European Asset Managers Are Using MiFID II as a Weapon in the Battle for Global Asset Flows

Capitalizing on the Complacency and "Regulatory Fatigue" of their US Competitors

By Neil Scarth, Principal, Frost Consulting

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Far-sighted European asset managers are forging a commercial advantage out of an unlikely source - the inevitable regulatory reality of MiFID II.

This alchemy may help European managers turn the tide against the predominant theme in asset flows since the turn of the century – the seemingly inexorable market share gains made by large US-based managers as they have broadened asset raising efforts outside of their domestic market.

MiFID II requires fund level research budgets

MiFID II will require managers to construct monetary research budgets at the fund level potentially allowing European asset managers to increase returns and create greater alignment with client (asset owner) investment objectives. US managers who choose not adopt this global best practice risk reducing client returns through inflated and inefficient research spending that is not specifically aligned to different investment mandates.

Traditionally, asset managers have allocated ~$20 billion dollars per annum of their clients' research commissions via broker vote – a which rewards research producers (overwhelmingly investment banks) with a specific percentage of an unknown and volatile commission total. This volatility means research spending can vary sharply from year to year depending upon market conditions – despite similar levels of research consumption.

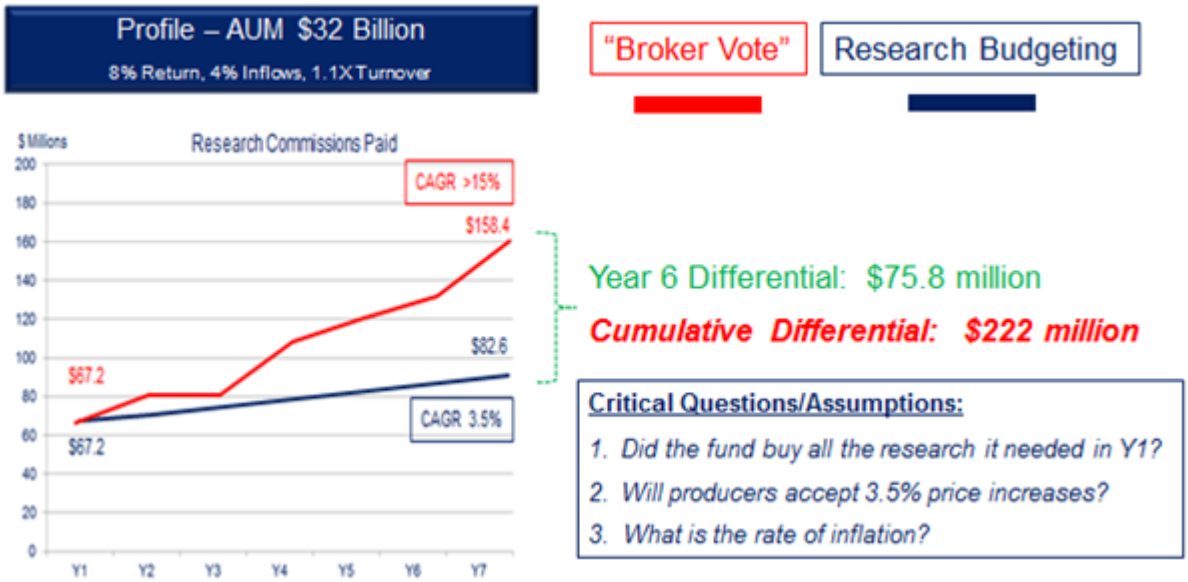
Because commissions are the asset owner's money (deducted from returns) and because asset managers had the luxury of using their clients funds to purchase the main raw material (research) in their industrial process (investment decision-making), European regulators desired greater alignment between this spending and client outcomes.

The regulatory objective was to, t cut the link between trading turnover and research spending. Spikes in market volatility and turnover have resulted in unintentionally inflated research payments being made. This excess spending was then deducted from the client's return.

Setting research budgets impacts investment returns

MiFID II will require European managers to decide at the beginning of the year, how much (in dollar terms) to pay research providers for specific services Once those limits are reached (with a broker) trading commissions move to ex-only rates, capping the research payments regardless of equity market volatility.

This can have a significant effect on investment returns as the example below demonstrates. In this case a $32 billion AUM fund with 8% returns, 4% asset inflows and 1.1X portfolio turnover tracked its research spending over a 7 year period using the traditional "Broker Vote" method. It then compared the results to a research budget regime featuring a 3.5% annual price increase.



The savings were material and would have been directly added back to the fund's return. In the current environment of generally decreasing research commission spending, most research producers would relish the prospect of a 3.5% annual price increase.

Moreover, MiFID II will require asset managers to inform asset clients' of their respective share of the managers anticipated monetary research budget *in advance.* This implies monetary research budgeting *at the fund level rather than at the firm level*: asset owners have to be allocated their portion of research costs that relate to the actual investment products in which they are invested.

Cross-subsidisation is off the menu

Asset owners are increasingly sensitive to fund cross-subsidization. They do not want *their* commissions spent on research products that are not related to the specific mandates managed on their behalf.

Transitioning from a blunt, firm-wide broker vote process to fund level, product-based monetary research budgets represents a significant operational challenge for European asset managers. But, the rewards are also substantial.

Policy decisions by senior management can have a material effect on both asset manager and client outcomes. The key is motivating busy investment teams with an aversion to change and administration.

Most investment teams are extremely interested (if not obsessed) by their returns; they are very keen to grow AUM, and are frequently passionate about promoting their specific investment processes.

If fund-level monetary research budgeting is presented as an opportunity for investment teams to generate alpha, grow AUM, identify and retain the research that is critical to their process, and achieve greater alignment with their clients, rather than as the latest in an endless procession of regulatory requirements, adoption will be enhanced.

Client alignment is critical

Client alignment is critical. The "contract" between the asset manager and the asset owner goes far beyond the fee structure. To invest, the asset owner must be comfortable with the manager's investment process, fund strategy, risk framework, securities universe and expected return targets. Fund-level research budgets can uniquely reflect both investment process and portfolio construction, completely aligning the research spending with the investment objectives that have been mutually agreed by the asset manager and the asset owner.

For European asset managers, this is a 360 degree "win-win" situation. Returns improve. Investment teams are happy. Clients are happy. Compliance is happy – and, marketing is delighted as targeted fund-level research budgeting is integrated with the investment process allowing the manager to demonstrate how it maximizes ROI on research spending, while simultaneously supporting mutually agreed investment objectives – thereby transforming unavoidable regulation into competitive advantage.

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About Frost Consulting:

Frost Consulting is a London/Frankfurt-based firm that works with asset managers and asset owners on a variety of research issues including research valuation and budgeting. The FrostRB software platform allows managers to construct strategy/fund specific monetary research budgets reflecting investment process, portfolio construction and expected returns.

About Neil Scarth:

Neil has held a wide range of roles in asset management and investment banking in both Europe and North America, ranging from running equities businesses at global banks to launching and managing all aspects of varying asset management products.

Neil was appointed to the IMA's Research Review Advisory Panel. Frost was sponsored by CFA UK/CFA Institute to write a White Paper on the Valuation of Equity Research to help the industry meet new UK regulatory requirements.