MIFID II: Assessing the Market for Investment Research One Year On

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ABSTRACT

Since the introduction of MiFID II in January 2018, asset managers and investment banks have weathered a shakeout in the investment industry as investment firms seek to recalibrate their research needs under the new regime. Although MiFID II has brought transparency and competition to the investment research business, a Europe-wide survey by CFA Institute on the outcomes of MiFID II one year on paints a picture of reduced research budgets and rising concerns over a perceived reduction in research quality and coverage. With indications that buy-side firms are in-sourcing research, pressure is mounting on independent and sell-side research providers. The investment professionals surveyed cite decreases in the number of analyst jobs and a scaling back of research coverage, with the small- and mid-cap equity sectors affected most.

Introduction

The European financial services industry underwent its biggest regulatory overhaul in more than a decade with the introduction of the revised Markets in Financial Instruments Directive (MiFID II) on 3 January 2018. The legislative package introduced significant changes to investment firms and financial markets, including enhanced “inducements” rules governing the payment for investment research.

Additionally, MiFID II introduced new trade-transparency requirements in equity and fixed-income markets, strengthened requirements for the provision of investment advice, and enacted new product governance rules.

Most notably, the changes to portfolio management inducements rules disrupted the provision of investment research. Under MiFID II, providers of research, such as investment banks and brokers, are required to set prices and charge for research separately from trading costs (commissions and spreads). Investment management firms — users of research — have had to determine whether to absorb the cost of research or to pass on those costs to clients. The changes broke the historical business model of investment firms bundling research with transaction costs, which are deducted from the client’s account.

The motivation for introducing these rules was to alleviate potential conflicts of interest between investment managers and their clients when transacting with brokers. The provision of supplementary research services by the executing broker — such as research reports, analyst calls, corporate access, or other nonmonetary benefits — creates incentives to route trades to that broker. These so-called inducements may create the potential to trade more often than is appropriate for the client or to preclude the use of other brokers who may provide more favourable execution services. Consequently, end-clients may incur higher (bundled) transaction costs than would otherwise be appropriate.

With the implementation of these changes, the nascent market for investment research has undergone a period of price discovery, with research providers seeking to establish prices for different research products and services, and investment managers developing research budgets that align more explicitly with the investment strategy being pursued. A key business decision for investment managers has been to determine whether to pay for costs internally (against the firm’s profit and loss) or to pass costs on to clients (by way of a research payment account). As investment managers have calibrated their budgets, research providers have had to adjust pricing estimates and to consider the scope of coverage across asset classes, sectors, and geographies.

One year on from the introduction of MiFID II, we sought to assess the state of the research marketplace through a survey of investment professionals. We set out to gauge the industry's perceptions of the impact of the rules on research budgets, costs, quality, coverage, and other aspects, building on work undertaken with buy-side investment professionals published one year ago. This enables a comparison of market expectations before the introduction of MIFID II with perceptions of the research marketplace one year into the new regime, and builds upon the prior work by incorporating the view of sell-side professionals in addition to buy-side professionals.

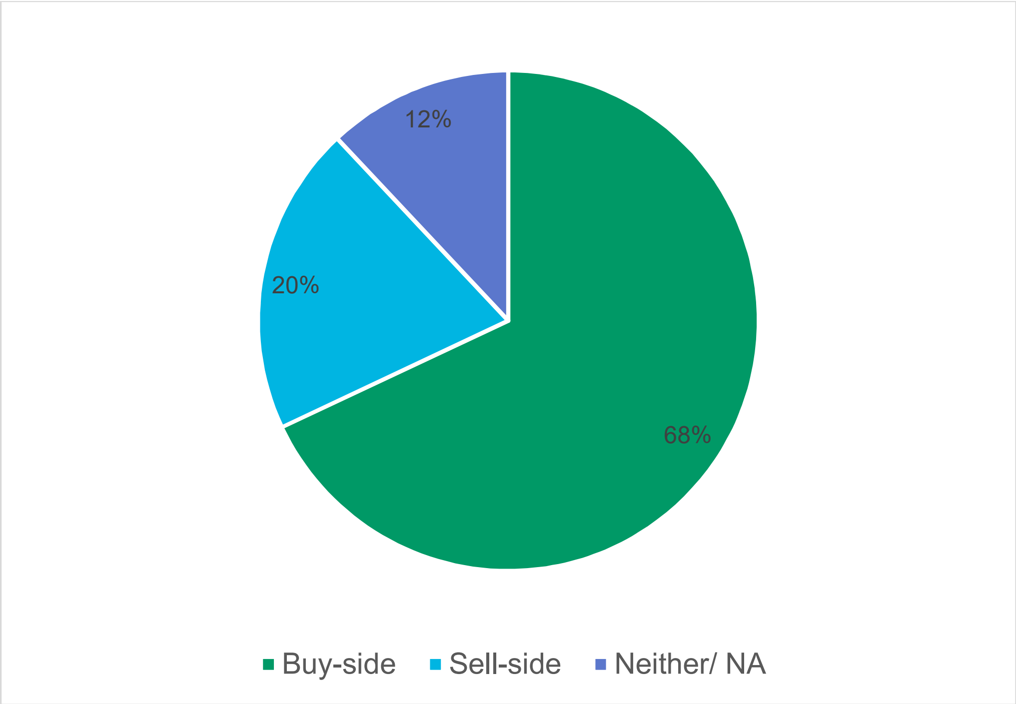
Survey Methodology and Demographics

CFA Institute conducted a survey of its European members between 6 and 19 December 2018. The survey was sent to a sample of 12,633 members in the European Union, the United Kingdom, and Switzerland. In total, 496 responses were received, for a response rate of 4% and a margin of error of ±4.3%. Respondents came from 449 different firms across 25 different European countries.

The top four occupation categories represented are: portfolio manager, research analyst, C-suite (chief executive officer [CEO], chief financial officer [CFO], chief investment officer [CIO]), and financial adviser or wealth manager. Collectively, these core investment management job functions account for 60% of respondents.

