Counting the cost of RESEARCH

The unbundling of research costs in fixed income could see the market shrink to a shadow of its former self

By: Louise Bowman

The market for fixed income research won a temporary reprieve from the impact of Mifid II on February 10 this year when the European Commission proposed a delay to the new regulation to take account of 'exceptional technical implementation challenges faced by regulators and market participants'.

While the research market breathed a collective sigh of relief at the one-year postponement, the changes to research that Mifid II will bring are still a serious challenge that fund managers should be addressing urgently. However, that message is struggling to get through, judging by responses given to Euromoney in its fixed income research survey this year.

Of the 2,105 investors surveyed, 88% had not set a research budget for 2016 and 81.4% of the sample said that they had no plans to change the number of research providers they use. If asset managers keep their heads in the sand about paying for research under the new rules, they face a difficult task to catch up with the implications of this new cost to their business.

The EC published draft rules for full unbundling of research and trading fees under Mifid II on April 7, revealing the Delegated Acts under which fund managers should pay for research. Investment firms must set up a research payment account (RPA) funded by specific research charges billed to its clients. These must be based on a research budget, and the frequency of the research charge must be agreed between the asset manager and its clients.

The market had hoped for clarity on the future of commission sharing arrangements (CSAs) under Mifid II. The draft rules state that 'every operational arrangement for the collection of the client research charge, where it is not collected separately but alongside a transaction commission, shall indicate a separately identifiable research charge'. As they stand CSAs do not meet Mifid II requirements, as they allow research charges to be linked to transaction volumes. But it appears that some form of adapted CSA may still be allowed under the new regime.

Unbundling research and execution charges is much easier to achieve on the equity side than the fixed income side. The market was hoping for a fixed income exemption but fixed income research providers will have to put a price on anything that clients will value, otherwise it will be deemed an inducement.

"If research involves the allocation of valuable resources to produce, it is substantive and cannot be deemed to be a minor non-monetary benefit," explains Mike Carrodus, founder and chief executive of Substantive Research, which matches asset managers to macro research providers. "Where the line is drawn on what constitutes 'valuable resources' may be interpreted many ways, but the intent is clear."

Asset managers therefore face three options. The first is hard payment, whereby they simply pay for research directly themselves out of their own P&L (they must still have research budgets and make all payments through an RPA). The second option is the Swedish model, whereby the asset manager sets aside an agreed research charge that is deducted from the fund on an accrual basis and transferred to the RPA to pay for research. The third option is to use an enhanced CSA arrangement.

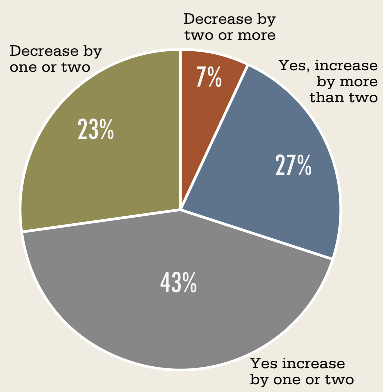
On April 1 this year UK fund manager Woodford Investment Management said that it would "go hard", paying directly for research for its £8 billion flagship CF Woodward Equity Fund. Figures published on the fund's website show research in 2015 amounted to 0.02% of the 0.84% total cost to the firm of investing. This approach to payment is a direct cost to the P&L. According to consultant FrostRB, in 2015 global secondary equity commissions totalled $30 billion, split 67% for research payments and 33% for execution payments.

Many in the industry believe that this might have to be the way forward for fixed income too. "For fixed income, it's not a decision – it will have to come out of P&L as it is a new cost which clients won't wear, especially in a negative rates environment," says one investor.

Fixed income investors are likely to face strong resistance from asset owners over the cost of research. Pension funds looking to account for every basis point of costs will take a hard look at research spend. At the recent Pensions and Lifetime Savings Association annual conference in Edinburgh, this was high on the agenda.

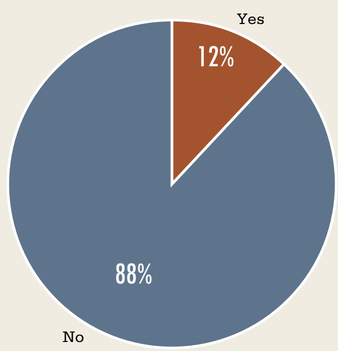
"End investors have relatively few resources at their disposal. Asset managers have a lot more," pointed out Chris

Will you change the number of research providers you use in the next 12 months?



Source: Euromoney

Have you set a research budget for 2016?



