Data/Solutions

Three years from the onset of MiFID II, market participants and governments/regulators are assessing its outcomes and considering adjustments. A combustible mix of global research regulatory fragmentation combined with the diverging views of Trans-Atlantic asset owners has been set against the backdrop of growing investment consciousness about "sustainability". The net result has created significant threats to both European pension beneficiary returns in active equities, and potentially, the long-term health of the planet.

MiFID II, and the commercial reactions to it by both asset managers and asset owners represent a grave threat to the achievement of European ESG objectives. As the paper will discuss, Europe is merely one Bear Market away from substantially disrupting ESG goals as a result of a massive duration mismatch between ESG funding and long-term ESG targets.

To understand this, we must first analyze the impact of MiFID II on European asset manager research spending.

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.

However, as a result of the near universal move to fund research budgets via P&L by European asset managers, the result has been the inverse of the regulator's intentions:

- Manager research spending transparency has been <u>virtually eliminated</u> (as P&L managers have <u>no</u> requirement to inform clients of changes in research budgets)
- Significantly <u>greater risk</u> to asset owner returns, as any research "savings" from P&L managers have been completely overwhelmed by manager research budget cuts leading to significant variance in fund returns.

Are European Asset Owners/Consultants Asleep at the Wheel?

MiFID II and the emergence of ESG have, in rapid succession, posed the biggest challenges in generations to the investment processes of active equity managers. Yet most Asset Owner/ Consultant's manager evaluation processes are designed for an environment which no longer exists.

On an elemental level, this comes down to an understanding the components of equity returns. European Asset Owners/Consultants almost universally analyse trade costs, but routinely ignore large changes in manager research spending that can have a far greater impact on returns.

Does Research Matter?

This is a binary question. The answer has significant implications for Asset Owner Stewardship and Fiduciary Responsibility, particularly as the scope of both of these concepts is being widened to reflect to new regulatory/industry priorities.

Assumption One: External research adds no value to active equity returns.

The good news in this scenario is that asset owners no longer have to think about research – other than to explain why they've spent in excess of $100 billion of stakeholder capital on this worthless input over the last decade.*

Assumption Two: External research does add value to active equity returns.

In this case, post MiFID II, asset owners/consultants should be keenly interested in any changes to research budgets at the fund level as a significant forward-looking performance risk factor.

To quantify this, equities return ~700 Bps per annum over the long term.

In a severe outcome, poor trading results may result in portfolio drag of ~40 Bps**

The potential impact of research spending is far larger.

A recent Frost Consulting/ EvercoreISI study found that the average differential between mid-1st and mid-4th quartile equity performance in 2019 averaged >2,000 Bps in a sample of 5,400 Trans-Atlantic funds over 15 equity categories.***

P&L Manager Research Budget Cuts: Cost Asymmetry

The relationship between asset owner and asset manager relative research costs was not fully considered by European regulators. As noted, research costs for asset owners are very low.

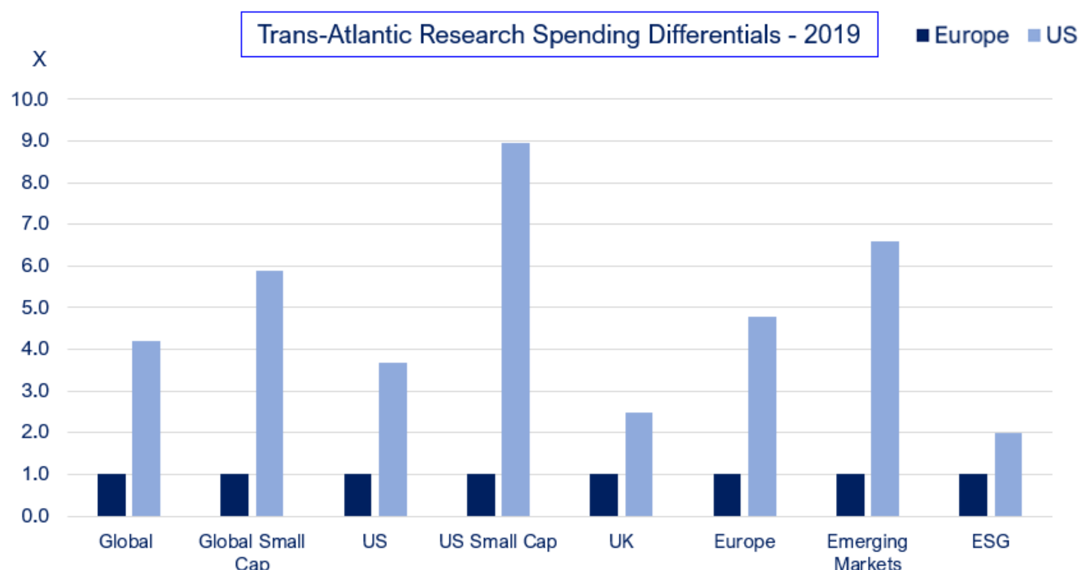
However, when this research cost is transferred to the P&L of asset managers, it is frequently their second largest expense – just behind staff compensation. The inverse relationship between research budgets and manager profitability likely explains manager research spending cuts frequently (far) exceeding 50% of pre-MiFID II levels.***