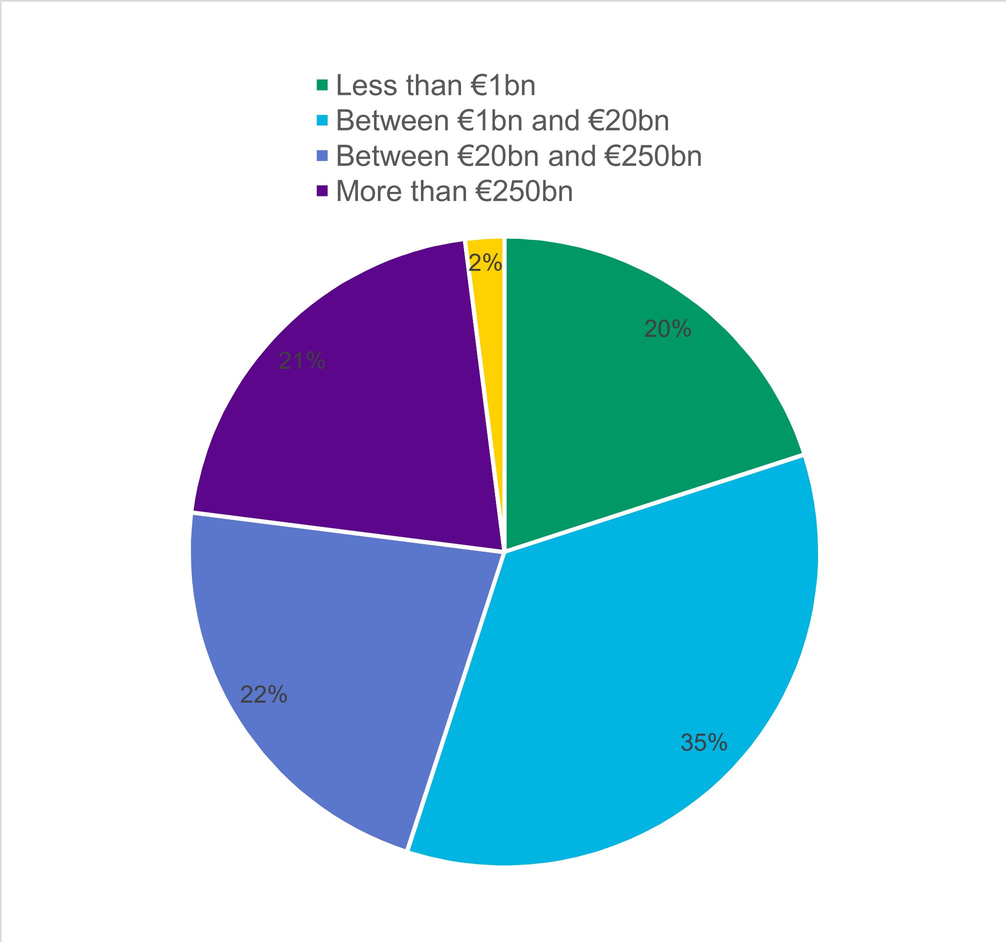
Approximately 60% of the respondents work in asset management or private wealth management firms, and nearly 25% of respondents work in banking institutions. In total, approximately two-thirds of the respondents work on the buy side of the investment industry, and one-fifth work on the sell side (Figure 1).

Figure 1: Respondent Profile by Type of Firm, Buy Side or Sell Side



The assets under management (AUM) of buy-side respondents' firms are shown in Figure 2. The data illustrate that a broad cross-section of firms across all size categories are represented in the survey results. We subsequently grouped responses into four AUM categories, with a similar mass of respondents in each category, to enable statistically significant comparisons across firm size (Figure 2).

Figure 2: Respondent Profile by Firm Size - Assets Under Management (grouped)



Results

We tailored the survey questions according to which side of the industry (buy side or sell side) the respondent represented. For buy-side respondents, we sought to determine whether the firm or the client pays for investment research and asked: How does your firm pay for investment research?

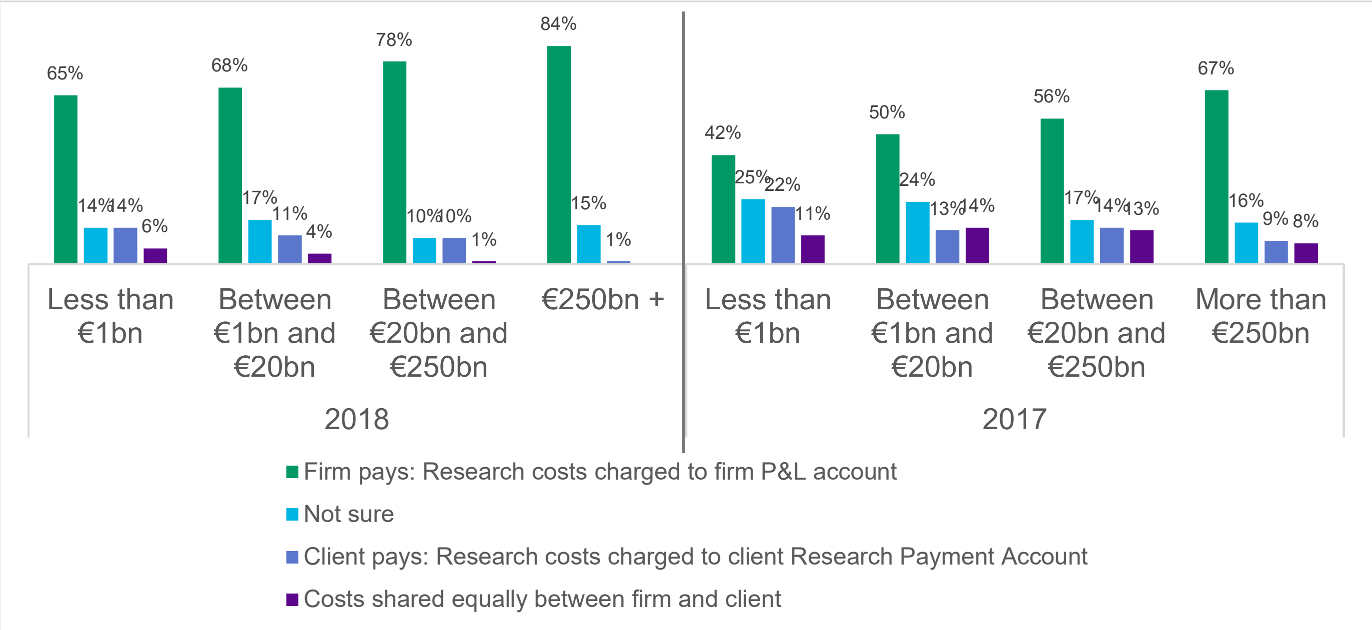
In the months leading up to the introduction of MiFID II in January 2018, industry professionals observed a general trend toward firms opting to pay for research (charged against the firm's profit and loss) as opposed to charging clients. This observation was corroborated in our 2017 survey data. One year on, the survey results affirm that trend, as illustrated in Figure 3. The clear majority of respondent's firms pay for research, which holds true across all AUM size categories. We observed this same trend when analysing the results for this question according to the geographic distribution of respondents (not shown).

