AbelNoser

Unintended Consequences of MiFID II Research Unbundling

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Introduction

For several years, we have been alerting asset owners and investment managers about both the opportunities and potential unintended pitfalls associated with the Markets in Financial Information Directive II's (MiFID II) research unbundling rules.[1] To be sure, we support the increased transparency and accountability engendered by the new rules. However, we have also cautioned asset owners to be proactive in ensuring that the manner by which their managers comply with MiFID II does not inadvertently put client funds at greater risk, and/or disadvantage US asset owners relative to their managers' European clientele (regarding the payment of each client's pro-rata share of the manager's research costs).

We now have 20+ months of history since MiFID II went into effect and feel it is worth revisiting one of our concerns to reassess its validity. While it's obviously still early days, nothing we currently see in the marketplace gives us cause to revise our initial view

Specifically, the concern we raised was the risk that managers who decided to use their own operating budgets to purchase research (rather than use client money via bundled commission rates, soft-dollars, CSAs etc.[2]) may subsequently face internal pressure to reduce the amount of research they bought in order to maintain adequate profit margins. While this impulse is certainly understandable from a financial management perspective, it must be properly balanced against portfolio management needs so as to ensure the reduction in research doesn't negatively impact the firm's investment performance.

In this regard, according to recent research from Evercore ISI[3], the 2018 investment performance of managers who chose to pay for research from their own operating budgets significantly underperformed managers who adhered to the more traditional bundled-research/soft-dollar model.[4] Even taken at face value, we would not argue that such a finding repudiates the genuine grievances MiFID II was designed to address. However, it does present asset owners with an interesting conundrum. To wit, the immediate appeal of having a manager pay for its own research (and thereby reduce the commissions paid from the asset owner's fund assets) may have a longer-term unintended effect of hurting the manager's overall investment returns.

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[1] See: Glass, "*The $250 Econ 101 Textbook and other Soft-dollar concerns for asset owners*," (Fourth Quarter 2014); Glass, "*Commission unbundling: a new fiduciary responsibility for asset owners. Are you ready???*" (Mid-year 2016); and Glass, "*Commission Unbundling: Carpe Diem!"* (Mid-year 2017), copies of which are accessible on Zeno AN Solutions' website.

[2] It should be noted that the terms "bundled commissions" and "soft-dollars" often entail different mechanics for determining the amount paid to research providers as well as types of research received in return for those payments. However, conceptually, both terms connote the practice of managers paying higher commission rates than they otherwise would, in order to purchase research with their client's money. Given the focus of this article, the different mechanics are immaterial, and the two terms are therefore used interchangeably herein.

[3] Evercore ISI is a global strategic advisor, investment management, and research firm. In 2018 it had the second highest number of analysts ranked #1 by *Institutional Investor*, as well as being ranked the #2 research firm on a weighted basis and #4 in overall positions. Evercore ISI serves more than 1,300 institutional investors globally, representing some of the largest asset managers and fund complexes in the world.

[4] Schorr, Chung, Dunn, Young, *The Most Self-Serving Research Note Ever?* Evercore ISI Research, (April 26, 2019). The research was conducted with the assistance of Frost Consulting and Strategic Insight Simfunds.

In this article, we look at this potentially disconcerting consequence of MiFID II's research unbundling rules. After exploring possible explanations for such a result, we conclude with recommended due-diligence steps that both asset owners and managers might consider undertaking.

Unintended Consequences?

As we and other industry experts have often opined, MiFID II's research unbundling rules may inadvertently create an environment whereby global and European managers find it administratively expedient to simply use their own money when purchasing external research rather than go through the new steps required under MiFID II to continue using client money. This of course begs the question: Will those managers continue to buy the same amount of research (as in prior years) once the cost of that research falls onto the manager's financial books?