Research Spending Differentials: Geographic/Information Asymmetry

In the US, the SEC, under any administration, has zero desire to encourage managers to fund research via P&L owing to their concerns about the impact on the research eco-system and manager competition.

This has fostered huge gaps in research spending between US funds (client money) and most European funds (P&L). The FrostDB research spending database illustrates that the largest gaps are in the most research-intensive fund categories such as Emerging Markets and Small Cap Equities, in which managers require dozens of globally dispersed research sources, rather than just depending upon a small number of large banks.

FROSTDB RESEARCH SPENDING DATABASE - IMPACT OF MIFID II



** Source: FrostDB Research Spending Database*

For example, in global equities, managers using client money are spending more than 4 times as

much as P&L managers. While the nominal research spending numbers are small (e.g. 6 Bps vs 1.5 Bps.) 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 equity categories.

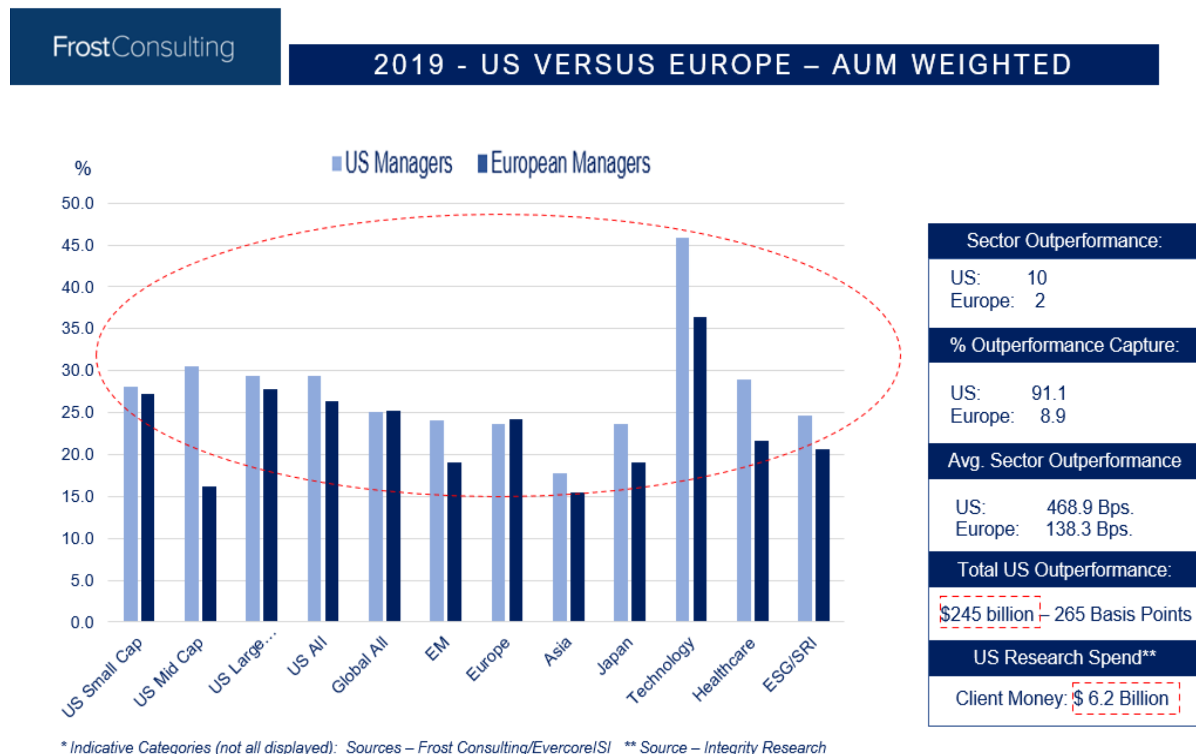
What is the potential impact of significant changes in strategy research spending on the relevance of historic product returns - which are frequently the central factor in asset owner product purchase decisions?