With clients (asset owners) of large investment firms expecting research costs to be paid by their managers, competitive pressures have forced most asset managers to absorb research costs. An additional factor behind the decision of firms to absorb these costs is the administrative convenience of doing so. Firms that opt to charge clients must establish research payment accounts, which carry additional regulatory requirements. Furthermore, booking the research cost against the firm's profit and loss may confer certain tax advantages.

Since the introduction of MiFID II, there has been little evidence of investment firms increasing their management fees to compensate for the absorption of research costs, which typically amount to a few basis points of AUM. This outcome is largely positive for end-investors, but it implies that asset managers face some additional margin pressure. This margin pressure most likely will be felt by smaller firms, which incur proportionately higher research costs per unit of AUM, suggesting a potential competitive tilt benefitting large firms.

Figure 3: Attribution of Research Costs under MiFID II

Question: How does your firm pay for investment research?



Note: Results are grouped by AUM of the respondent's firm, with 2017 data (right panel) shown for comparison.

A key business decision for asset managers is how much to budget for research. The budget is a function of a variety of factors, including the extent of reliance on external research providers, the type of investment strategy pursued (i.e., the research intensity of that strategy), and the nature of the firm's relationships with brokers (i.e., the firm's importance and therefore its bargaining power).

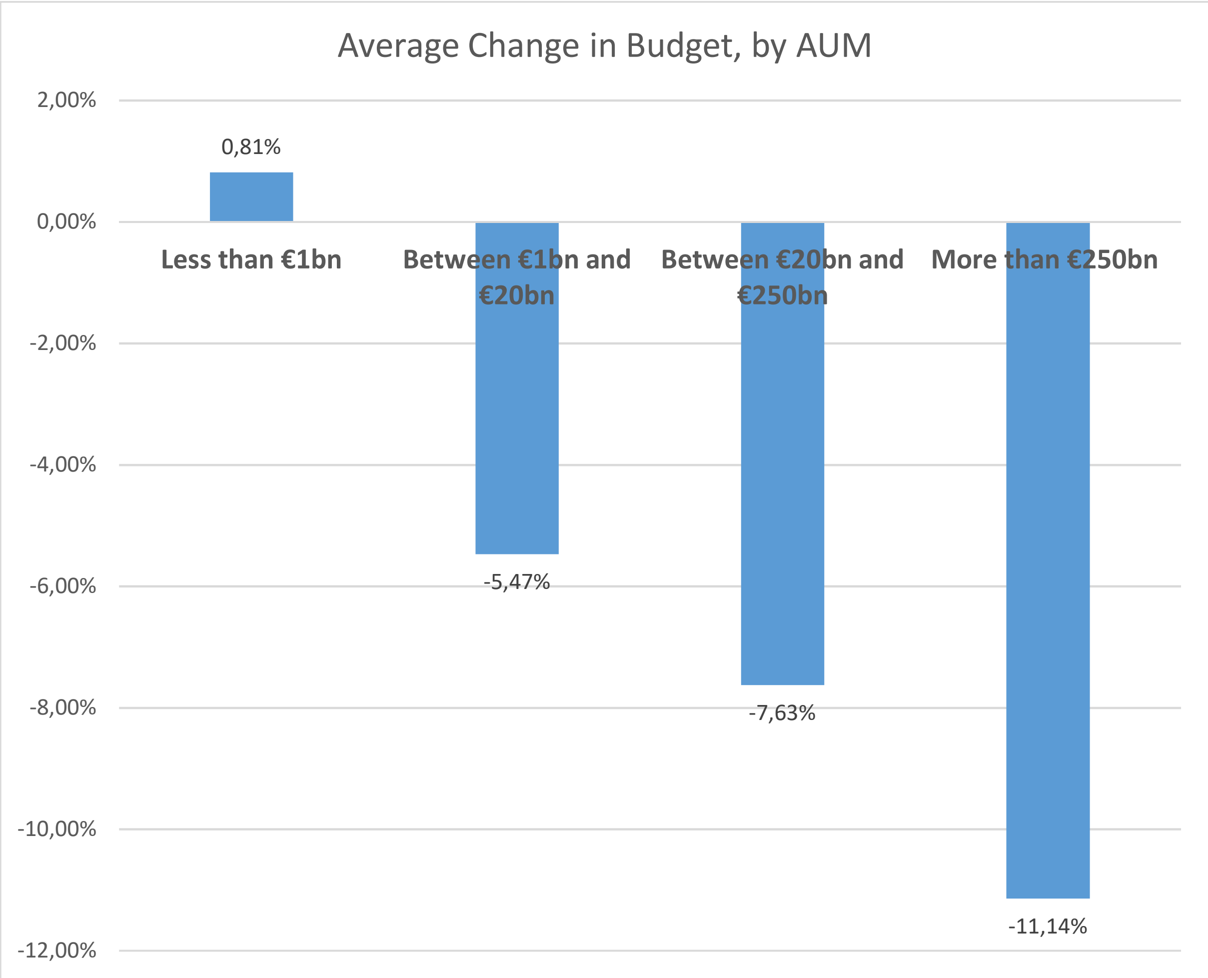
To understand the effect of MiFID II on research budgeting, we asked: How has your firm's research budget changed since the introduction of MiFID II? Figure 4 illustrates respondents' perceptions regarding changes in their firms' research budgets since the introduction of MIFID II. Across the full sample, the average decrease in research budget according to respondents is 6.3%. The reduction in budget, however, increases with firm size: for firms managing more than €250 billion of assets, the average budget reduction is 11%, whereas for firms managing less than €1 billion of assets, the budget change is negligible.

