

## Unbundling triggers second “Big Bang”

- Arete Research seminar on unbundling
- Myners: Fundamental changes are coming
- Research quality and pricing to be linked
- Consolidation likely in the broking industry

The signs are definitively here that fund managers in the UK are waking up to the realities of unbundling.

With similar changes being debated again at the SEC in Washington, unbundling of payments for research and execution is a becoming fact of life. The disclosure code from the UK's Investment Management Association will mean the first details of payments will be given to clients in the first quarter of 2006.

For now, admittedly, what that means is that disclosure has arrived – which is not necessarily the same as unbundling. Some fund managers will continue to make bundled payments for full service brokerage. But the genie is out of the bottle and in a cash equities business which already operates on “wafer-thin” margins, any shake-up to payment mechanisms and payments is likely to have profound implications.

A seminar in London arranged by Arete Research was packed to the rafters with fund managers, brokers and independent research providers all looking to figure out what the changes would mean for them.

Paul Myners, author of the eponymous report that started the upheavals in the investment management industry UK in 2001, steered the discussions. Myners was emphatic in describing the impact of the changes. “This is the second Big Bang,” he declared, in reference to the UK market reform of 1986. “There are fundamental changes coming and some people have yet to smell the coffee. Those are the organizations that will be at a competitive disadvantage”.

One fund manager spoke of “irreversible momentum gathering pace” and the discussions have moved decisively from the realm of the theoretical to the realm of the practical: fund managers are divvying up their commission budgets and calculating their research spend.

The sums are still rough and ready – with a couple of large buy-side institutions estimating that they would make a 50/50 split in the allocation of commission payments between execution and research. Myners was quick to dismiss the long-term workability of a simplistic split of this kind, and others agreed that divisions of this nature would be indefensible if commission payments increased sharply in line with market turnover.

While calculations like this are provisional, commission sharing arrangements (CSAs) are very real and are being more widely implemented. And there is, said Bernard Coupez, Head of External Research and Relations at BNP Paribas Asset Management, the possibility that CSAs will also

become part of the landscape in France. David Hagan, Director, M&G Investment Management did, however, strike a note of caution by asking how scaleable CSAs would be, given the burdensome amount of administrative work involved.

## RIGOROUS EXAMINATION

Along with CSAs goes an increasingly rigorous examination of brokers' research – something that was apparent from the buy-side. Hagan said that M&G is using its internal voting system and is benchmarking the sell-side research input more rigorously – with the goal of eliminating repetitive research and ensuring that payments are focused on “better” quality research in a more transparent way. For example, when a fund manager spends time on the phone with the sell-side it is benchmarked in terms of cost per hour, written work is compared with that from independent providers, as are conferences.

The new emphasis was echoed in the response from the sell-side. As Charles Scott, Head of Equity Client Services at Morgan Stanley put it, “we will welcome transparency over the next two years. It will be a lot easier for purchasers to focus on value in research. We see a real discipline on the buy-side as it takes internal voting a lot more seriously”.

Likewise, said Rick Galiardo, Director of European Research at Bernstein, “good stockpicking is what matters”. For him, the outstanding question is “how can the quality of research be linked to payments for research?” The drive towards value is even more apparent on the execution side, where it is backed by the looming MIFID directive, which will enforce a requirement for fund managers to achieve consistently best execution once it is implemented in 2007. “Best execution” will be defined not only in relation to price, but size, ability to settle and – crucially – non-execution services. Chris Hibben from the FSA told the meeting that there would be no letup to the timetable for the UK to introduce legislation to underpin MIFID.

That, in turn, prompted debate about the likelihood of a drift of business to a small number of very large players – something which will accentuate the pressures on smaller Continental European brokers. As Hagan said, “many of these brokers don't understand what I'm talking about when I ask them about splitting research and execution costs”. But from the dealing perspective, Mark Winter, Head of Equity Dealing at Insight investment management welcomed the fact that CSAs will mean buy-side analysts and fund managers rewarding good research contributions while dealers are free to focus on the quality of execution in an “unconflicted way”.

What is easy to calculate on the execution side is the cost of using an execution-only broker. By definition, the additional cost of using a full-service broker will reflect the additional payment for research, though brokers could be rewarded under this rubric for providing corporate access as well as for supplying the traditional research product, whether electronically or in hard copy.

## PAYING FOR RESULTS

On both buy-side and sell-side there was agreement that specific payments for research should lead to improvements in quality. Richard Kramer, managing director of Arete, called for research departments to behave more like businesses. “Research needs an open market price and should no longer be ‘free’, with pricing being differentiated in line with performance criteria,” he argued. He predicted the emergence of research pricing based around retainers and performance fees and called on fund managers to tell brokers to stop sending them research that was of no value.

That was exactly the message from Sheena Kelman, Head of Dealing and Asset Control at Martin Currie in Edinburgh. “We only want to pay for value-added research,” said Kelman, “and we won't accept blanket coverage from anyone”. As the research marketplace becomes more defined, fund managers will be able to specify which analysts or sector teams they want to deal with in a particular firm – a demand which the sell-side has been very reluctant to accept with its “all or nothing” approach.

Charles Scott at Morgan Stanley described the bundled approach as “an unsophisticated auction system” with fee tiers to dictate the quality of service which different clients received. “There will be a more sophisticated version in the future – as we get a better understanding of what clients will pay

for". This promise of "granularity" in pricing was picked up on by Mark Rogers, a Managing Director at UBS, who also tied it to improved feedback from clients.

The more the buy-side is willing to invest in specifying what it wants and what it values – and what it doesn't want or value – the more signals the sell-side will have in pricing its products. That, in turn, means the buy-side recognizing the value in the offerings of the research monitoring industry.

Ultimately, what matters in all this is what clients make of the data they are provided with. Some participants in the seminar were sceptical about the ability of clients (particularly those in the US) to understand and act on the information received.

Consultants, as AQ has found from its own discussions, are not exactly leading the way in grappling with the issues. And, for fund managers, there is still a belief that what matters in their relationship with their clients is performance, not the commission spend.

That said, once the figures on research and execution spend are out in the open, then they will be fair game for cost-cutters on the buy-side and for trustees who are concerned about payments which can, said Paul Myners, often exceed the agreed management fee several times over. Making the payments for research explicit will, said Myners, also break the linear relationship between commission and turnover.