Performance Impact?

Frost Consulting and EvercoreISI analysed four years of performance data (starting in 2016 – pre-MiFID II) from ~5,400 Trans-Atlantic equity funds with cumulative AUM of ~$9.3 trillion across 15 equity categories. Key findings:

- Over 8 annual observations (measuring funds by arithmetic and weighted AUM averages annually), US managers outperformed in 7 of 8 instances and captured 80% of the cumulative outperformance.
- In 2019 US managers captured >90% of outperformance.
- In 2019 US managers outperformed by $245 billion versus a research cost of ~$6 billion, illustrating the fact that research costs are dwarfed by performance differentials.
- This relationship has held regardless of market direction (2018 MSCI World -8.26%, 2019 +28.4%)

Selected Sector Detail for 2019 in the Chart Below:



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.

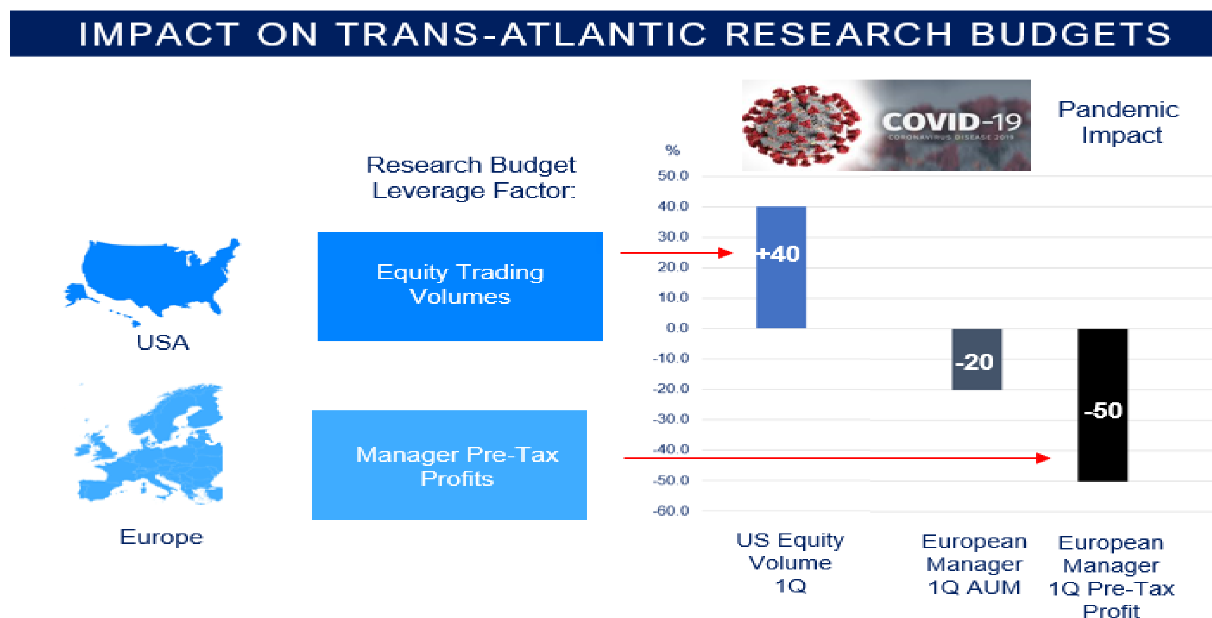
Covid Impact

EU regulators, post-Brexit, have been re-examining the impact of MiFID II, specifically with regard to SME research. The Covid market drawdown added urgency and a new critical data-point to their deliberations.