With firms absorbing research costs, these results suggest a greater focus on profitability and efficiency with regard to research procurement, and potentially a scaling back of the number of research inputs and external providers used to support a firm's investment strategies. The disparity in the size of budget reductions between large firms and small firms may allude to the ease with which a firm can substitute externally procured research for in-house research.

Other possible factors behind the budget reductions include a narrowing of the scope of what constitutes "research" under the inducements rules as well as tax considerations with research being invoiced separately from other brokerage services. More generally, against the backdrop of rising demand for passive investment products and strategies in relation to active strategies, firms may need marginally less research to support clients' investment objectives.

Figure 4: Change in Research Budgets under MiFID II

Question: How has your firm's research budget changed since the introduction of MiFID II?



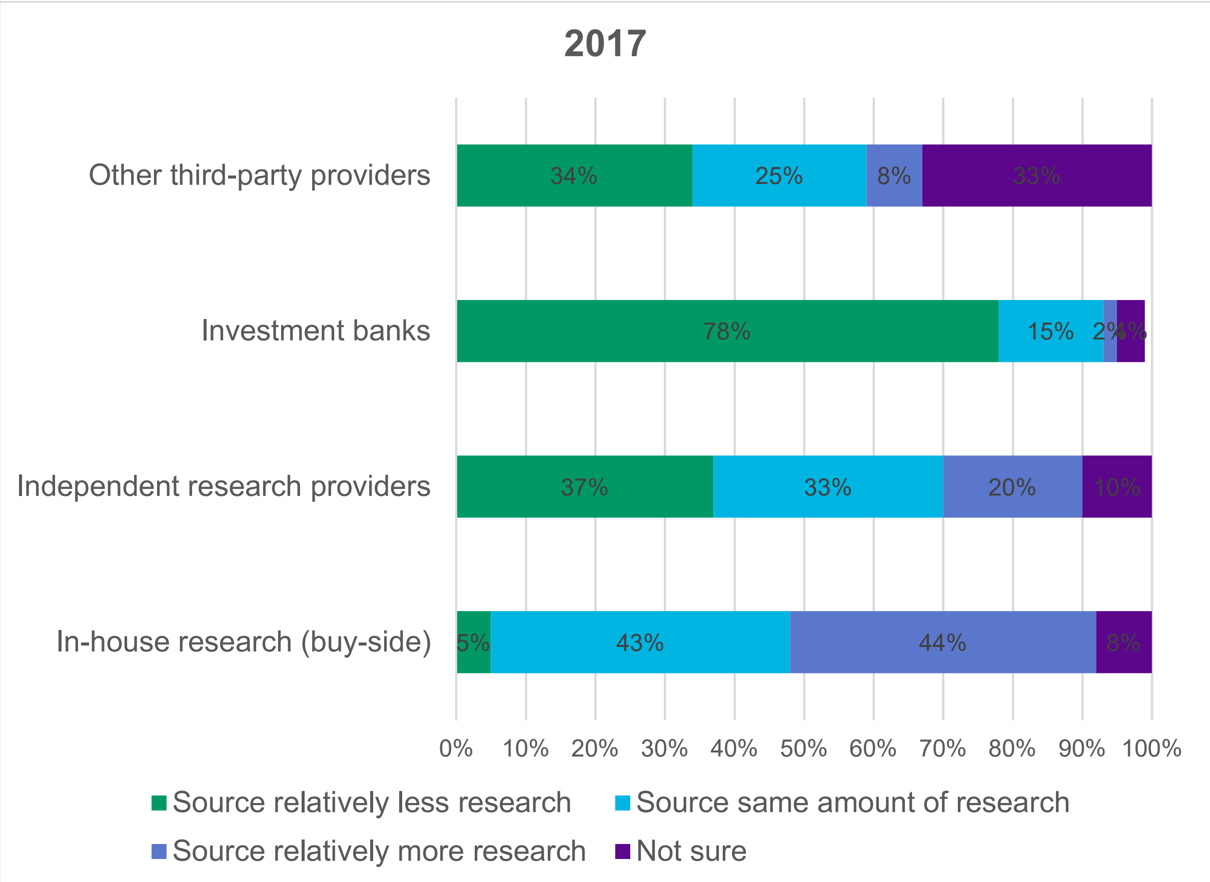
In the 2017 survey data, we observed an expectation among investment management professionals of a reduction in the amount of research that would be procured from the sell side (investment banks) under MiFID II, with research procurement shifting somewhat from the sell side to the buy side (in-house). Those expectations have been borne out in the first year of implementation of MIFID II.

As illustrated in Figure 5, 57% of respondents noted that they source relatively less research from investment banks since the introduction of MiFID II. Approximately half noted that they use the same amount of in-house research, while a further 34% noted that they use more in-house research.

The results also suggest that independent research providers have not benefitted much from the introduction of MiFID II. More transparency and separate pricing of research are intended to create a more level playing field among research providers, yet it appears independent houses have not been able to grow their market share. As shown in Figure 5, only 17% of respondents source relatively more research from independent providers, which is little changed from expectations before MIFID II. As bulge-bracket investment banks have cut prices to maintain client business and squeeze competitors, independent providers appear to have realized little, if any, market share gains at this stage.

