Neil Scarth
Frost Consulting
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Unintended MiFID II Consequences: 'Information Asymmetry' and the Sudden Need for Research Spending Data

While Information Asymmetry has always existed, post-MiFID II, it will become global in scale and potentially institutionalized, with enormous competitive and return implications for asset managers and asset owners. In the short-term, the fulcrum of IA will be an asset manager's willingness and/or ability to pay for research.

MiFID II is revolutionizing the way information flows between research producers and asset managers in Europe, with implications for both performance and the relative competitive positioning of European managers in a global context.

The impact will soon become apparent at the portfolio level. One of the most foreboding sensations for portfolio managers is when a stock they own is falling rapidly, on high volume, and they have no idea why – and can't seem to find out. Obviously, something is happening, and obviously, somebody (or everybody except the PM) knows something that the PM doesn't.

This will be a major challenge in the MiFID II environment as PMs (at least in Europe) learn (the hard way) that they can't just call any analyst they want, whenever they want, in their panicked attempt to find the crucial piece of information they are missing. Under MiFID II, unless there is a specific contractual research relationship between the manager and the research producer, the sell-side analyst that has the critical market insight may be inaccessible, limiting the PM's ability to "survey the market."

This is a micro level example of a concept that will dominate the post-MiFID II investment landscape: "Information Asymmetry" (IA) – the fact that some market participants have more (and better) information than others.

While IA has always existed, post-MiFID II, it will become global in scale and potentially institutionalized, with enormous competitive and return implications for asset managers, asset owners and governments, which ultimately must fund aging populations. In the short-term, the fulcrum of IA will be an asset manager's willingness and/or ability to pay for research.

A key question is whether European managers will be at a competitive disadvantage versus their US peers. Although a number of large US managers have said they will pay for research via P&L, most will do so for European clients only. Consequently, ~90% of their research budgets will continue to be funded via commissions in the US (based on AUM). For large European managers using P&L to buy fund research, the percentages are reversed. This suggests that US managers may have a significant advantage, both in terms of size (and flexibility) of research spending.

The research funding choices made by asset managers themselves – P&L versus client money – may play a prominent role in long-term asset owner returns. Given the inevitable decline in asset manager research spending, particularly in Europe, profit-challenged research producers will be forced to re-allocate research capacity toward those clients that can pay (the most) for research.

The intent of MiFID II was clearly to increase asset manager research spending transparency in order to enhance returns for asset owners. The collision between an untested regulation and a fluid competitive environment has produced quite the opposite result.

The widespread move to P&L in Europe has actually reduced research transparency, given that P&L managers have no regulatory obligation to report research spending (unlike managers using client money). Combined with often significant budget cuts at P&L managers (Credit Suisse estimates 50% on average), MiFID II may have actually increased risks for asset owners.

The critical question for asset owners is: Does the specific strategy in which they are invested have sufficient research access to continue to generate the historic returns which (heavily) influenced the product decision purchase in the first place? This analysis must take place on a product or strategy basis rather than a firm level. The asset owner is not invested in BlackRock as whole (for example), but rather a specific fund/mandate.

The risk to asset owners that regulators sought to address in the pre-MiFID II environment was that their managers might overspend (client money) on research, thereby reducing returns. Rather than spending 3 bps, the manager might have spent 8 bps through inattention or a lack of discipline – as it wasn't their money.

The risk post-MiFID II is that P&L managers may cut research budgets sharply, which may reduce returns by far more than the original research "overspend." The latter was likely measured in single-digit basis points – the latter, potentially in hundreds of basis points. Even European regulators will concede that the lowest possible research cost may not always be in the best interest of the client

Another related, and critical, "asymmetry" in the post-MiFID II environment is the relative research costs borne by asset managers versus asset owners. For asset owners (whose managers use client money), the cost of research is very low, usually single-digit basis points of AUM. (For context, long-term equity returns are ~700 bps per annum.)

By contrast, when the research charge is transferred to the asset manager P&L, the historic (client money) research cost often represents the manager's single largest expense – after every manager's number one cost: staff compensation.

This research cost asymmetry clearly explains why the vast majority of P&L managers are cutting research budgets. The impact is particularly acute at managers that had planned to use client money for research (a big number) but reversed course late last year.

The CIO suddenly has to ask the CFO if it's possible to somehow find XX million dollars for research from the 2018 budget – that had not been anticipated, and with less than three months' notice.

The P&L research budget request will have profitability implications for all asset managers, increasing in intensity and importance depending upon whether the manager is publicly listed and/or has relatively small AUM.

The trade-off between research spending and profitability raises existential questions for P&L managers. How can the firm best balance short-term profitability with sufficient research spending to generate the medium-term alpha, which in turn, drives long-term franchise value?

Because asset owners will examine manager research spending on a fund/strategy basis (the level on which they are invested), managers too must adopt this lens to allocate their aggregate research spend between strategies – regardless of how it is funded.

All market participants, particularly regulators and asset owners, increasingly recognize that not all investment strategies require the same amount of research. Consider the research needs of a US Treasury portfolio (low return/low volatility) versus those of an Emerging Market Distressed Corporate Bond Fund (high return/high volatility).

In the first instance, both the issuer (US Government) and the security (10-year T Bond) are well known. In the second, there are multiple significant risks to be analyzed, including the company-specific risk, risks of the local legal framework, currency risk, etc. Clearly, the second portfolio requires more research and a larger research budget. Investors should be wary of funds requiring complex risk analysis with insufficient research budgets (i.e., a Small-Cap Biotech Equity fund).

Frost has done pioneering work on the relationship between the return/volatility characteristics of investment products and their "research intensity." Strategies targeting higher than average returns primarily achieve them by taking higher than average risks – which are frequently complex. (The FrostRB Research Intensity Template quantitatively derives customized fund/strategy top-line budgets for managers using client money and serves as an internal research budget allocation mechanism for those using P&L.) This process allows managers to answer the question: Where did the top-line budget number come from?

Given the "Information Asymmetry" between managers created by MiFID II, and the lack of research spending transparency resulting from the widespread move to P&L, asset managers need industry data to know where they stand in this rapidly evolving competitive environment. Key questions include:

- *For managers using client money* – How do our fund/strategy research budgets compare to our peers in similar products? If our budgets are above peer averages, a) it's good to know, and b) how will we explain this to clients?
- *For managers using P&L* – How do our fund/strategy research budgets compare to those of managers using client money in similar products? Are our research budgets sufficient to allow our investment products to be competitive?
- *For all managers* – How can we analyze and optimize research ROI by fund/strategy?

The answers are critical. Managers that can demonstrate high research ROI are far more likely to retain the use of client money for research. For P&L managers, this data will be a critical in managing the balance between profitability and investment competitiveness.

If P&L managers cannot maintain competitive research budgets without significantly impairing profitability (and franchise value), might they re-visit the P&L decision with their clients (whose primary objective is that the manager continues to generate historic rates of return in the investment product they own)?

This is why Frost Consulting has built and commenced the global rollout of FrostDB, an asset manager research spending database designed to let managers "know where they stand" on a strategy budget by strategy budget basis.