The 1Q 2020 equity meltdown illustrated that US and European research budgets were both pro-cyclical, but in completely opposite directions.

In the US bundled commission model, research budgets are a function of equity turnover, which increased ~40% year over year in 1Q, significantly boosting US manager research spending.

In Europe (for P&L managers) research budgets are a function of the manager's pre-tax profitability. A sudden 20% decline in equity index levels rapidly cut manager AUM by a similar amount (before redemptions). This triggered an immediate revenue reduction of 20%, and, given the operating leverage in the asset management model, suggested a ~50% decline in manager pre-tax profits (from which the research budget is drawn).



European regulators suddenly faced the alarming realization that, the lower markets went, the less and less research P&L managers would be able to access. Was this their intention in MiFID II, or in the best interest of asset owners?

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

EU MiFID II Review

This accelerated the post-Brexit MiFID II review taken up by the AMF, ESMA, and ultimately the European Commission. The latter, in its Emergency Pandemic Financial Package, suspended MiFID II research rules for small cap stocks with a market cap. of up to € 1 billion (although € 10 billion had been suggested). These market cap. limits may remain under review.

The UK FCA is considering how they will respond to this change.

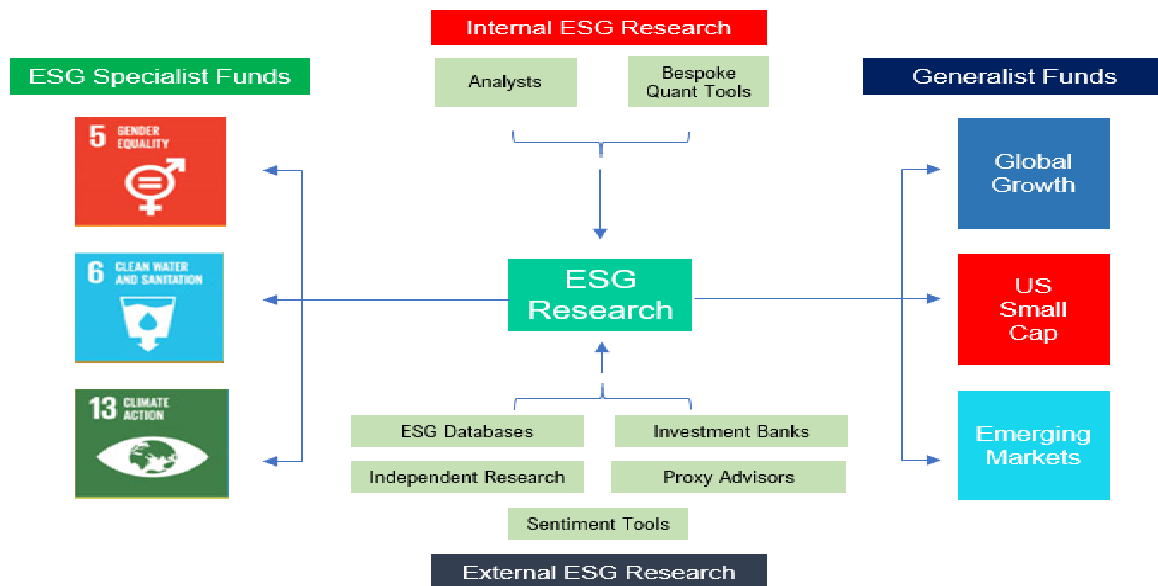
ESG Implications

The research spending debate is no longer a side issue – not when lower asset manager research spending jeopardizes an objective universally shared by asset managers, asset owners, regulators and governments in Europe – the transition to a more sustainable economy.