Figure 5: Research Procurement Trends

Question: For each of the following research providers, how much research do you source compared to before MiFID II?



Note: 2017 data reflect respondents' expectations of how much research they would source from the different providers under MiFID II and are reproduced here for comparison.

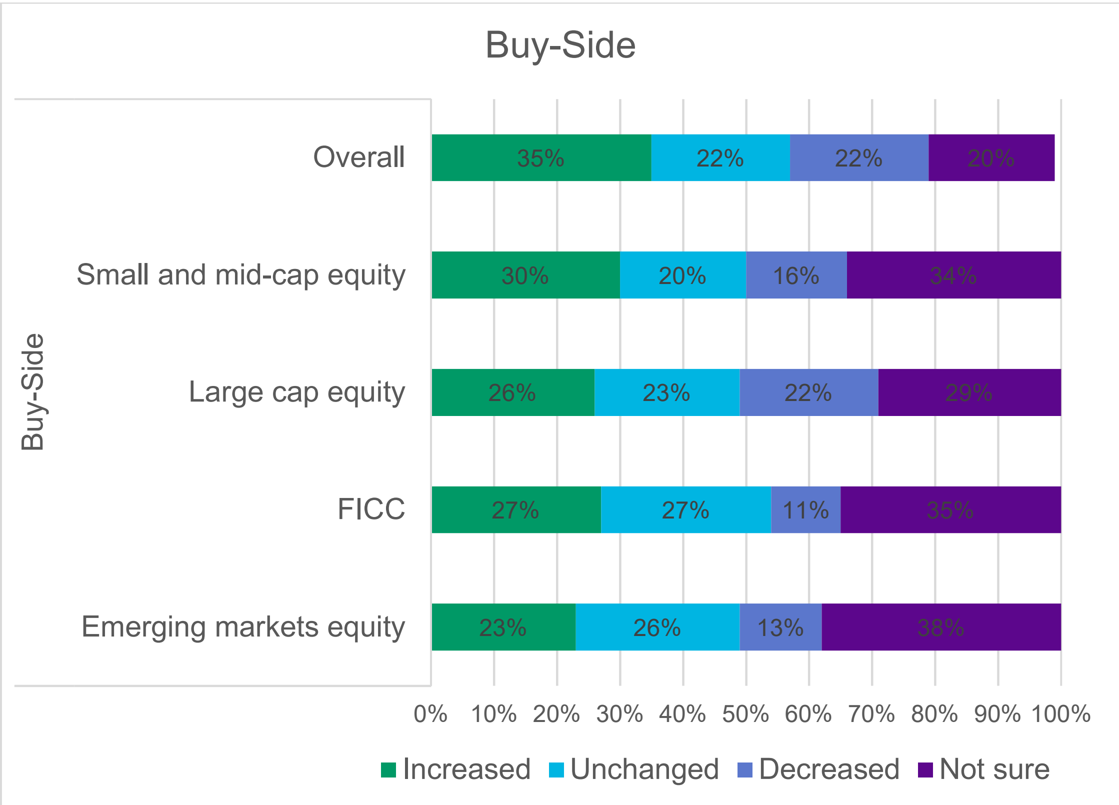
The advent of MiFID II led to a period of price discovery for research products and services. In the months leading up to the introduction of MiFID II, reported prices quoted by sell-side providers varied significantly, although reports suggested significant reductions in price quotes from initial estimates as providers competed to retain client business.

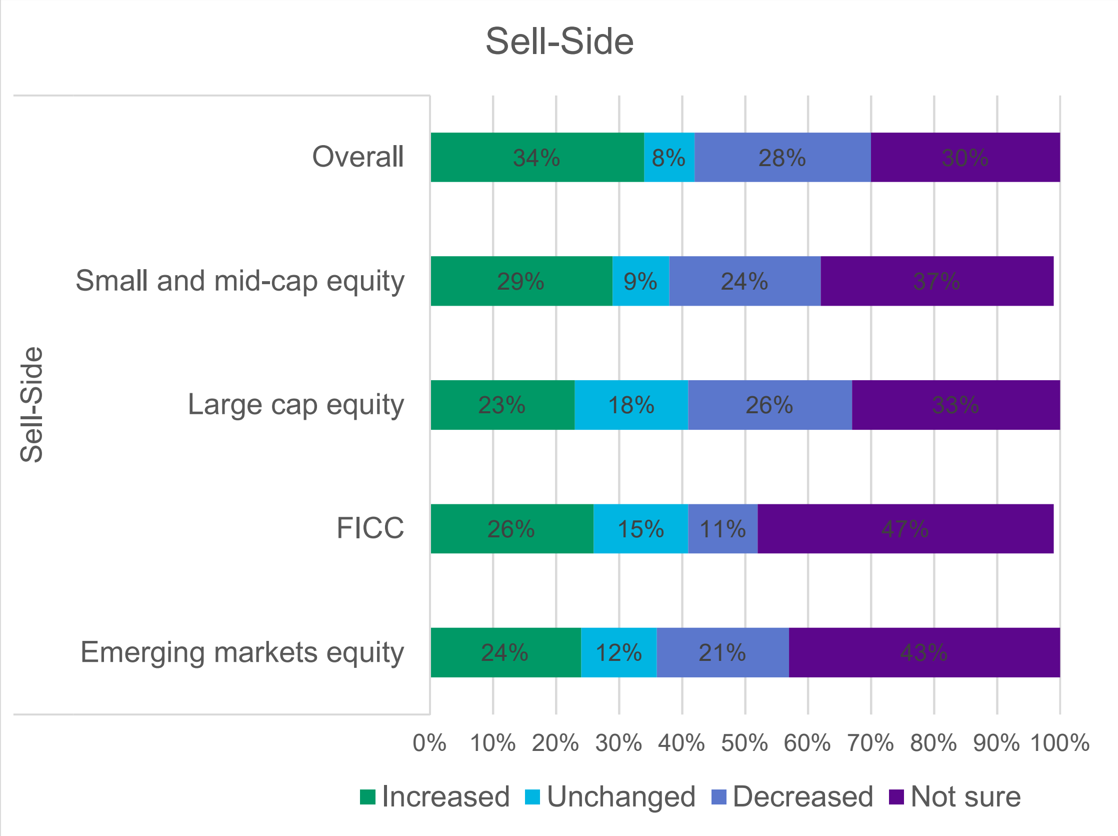
We asked both buy-side and sell-side professionals their views on research costs under MiFID II. The results, presented in Figure 6, are broken down by asset class. The mixed nature of the responses likely reflects the price discovery process, with research costs being discoverable for the first time. Moreover, the mixture of perceptions reflects the lack of clarity and comparability of research costs before the introduction of MiFID II.