Indeed, beginning in the second half of 2017, an increasing number of global and European managers announced that they would commence using their own money, rather than their clients' money, to purchase external research. Equally significant, throughout 2018, reports surfaced that a number of those global and European managers had slashed their research budgets by upwards of 50% or more.[5] This in turn, begs a second question: Will those managers be able to sustain their historical performance levels after significant research cuts?

Most recently, this same question was posed by the CFA Institute in its 2019 report analyzing the provision of research in the US following MiFID II.[6] The bulk of the CFA Institute's paper focused on the history of MiFID II's new rules and the potential conflicts faced by managers who use client money to buy research. However, the paper also detailed a number of risks asset owners should be mindful of. In this regard, in projecting the potential consequences of managers cutting their research budgets, the CFA Institute warned that, "lower investments in research by small and midsize asset managers… has significant potential to hurt investment performance for managers and their clients over time."[7]

Coincidentally, at the same time the CFA Institute was writing its report, Evercore ISI was conducting its analysis of manager performance in 2018 (the first full year in which MiFID II's research unbundling rules went into effect). Their research showed that, in 2018, managers domiciled in the US (who primarily still used customer funds to purchase research) outperformed their non-US competitors (who were primarily purchasing research with their own money) by significant margins. Importantly, the degree of outperformance by US managers was statistically greater than the outperformance those US managers historically enjoyed.

While recognizing that the review period is only one year (and therefore too short to be dispositive of long-term performance trends), a number of experts have opined that this divergence from historical norms is not coincidental and, in fact, is closely tied to the disparate levels of research purchased by US and non-US

[5] For example, on February 25, 2019, Andrew Bailey of the Financial Conduct Authority (FCA) observed in his remarks before the European Independent Research providers that in the UK, the FCA had found that manager research budgets had been reduced by around 20-30% (it should be noted that these percentages are significantly bolstered by hedge funds who continue to use client money for research); in 2018 Credit Suisse published research estimating that research budgets would be cut by around 50%; in 2018 Zeno conducted audits on behalf of its clients in which several managers indicated they had cut their research budgets by as much as 70%; and the CFA Institute noted an example of an European manager who cut its payment to a research provider "to $50,000 in 2018, from $1 million the year before" CFA Institute, *The Future of Research in the US After MiFID II*, 27 (2019) ("CFA Institute 2019 Future of Research")

[6] CFA Institute 2019 Future of Research, at 27.

[7] Id.

managers, respectively. To our knowledge, the Evercore ISI research is the first analysis to look at the impact of MiFID II's research unbundling rules on manager performance. As such, we feel it is worth taking a closer look at their findings.

Methodology

Evercore ISI's study reviewed the performance data of every available equity mutual fund with at least $100 million in AUM. Because there is no formal repository for tracking which mutual funds pay for research with client money versus their own internal budgets, as a proxy, Evercore ISI compared US versus global and European managers. This decision was based on abundant anecdotal evidence suggesting that the vast majority of global/European managers have switched to using their own P&L for purchasing research[8], while most US-based managers continue to use client money to purchase research (i.e. via soft-dollars, CSAs, etc.).[9]

In all, Evercore ISI looked at 3,363 mutual funds managing almost $6 trillion. 53% of the managers were US-based, and 47% were global/European (although 85% of the assets were with US-based managers). These funds were then divided among five US investment strategies (e.g. Large Cap Growth, Small Cap, etc.), seven global categories (e.g. global equity, emerging markets, etc.), and three sector categories (ESG, technology and health care).

Once Evercore ISI had properly categorized each mutual fund, they measured the relative performance (i.e. outperformance or underperformance) of US verses global/European funds within each investment strategy. These calculations were performed for 2016, 2017, and 2018. Evercore ISI chose to begin their analysis with 2016 because they recognized that some managers had begun changing their research policies in 2017 (in anticipation of MiFID II becoming law in 2018). Reviewing all three years thereby enabled Evercore ISI to compare returns from both before and after each manager's MiFID II changes went into effect.