While active equity managers in Europe have benefited from the AUM growth in ESG strategies, this has required a more complex set of research inputs. Additionally, European regulation (SFDR) will soon require European managers to integrate ESG variables into all fund products, not just specialist ESG funds.

This is a significant challenge as managers must incorporate expensive ESG inputs such as databases and proxy advisors to serve both ESG and traditional fund strategies.

ESG INTEGRATION CHALLENGES

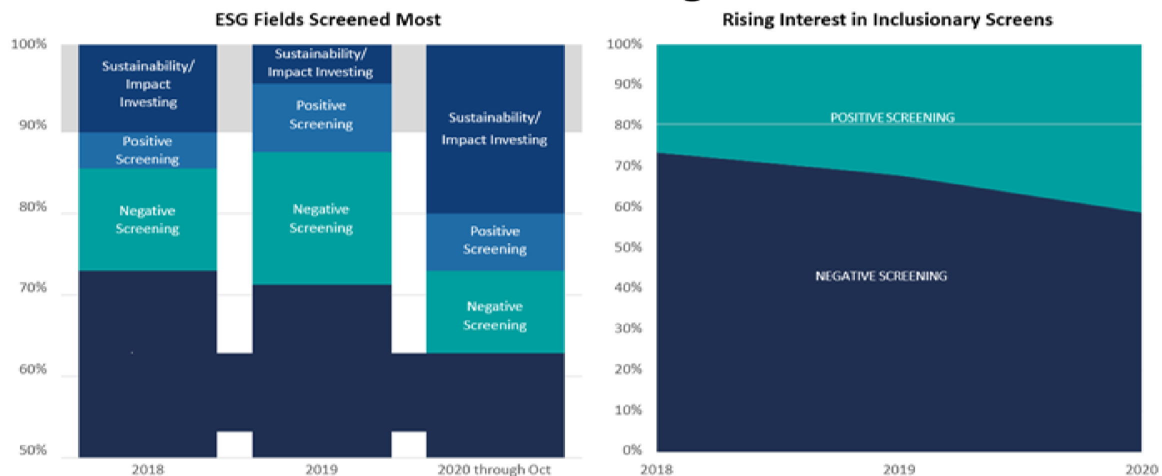


Alongside the growing ESG regulatory requirements in Europe, the cost of these inputs are rising, putting greater pressure on already strained manager research budgets.

The "research intensity" of ESG strategies is also growing as managers adopt more complex ESG approaches such as positive screening. It requires a great deal more research to establish the carbon intensity trajectory of complex companies that it does to merely identify producers of weapons or dirty energy in order to exclude them in negative screening approaches.