In the case of fixed income, in which brokers are remunerated through the dealing spread as opposed to a trading commission, the relative majority of respondents on both the buy side and sell side were unsure about the change in costs, reflecting the difficulty of comparability with the pre-MiFID II regime. Overall, however, a relative majority of respondents felt that research costs have increased.

Figure 6: Respondent Perceptions of Research Costs

Question: Since the introduction of MiFID II, for the following asset classes, research costs have:





We next sought to determine the opinions of both buy-side and sell-side professionals on research quality and research coverage, respectively, under MiFID II, and asked: Since the introduction of MiFID II, for the following asset classes, research quality (Figure 7) and research coverage (Figure 8) has [increased, remained unchanged, decreased, not sure].

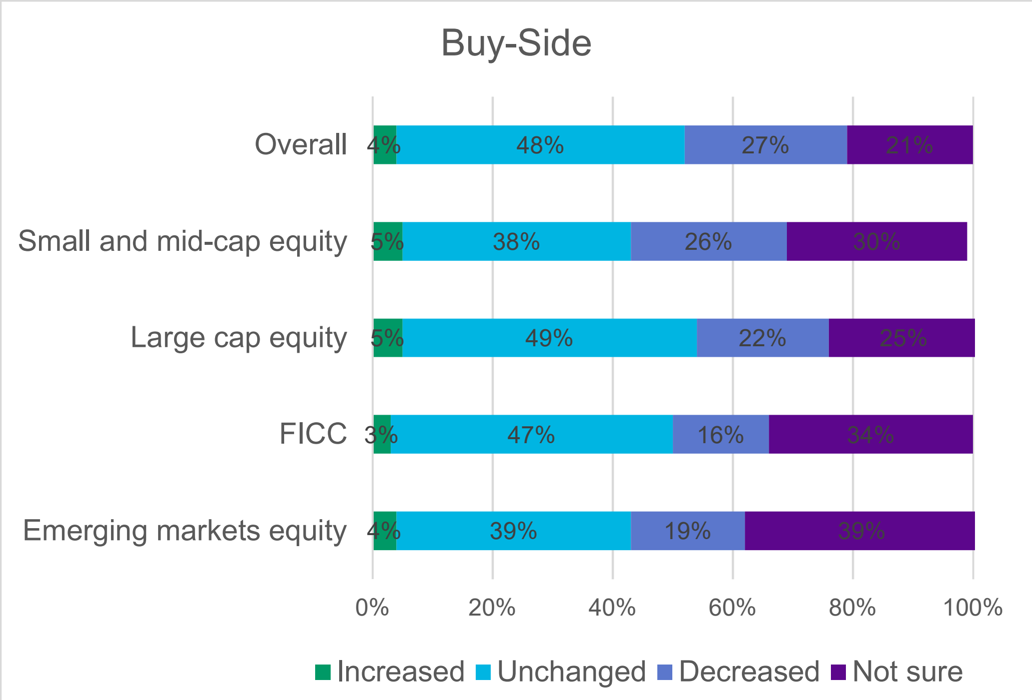
As the figures illustrate, very few respondents perceive an increase in research quality or coverage under MiFID II. Across all asset classes, less than 10% of respondents on both the buy side and sell side believe research quality or coverage has increased. This is concerning for investment managers and their clients, as well as for corporate issuers, and suggests the MiFID II reforms have not, as of this point, led to improvements in the provision of research.

As shown in Figure 7, buy-side professionals mostly believe that research quality is unchanged. Sell-side respondents are generally more pessimistic, with 44% believing that, overall, research quality has decreased.

As shown in Figure 8, it is significant that approximately half of respondents on both the buy side and sell side believe coverage of small- and mid-cap equities has decreased, whereas coverage of large-cap equities appears to be mostly unchanged. This outcome suggests research providers are focusing their coverage on the more heavily traded, less-costly sectors. If this trend persists, the perceived lower coverage of small- and mid-cap stocks may exacerbate illiquidity in this sector and make it more difficult for corporate issuers to raise capital.

Figure 7: Respondent Perceptions of Research Quality

Question: Since the introduction of MiFID II, for the following asset classes, research quality has:



