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Wall Street soaks up research business

By Michael Shari

When an institutional asset management firm in the US decides where to buy its equity research, a vote is taken in democratic Wall Street fashion – not just from the portfolio managers and analysts, but also the folks on the trading desk.

Investment banks such as Goldman Sachs and JPMorgan usually win over independent research, no matter how revered or specialised they are. The reason is that, in accordance with US securities laws, the investment banks can bundle research in with a range of services the independents do not offer, such as trading execution, IPO allocations and access to management.

“It’s an oligopoly,” says Patrick Shea, executive director of the Investorside Research Association in New York, which claims a membership of 85 independent research companies.

“The portfolio managers want an IPO allocation because, if it’s a good IPO, it will jump up five points, and they’ll sell it. It’s just an easy way to make money,” Mr Shea adds.

The irony is that independent research companies had been expected to come into their own with the \$1.4bn (€30m, £840m) global research analyst settlement, which was driven by Eliot Spitzer, then New York attorney-general, to stop research analysts at investment banks from using buy/sell recommendations to help the trading desks sell stocks.

The 10 banks in the settlement spent \$430m buying research reports from independent companies and distributing them to asset managers from September 2004 to July this year.

“A lot of things that appear to be logical don’t pan out the way the market response was predicted,” Mr Spitzer said in an interview with FTfm. “A lot of people may run at a time of massive insecurity to a well-known name like Merrill Lynch. They want something big and stable.”

When the independent research provision of the settlement expired in July, the providers of that research had the rug pulled out from under them.

“We have to start over from scratch,” says Paul Henneman, president of Valu-Engine, a small firm in Princeton, New Jersey, that forecasts stock prices.

UBS and Deutsche Bank, both ValuEngine clients under the settlement, have not indicated whether they will retain the company again. “The fact that we had supplied research to them for five years had no bearing on what we would do for them after the settlement,” Mr Henneman says.

The research provision could hardly have expired at a worse time for the independents, which have seen revenues fall even faster than the rest of Wall Street.

For the calendar year 2009, asset managers will have spent about \$1.67bn on research from independent providers, down 18 per cent from \$2.05bn in 2008, estimates Sanford Bragg, chief executive of Integrity Research Associates, a New York firm that tracks the research industry.

In sharp contrast, investment banks raked in an estimated \$9.7bn from selling research in 2009, which Mr Bragg estimates is only 10 per cent down on 2008.

Of the 1,115 independents that Integrity Research tracks, at least 131 are no longer operating, up from 76 a year ago. “We expect more people to be exiting the business,” he adds.

Similarly, the ranks of Wall Street are thinning out. The National Association of Securities Dealers had only 4,646 members as of June this year, down from 5,178 two years earlier.

As a result, says Brian Stack, manager of the \$631m Pioneer Growth Opportunities Fund, “there is less and less research being done”. And the work that is being done, he says, focuses on large-cap blue chips that are found in any passive index strategy.

Despite the odds, a minority of independents are still thriving, particularly ones that specialise in lucrative niches such as biotech and anti-trust law.

There are also three one-woman shops founded by star equity analysts who made their names at investment banks and then discovered big clients would pay handsomely for their customised research. They are: Ivy Zelman, a housebuilding industry analyst who left Credit Suisse Group in 2007; **Dana Telsey, a luxury goods analyst who left Bear Stearns in 2006**; and Meredith Whitney, a financial services analyst who left Oppenheimer in February this year.

“The legacy model is flawed,” Ms Whitney said soon after opening her Madison Avenue office. “My clients pay me directly, so I get paid more than before.”

But even the best-placed independents face an uphill battle as Wall Street emerges from the financial crisis. As asset managers look to cut costs by replacing higher-cost research from Wall Street with cheaper research from independent companies, the investment banks retaliate by stripping out other services, such as IPO allocation.

“The investment banks are pushing back,” says Mr Bragg.