MORE RESEARCH INTENSIVE ESG STRATEGIES

ESG Criteria Investors are Screening in 2020

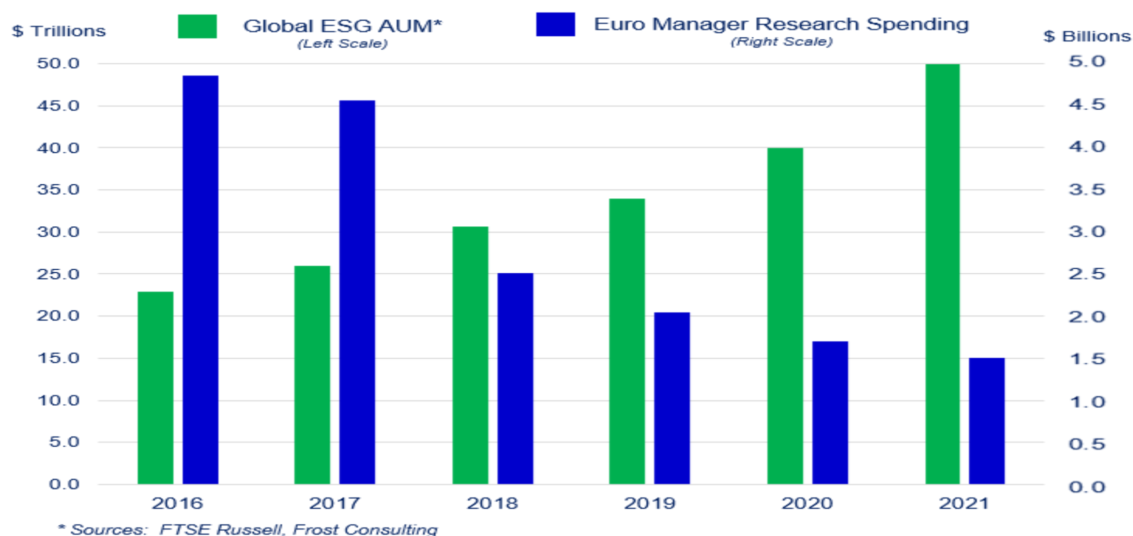


Source: eVestment Advantage, through Q3 2020

Furthermore, recent industry guidance in the form of the CFA Institute Consultation Paper on ESG Disclosure Standards and the UK Asset Management Task Force Investing with Purpose Stewardship Guide, envisage unprecedented levels of asset manager ESG engagement with companies that will require a substantial (and expensive) commitment by managers to achieve.

The chart below contrasts the growing AUM of ESG strategies globally with the declining research spending by MiFID II P&L managers – a trend that threatens the advance of ESG initiatives (particularly if equity markets ever decline).

ESG AUM GROWTH: DECLINING RESEARCH SPENDING



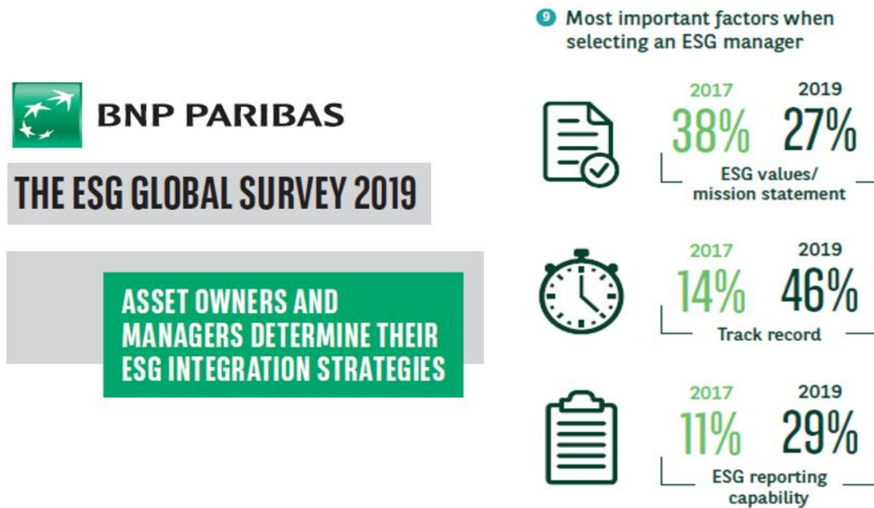
The Interaction of Research and ESG Costs

Just as P&L managers are cutting research budgets in an attempt to maintain margins, the rapid growth of ESG mandates has been exceeded by the even more rapid growth of ESG costs, both internal and external. Indeed, the full costs of ambitious Stewardship/Corporate ESG Engagement objectives have yet to be felt by many managers.

One of the key concerns is that these budgets may begin to cannibalize one another:

RESEARCH VS. ESG SPENDING (EXTERNAL)