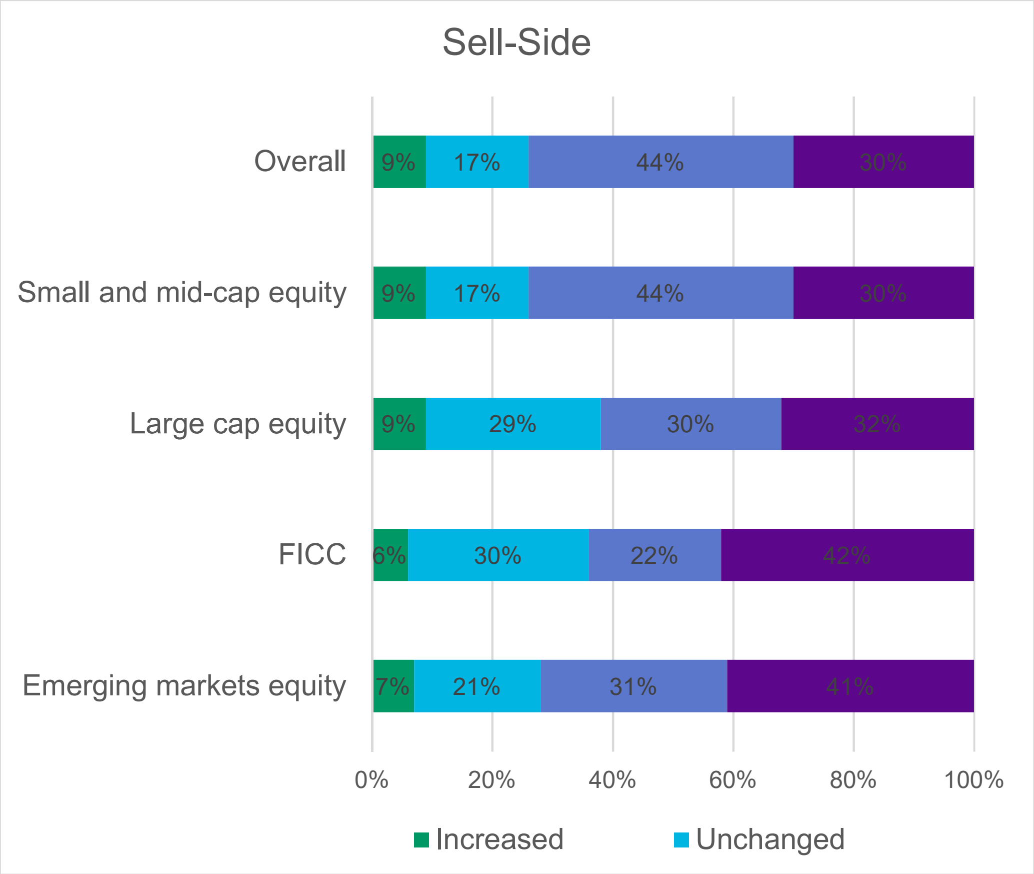
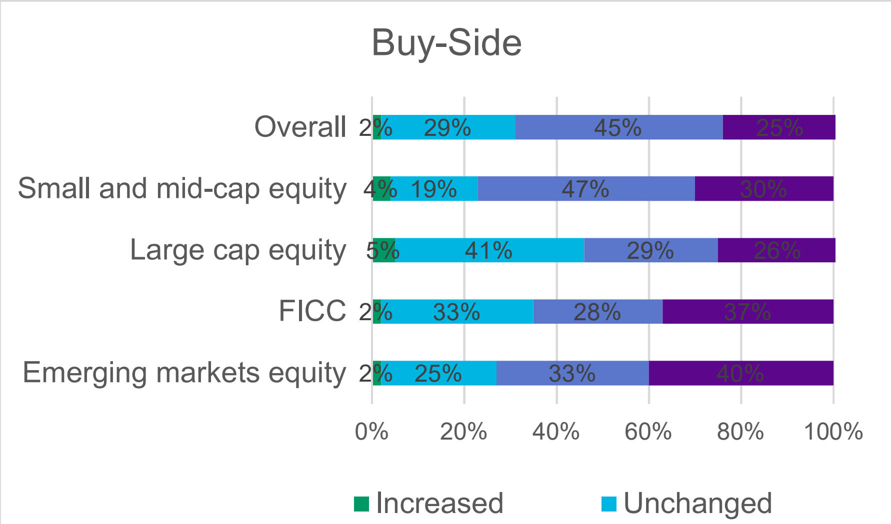
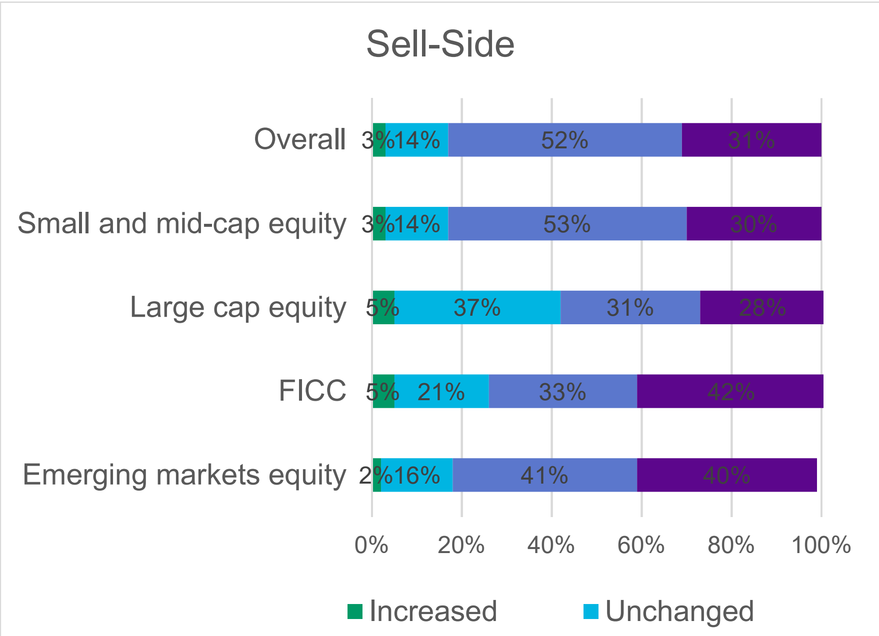

Sell-Side
Overall
Small and mid-cap equity
Large cap equity
FICC
Emerging markets equity
9%
17%
44%
30%
9%
17%
44%
30%
9%
29%
30%
32%
6%
30%
22%
42%
7%
21%
31%
41%
0%
20%
40%
60%
80%
100%
Increased
Unchanged

Figure 8: Respondent Perceptions of Research Coverage

Question: Since the introduction of MiFID II, for the following asset classes, research coverage has:





We also asked sell-side professionals their views about changes in the number of analysts employed following the introduction of MiFID II. A clear majority of respondents believe that the number of sell-side analysts has decreased. This finding is consistent with the view of sell-side professionals in Figure 8: analyst numbers would appear to be falling as investment banks scale back their research coverage.