Key Findings

- While in 2016 US-based managers generally outperformed global/European managers, starting in 2017 and continuing through 2018, the US-based manager outperformance became more pronounced and across more investment strategies.

- The US-based manager outperformance was even more significant when focused on alpha generation (with US-based managers accounting for 67% of the alpha in 2016, 78% in 2017, and 91% in 2018).

- The US-based manager outperformance was especially dramatic when calculated on an AUM-weighted basis (as opposed to an equal-weighted basis). Specifically, the number of US-based managers that outperformed global/European managers in 2018 grew to 87% (if calculated on an AUM-weighted basis) from 71% (if calculated on an equal-weighted basis), with global/European managers outperforming in only two investment strategies. The same holds true when looking at alpha generation, which increased to 98% (if calculated on an AUM-weighted basis) from 91% (if calculated on an equal-weighted basis).

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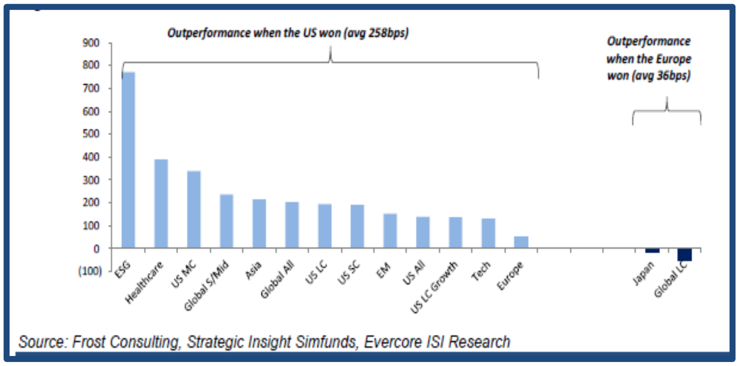
[8] CFA Institute 2019 Future of Research, at 7 (quoting remarks from Andrew Bailey of the FCA, "Most notable has been the shift by a vast majority of traditional asset managers to fund research from their own revenues – instead of using their clients' funds." Supra Note 4. Further, in a 2019 study of UK managers, the UK CFA Institute found that by 2018, 65% of small mangers had stopped using client money to buy research and virtually no large firms were still using client money. CFA Institute, "*MiFID II: One Year On: Assessing the Market for Investment Research*," (2019).

[9] For example, the US CFA Institute found that only around one-third of US managers don't use client money to buy research. CFA Institute 2019 Future of Research, at 28.

- It should be noted that Evercore ISI's AUM-weighted findings are particularly relevant for institutional asset owners since AUM-weighted comparisons are more reflective of the performance of larger managers (i.e. who are capable of managing institutional-level assets).

- As shown in Table 1 below, on an AUM-weighted basis, US-based managers outperformed their global/European counterparts in the vast majority of investment strategies, often by many hundreds of basis points. Further, in the few instances where the global/European managers outperformed (i.e. Japan and Global Large Cap), the outperformance was only slight.

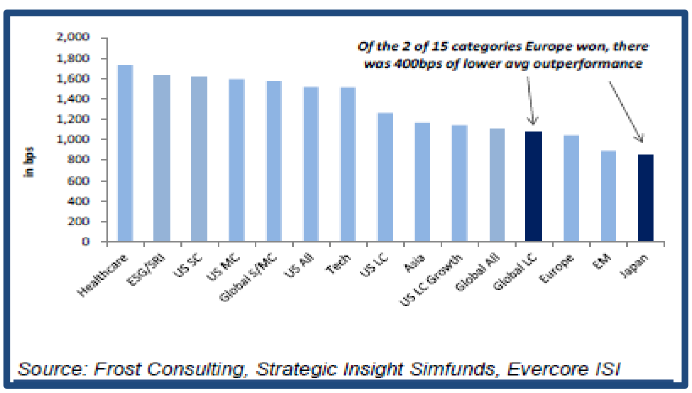
Table 1



Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI Research

- Perhaps equally important, if one assumes that purchasing less research hinders performance, asset owners should take care that a previously top-performing manager doesn't fall to the bottom quartile if they cut too far back on research. In this regard, Evercore ISI noted that the spread between the top-quartile and bottom-quartile managers within the same investment strategy often exceeded 15%. Table 2 displays the difference between 1st quartile and 4th quartile managers, on an AUM-weighted basis, for each of the investment strategies reviewed.