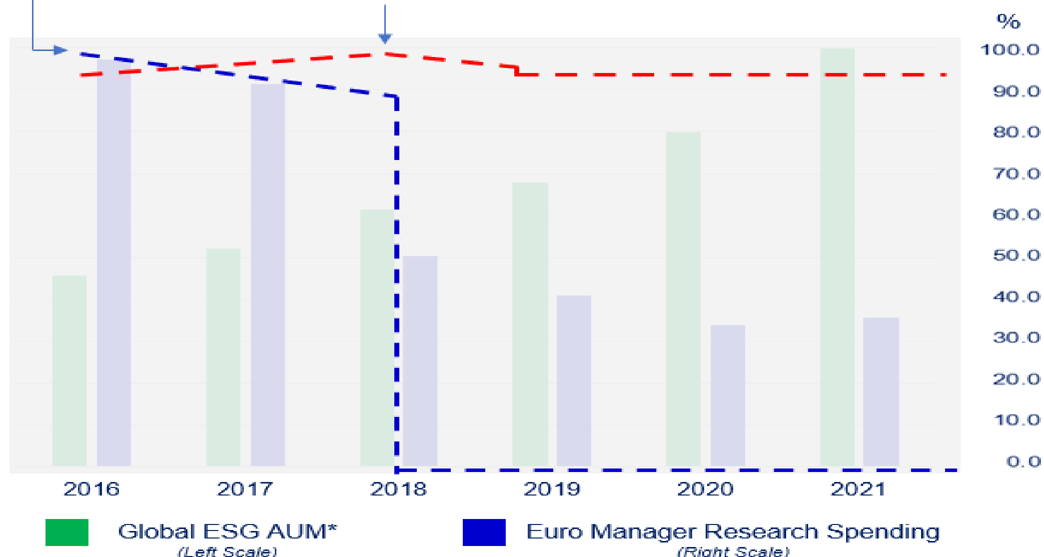
Current popular investment wisdom holds that “ESG” will disappear as a separate investment category as all funds adopt ESG factors. If true, this will also blur the distinction between fundamental research and ESG budgets. As the graphic below indicates, in order to make sustainable funds “sustainable” both are required, highlighting the dangers of cannibalization.



Note that in 2017 the most important factor in ESG manager selection was a Utopian ESG Mission Statement. By 2019 that had been substantially eclipsed by more traditional performance considerations. Herein lies the cannibalization risk. Climate data alone (for instance), in the absence of complimentary fundamental research, is unlikely to generate “sustainable” levels of investment performance.

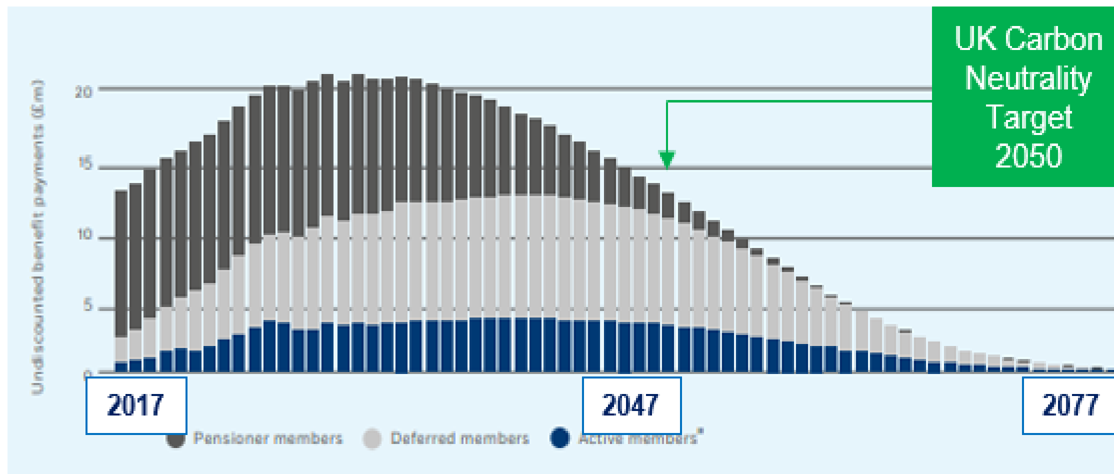
The Ironic Position of European Asset Owners