Taking stock of the changes introduced under MiFID II, we asked respondents their views of the overall competitiveness of the research marketplace: Since the introduction of MiFID II, the investment research marketplace overall has been [more competitive, unchanged, less competitive, not sure]. The results, presented in Figure 9, are shown by geographic distribution of the respondents. The responses are similar among buy-side and sell-side respondents (not shown).

Despite the somewhat-pessimistic views, the relative majority of respondents perceive the research marketplace to be more competitive overall since the introduction of MiFID II, a generally positive outcome.

A possible explanation for this trend may be that the greater transparency over research costs and control over research expenditures imply a more competitive market, notwithstanding the aforementioned concerns over research quality and coverage.

Figure 9: Competitiveness of Research Marketplace

Question: Since the introduction of MiFID II, the investment research marketplace overall has been:

Aside from reforms to the rules for investment research, other significant aspects of MiFID II include the provisions regarding pre-trade and post-trade transparency in financial markets. Specifically, MiFID II introduced requirements for more price and transaction data in fixed-income markets to be made public and requirements to restrict the amount of equity trading taking place in dark pools.

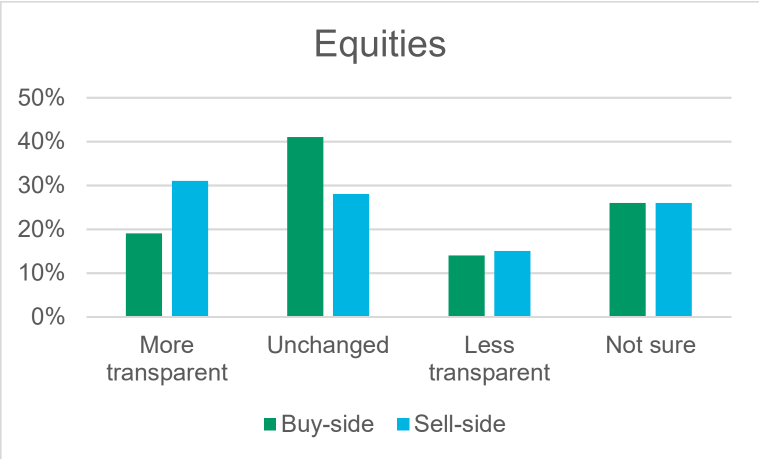
We sought to gauge market perceptions of whether these trade-transparency provisions have made equity and fixed-income markets more transparent overall and asked: Taking these aims into consideration, what are your thoughts on market transparency after MiFID II? The results are illustrated in Figure 10. A relative majority of sell-side professionals believe equity markets are more transparent, a view expressed by 31% of respondents, whereas most buy-side professionals believe equity market transparency is unchanged, a view expressed by 41% of respondents.

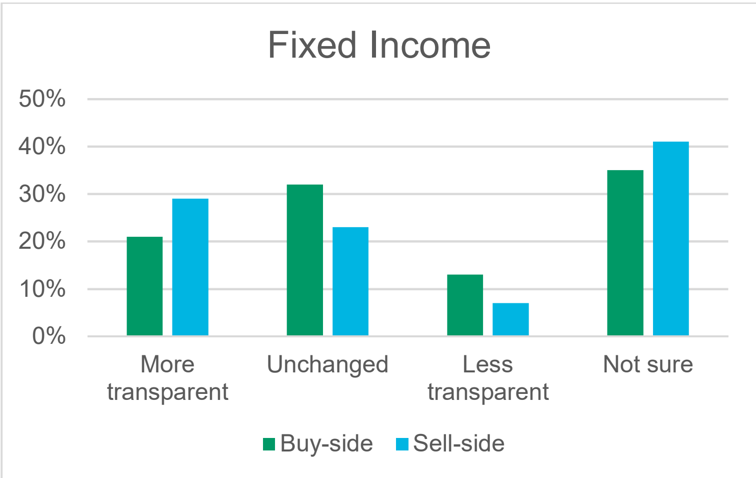
In fixed-income markets, most buy-side and sell-side respondents are unsure about whether the markets are relatively more or less transparent. This likely reflects the limited extent of the fixed-income trade-transparency regime, with the vast majority of bonds in issuance classified as illiquid and therefore largely outside the scope of the public price–transparency framework.

Nonetheless, 29% of sell-side respondents believe fixed-income markets are more transparent overall under MiFID II, and only 7% of such respondents believe fixed-income markets are less transparent.

Figure 10: Views on Trading Market Transparency

Question: MiFID II introduced requirements for more price and transaction data in fixed-income markets to be published, and to restrict the amount of equity trading taking place in dark pools. Taking these aims into consideration, what are your thoughts on market transparency after MiFID II?





Finally, we asked survey respondents whether they believe MiFID II reforms are delivering better outcomes for end-investors. A clear majority of respondents answered negatively.

This suggests that, at this stage, MiFID II is not meeting its principal objective in the eyes of the industry.

These results reveal general industry discontent with the disruption to business models and practices as well as the significant compliance costs associated with implementing MiFID II.

Conclusion

The survey findings presented in this report portray several drawbacks with the MiFID II regime for investment research. The findings suggest a competitive tilt favouring large firms as research budgets and profit margins come under pressure from client demands, increased competition, and business model disruption.

These competitive pressures are best illustrated by the findings that asset managers are overwhelmingly absorbing research costs against their profit and loss, and they are scaling back research budgets accordingly. The decline in research budgets increases with the size of the firm, and larger asset managers are more likely and better able to move research production in-house as they scale back their reliance on external providers.

Perhaps the most directly observable drawbacks are the perceived reduction in research quality and coverage, particularly for small- and mid-cap equities, which if sustained, could hurt liquidity and capital formation in that sector. The findings suggest that research provision is retrenching and focusing on the large-cap segment with fewer sell-side analysts employed.

On the positive side, however, investment professionals perceive the research marketplace to be more competitive overall, which perhaps reflects the extent of cost pressures and changes to research pricing, at least in the short run. Overcapacity in the supply of research is being removed, but it is an open question as to whether equilibrium has been reached that serves the best interests of end-investors.