Table 2



Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI

Implications for Asset Owners

The Evercore ISI research concluded that the effect of managers purchasing research with their own money may have resulted in managers buying significantly less research, which in turn may have resulted in a pronounced reduction in performance. Of course, any number of other reasons might have contributed to the lower performance, but this most simple idea that restricting access to both variety and quantity of external research may cause a negative drag on performance resonates.

There is also a very practical aspect to the above conundrum which every asset owner should recognize. If the aggregate research cost for a particular investment strategy is spread across all of a manager's clients, the impact to each respective client is only a couple basis points (i.e. a portion of their commission rate). Conversely, if the manager pays the entire research cost from the manager's operating budget, those research costs will likely represent the manager's second largest expense item (behind personnel costs) and can easily eat up 20-40% of the manager's profit margins.

For example, based on Zeno AN Solutions' Peer Group Universes, the typical Small Cap Growth manager currently pays an average bundled commission rate of about 2.2¢ (7 bp), and execution-only rates of around 1.5¢ (4 bp). At the same time, the average turnover rate for Small Cap Growth managers is currently around 75%. This implies that if a Small Cap Growth manager decided to stop using their clients' money to purchase research, those clients would see an improvement in their annual investment performance of around 4.5 bp.[10]

Of course, this assumes the manager would continue to purchase the same amount of research as they historically did when using client money. Using the same example, if that Small Cap Growth manager had $3 billion in assets under management, the research calculations described above would equate to the manager assuming an additional expense of over $1.3 million! One doesn't have to be a financial expert to recognize the toxic pressures and influence this dynamic may have on a manager's internal research-budget planning.

In particular, if the manager subsequently determined it could not afford an additional expense of $1.3 million and therefore dramatically cut their research budget, a prudent fiduciary may rightfully wonder whether the manager could continue to sustain their historical levels of performance. In this regard, as noted in Table 2 above, the 2018 the performance differential between a top and bottom quartile Small Cap Growth manager was upwards of 1,600 bp.

This is the conundrum asset owners face. More to the point, every asset owner must weigh the appeal of improving their portfolio returns by 4-5 bp (by virtue of no longer paying for manager research through higher commissions), against the risk that they may thereby inadvertently incur weaker returns on the order of multiple percentage points (as a result of less informed/weaker investment ideas).

Clearly, much more analysis is needed before presuming the existence of such a disconnect between fiscally responsible research-spends and weaker investment performance. However, a fair question all asset owners should ask is whether they need to wait for conclusive proof before investigating this possibility with their managers.

Conclusions

To be clear, Zeno AN Solutions is, and always has been, a strong advocate for asset owners (as many managers will attest). However, in this instance, given the risk of dramatically worse returns, we caution both asset owners and managers not to be "*penny wise and pound foolish*." Rather, we suggest that managers make a

[10] This number is derived by taking the difference between the median manager's commission rate of 2.2¢ (7 bp) (a portion of which is necessarily used to purchase research) verses the execution-only rate of 1.5¢ (4 bp). The difference of 3 bp is then multiplied by the 75% average turnover rate and doubled to reflect round-trip trading volume. This converts the bp differential into an annualized return.

comprehensive assessment of their underlying rationales for covering the cost of research from their own P&L and the potential long-term impact of dramatically reduced research budgets.