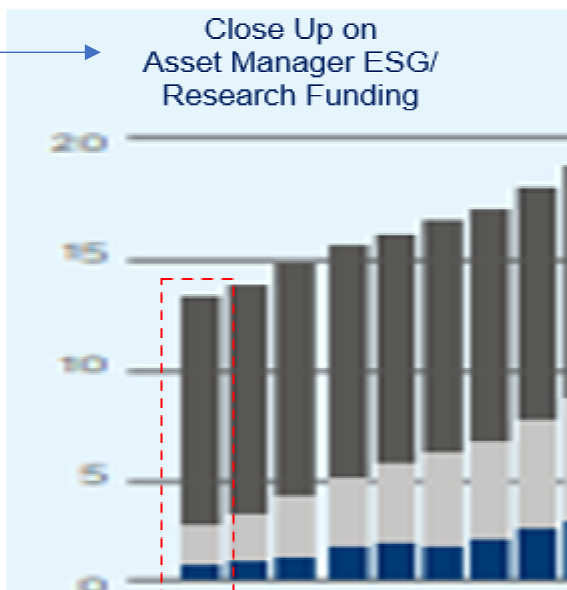
European asset owners universally expect their managers to integrate ESG variables. Many European pension funds have detailed ESG objectives of their own. Yet, as a result of the widespread move to fund research via P&L by European managers, asset owners make no financial contribution to the maintenance of the research eco-system (both ESG and non-ESG).



Most pension funds have liabilities that stretch decades into the future and they therefore have a significant vested interest in the “sustainability” of the research eco-system. Yet they have transferred the cost of this responsibility entirely to asset managers. This has created a significant funding duration mismatch, particularly in light of very long-term ESG objectives (Carbon Neutrality by 2050).

UK Pension Funds – Long-Tailed Liabilities





Europe is attempting to finance long-term goals (i.e. Carbon Neutrality by 2050) 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.

Despite their apparent advocacy of “long-termism”, European pension funds are so desperate to avoid very small short-term research charges, they may be endangering longer-term objectives.

Unless asset owners are willing to utilize their long duration and diminimous research costs to help underwrite these long-term ESG objectives, these efforts will fail unless:

1. Governments fund this entirely, or
2. Asset managers elect to become not-for-profit social enterprises.

Some of their arguments are reminiscent of the Climate Change deniers. "Climate change (aka the research eco-system) is not my problem". Until, of course, it is.

US asset owners continue to fund manager research budgets, an approach which is endorsed by the US Council of Institutional Investors, CFA Institute and the SEC Investor Advisory Committee. The Biden administration is likely to quickly reverse a previous revision of the ERISA Fiduciary rule that specifically prohibited US Pension Funds from considering EFG factors in selecting managers and investment products.

This may herald a flood of ESG products from US managers with input costs fully underwritten by US asset owners and a lighter touch regulatory framework versus Europe.

Attitudes of Pension Beneficiaries

Various studies have indicated that many investors are willing to trade off some portion of potential financial return in order to create more sustainable societal outcomes. Would European pension beneficiaries similarly be willing to bear slightly higher short-term (research) costs in pursuit of similar objectives? Has anyone asked them? Or, has this been decided for them?

The Good News

The mutual desire to enshrine ESG investment principals by both asset managers and asset owners (not to mention governments, regulators and society) potentially represents a framework for a more sustainable, transparent, and ultimately, responsible approach to research "sustainability".

The MiFID II regulatory approach has positioned asset managers and asset owners as adversaries. Nothing could be further from the truth. Both parties share one critical common interest – that the investment manager's product (owned by the asset owner) achieves its targeted return.

Frost Consulting has written an ESG Framework for Asset Managers/Asset Owner Research Collaboration, based on earlier work with the CFA Institute/CFA UK and Stanford University.**** This posits that if asset managers are willing to be transparent about (benchmarked) research costs, asset owners should be willing to contribute to research funding, as it's very likely in their interest.

Frost is introducing a detailed Manager ESG/Stewardship Research Benchmarking Survey to educate stakeholders about the actual costs of ESG implementation.

As it stands, the success of long-term European ESG initiatives are entirely contingent on the short-term movements of financial markets and their impact on European manager revenue and profitability.

There is another way, but it requires all stakeholders engaging in a transparent and realistic discussion about how to sustainably underwrite these important long-term objectives.

It would be a cruel irony indeed, if, just at a critical juncture when the world began to focus on sustainability, that 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 hundreds of millions its beneficiaries may be missing the forest for the trees.

**Frost Consulting Estimate*

***Assuming a developed market portfolio with one times turnover*

****Sources: Credit Suisse, AMF, Liquidnet*

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