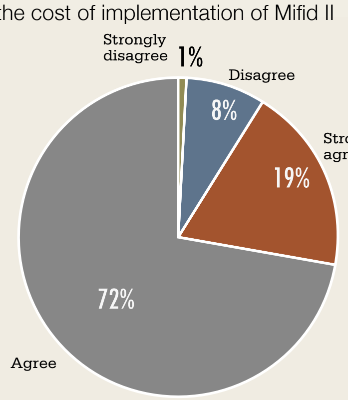
Source: Euromoney

Hitchen, CEO of the UK Railways Pension Trustee Co. "We are looking to asset managers to help us get the best deal through the value chain. The chain operates for the benefit of the people in the middle not at either end. We need to fix it."

Asset managers themselves are acutely sensitive to the issue of costs. "Increased complexity and conflicts of interest make it harder for clients to know if they are getting value for money," Andrew Stephens, head of UK intermediated business at BlackRock, said at the same conference. "From a cost perspective, asset managers are part of the solution. We should separate costs from value. They are not the same thing."

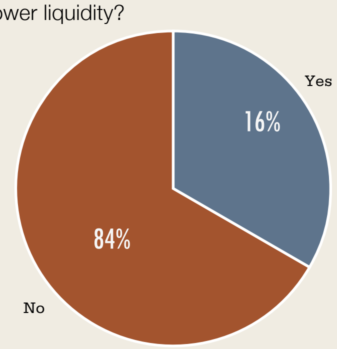
Legal & General Investment Management decided this year to pass research costs on and implemented a new fee structure from April 1 to its funds to cover the costs of research. Each fund has been assigned a research budget and fees have been increased by up to 15bp depending on the mandate. However, the more fixed income exposure each fund has, the lower

There will be consolidation in the sector as larger asset managers can better spread the cost of implementation of Mifid II



Source: Euromoney

Are you changing the terms and conditions of any of your funds in response to lower liquidity?



Source: Euromoney

"The buy-side consensus seems to be that budgeting by fund is now not necessary, but I suspect that the market is likely to end up with funds grouped into franchises organized by commonality. Budgeting will then be done by fund group"

Mike Carrodus,
Substantive Research

its fee increase has been, and funds invested exclusively in fixed income did not have research costs assigned to them – a grim indicator of the amount of fixed income research the investor plans to buy in.

Separating research costs and passing them on to clients as part of their fees will be very tough for client relationships and is likely to incentivize fixed income asset managers to go hard. This is bad news for research providers. "The received wisdom is that if all asset managers adopted hard payments the research market would quickly become two thirds of its current size," says Carrodus. Of the 18.6% of the Euromoney fixed income research poll respondents that indicated that they were planning to change the number of research providers they used, a surprising 43% indicated that they planned to increase the number by one or two providers and 27% planned to increase the number by more than two. If this is the case, they had better have a cast iron plan for how to pay for it. Mifid II will at the very least force asset managers to have a hard look at what they are getting for their money.

"Some of the least touched providers are getting the most money," says one investor. "Maybe that's reflecting the difference in the penetration of their work but I suspect much of it reflects inefficient procurement."

Once a research budget has been established and the method by which that budget will be spent agreed upon, asset managers then face the task of allocating these costs among their funds. "Post-trade allocation to each fund with differing research budgets after a trade will be a nightmare," predicts another investor. The draft rules simply state that firms must take account of the extent to which research purchased through the RPA benefits various portfolios and the firm must establish the approach it will take to allocate those costs. "The buy-side consensus seems to be that budgeting by fund is now not necessary, but I suspect that the market is likely to end up with funds grouped into franchises organized by commonality. Budgeting will then be done by fund group," says Carrodus.

If all fixed income research is now deemed substantive under Mifid II, and therefore must be paid for, providers have a tricky choice to make. There are now limited ways to approach research provision: have a free, non-substantive maintenance product or build a product around a particular strength that you can sell. For fixed income providers this could involve macro, rates or FX research built around a high profile 'rock star' strategist or research focusing on trade ideas and flow.

The ability to bear the cost of research provision will inevitably weigh heavily on the smaller players' ability to compete in fixed income. Of the two thirds of the Euromoney sample that have an opinion, 72% agree that Mifid II will prompt consolidation as larger asset managers are better able to bear the cost of implementation and 19% strongly agreed.

The delay to Mifid II was partly prompted by the redrafting of proposals for measuring bond market liquidity, something that does not seem to be of particular concern to this year's survey respondents. Some 84% of the sample do not plan to change the terms and conditions of any funds in response to lower liquidity. Of the 16% that are making changes, they are equally split between increasing liquidity backstops, increasing the percentage of gated assets and reducing daily liquidity. EM