At the same time, we encourage asset owners, as prudent fiduciaries, to explore these issues with each of their managers, particularly those who have already chosen to, or who plan to pay for their research costs out of their own budgets. Having said that, asset owners should not be surprised if some managers are unable to provide this information. This was the experience of the SEC in a study they conducted on more than 1,500 managers in July 2018.[11] In particular, the SEC noted that many managers were currently unable to:

- Adequately disclose their use of soft-dollar arrangements;
- Determine whether some clients bore a disproportionate amount of the soft-dollar costs than other clients;
- Provide accurate disclosure of the products/services they purchased with the soft dollars; and
- Allocate soft-dollar expenses in accordance with their stated policies.

To facilitate such discussions, we have therefore appended to this article a short checklist of questions asset owners might consider posing to their managers. We also encourage managers to conduct similar internal analyses, even if not requested by clients.

Such an exercise (regardless of who prompts it) will help focus attention on the causal link between research and returns, which should be viewed as an industry best practice. Further, in addition to providing comfort to clients, such an analysis would represent an important first step for managers trying to quantify the 'return on investment' associated with their research budgets (which also happens to be a MiFID II requirement). As always, we stand ready to assist clients in administering these questions and evaluating the answers.

In conclusion, the CFA Institute's 2019 report urged the SEC to implement several recommendations, including, "consider investor outcomes rather than specific costs when determining whether an investment manager or advisor has achieved best execution for its clients."[12] We agree. We also believe this sentiment is consistent with reinforcing the importance of managers purchasing enough research to sustain superior investment returns, even if it means using client money.

Let us replace sentimentalism by realism, and dare to uncover those simple and terrible laws which, be they seen or unseen, pervade and govern.

Emerson, The Conduct of Life (1860)

[11] SEC, *Risk Alert: Compliance Issues Related to Best Execution by Investment Advisors* (11 July 2018).
[12] CFA Institute 2019 Future of Research, at 31.

Appendix - Compliance & Fiduciary Oversight MiFID II Questions for Managers

1. Prior to January 1, 2018, did you utilize client money to purchase at least some of your external research?

2. After January 1, 2018 (and/or 2019), did you modify that policy? If so, in what manner?

3. How much was spent on external research for the entire investment strategy (not just our account) that we engaged your firm, in 2017, 2018 and 2019; and what percentage was paid from client assets vs. your internal operating budget?

	2017	2018	2019
Total amount spent on external research	$_____	$_____	$_____
% paid with Client assets (e.g. via Bundled, Soft-dollars, CSAs, etc)	___%	___%	___%
% paid from Manager's internal operating budget	___%	___%	___%

4. To the extent the amount of external research purchased in 2018 and 2019 was at least 15% less than the amount purchased in 2017 and/or 2016, please explain the following:
   a. Why did you feel you needed less research in 2018 and 2019 than in prior years?
   b. Why do you feel investment performance will not suffer if you purchase less research than in prior years?

5. What was the average commission rate our fund paid?
   a. In 2017 (both in basis points and cps) ___ bp ___ ¢
   b. In 2018 (both in basis points and cps) ___ bp ___¢
   c. In 2019 (both in basis points and cps) ___ bp ___¢

6. As of December 31, 2017, what was the investment strategy's 1-year, 3-year, 5-year, & 10-year returns and alpha?
   a. Annualized Return 1-year ___% 3-year ___% 5-year ___% 10-year ___%
   b. Annualized Alpha 1-year ___% 3-year ___% 5-year ___% 10-year ___%

7. As of December 31, 2018, what was the investment strategy's 1-year return and alpha?
   a. Annualized Return 1-year ___%
   b. Annualized Alpha 1-year ___%

8. As of September 30, 2019, what is the investment strategy's 3-quarter return and alpha?
   a. Annualized Return 3-quarter ___%
   b. Annualized Alpha 3-quarter ___%

For more information about this article and Abel Noser, please see our website at www.abelnoser.com or contact the authors, Steve Glass at sglass@abelnoser.com or Mike Earlywine at mearlywine@abelnoser.com .