London, UK, 14 January 2013

Edison predicts an accelerating trend in the separation of revenues from trading securities and payments for equity research

Asset managers expected to change commission allocation processes to meet new rules

Edison Investment Research and Frost Consulting have published a white paper, *The future of equity research*, following the FCA's publication of the *Conflicts of Interest* document in 2012, and the subsequent consultation paper, *Consultation on the use of dealing commission rules*, in November 2013.

The white paper finds that regulatory change has had a significant impact in shaping the equity research ecosystem. The proposed changes to the regulations in the FCA papers have the potential to be some of the most significant catalysts for change the industry has seen in a century. If the FCA's proposals remain intact, the authors see six key short-term impacts on the equity research industry:

- A continuation of the trend of a separation of revenues generated from the trading of securities and the payments for research services
- Research produced from investment banks moving from an unpriced to a priced environment
- An opening of the content universe available to asset managers
- Continued shrinkage of the overall payments made for research services to investment banks
- A reallocation of spend to research providers
- A continued consolidation on both the buy side and sell side

With the asset management industry continuing to consolidate and operate globally – the top 120 asset managers now look after 53% of global AUM, totalling $33trn – these changes are likely to resonate as asset managers adopt common systems to reduce complexity for their businesses.

While Edison believes there will continue to be a demand for equity research from investment banks, a change in regulation that facilitates price discovery for research content produced by investment banks is likely to change both the type of content investment banks are producing and the overall quantity.

Edison also anticipates a continued consolidation of both buy-side and sell-side analysts as asset managers respond to pressures to move research spend from off balance sheet to on balance sheet, effectively producing research in-house and paying for it out of their own P&L accounts, rather than through client commissions.

There has already been a substantial wave of consolidation in the investment banking sector and exits from cash equities, leading to a significant reduction in research capacity. The industry has seen a considerable fall in both revenues received by and budgets allocated to investment banks producing equity research, of which the most significant are believed to be:

- 50% reduction in the number of analysts following global equities from four per stock to two
- 43% reduction in global commissions for equity research
- 40% reduction in budgets to less than $5bn in 2013

Will Goodhart, CEO of the CFA Society of the UK said: "While clearer identification of the value of research and improved disclosure about the cost of research to clients are attractive outcomes, we also need to take care to identify all the impacts of any change."

After decades of the industry failing to innovate, Edison believes there are potential longer-term changes it may see as a result of the proposed regulatory changes:

- Asset managers will start to access a network of new 'alpha' research inputs and will guard the identity of those sources in an attempt to sustain its competitive advantage
- Innovation in the delivery of research content in searchable format to make it easier for asset managers to access the information they want
- Changing research content at investment banks, encouraging banks to specialise in areas of relative strength, where sector teams are profitable and generate the greatest opportunities
- Long-tail strategies to come into play, with research aggregators potentially becoming some of the largest beneficiaries from which asset managers can choose the niche services they require
- Stock exchanges facilitating the provision of research as they compete with each other globally to be attractive listing venues
- Growth in issuer-sponsored coverage as the sell side diminishes, which gives the asset manager greater choice at a more transparent and lower cost

Edison expects asset managers to become selective about what services and products they procure from investment banks and that a market place will evolve where each asset manager determines implicit prices they are willing to pay for research based on the perceived quality of the research and levels of service provided.

Neil Shah, Director of Research at Edison Investment Research, said: "In broad numbers, the global budget for quality equity analysis has halved in the past decade to under $5bn while the number of quoted companies needing thorough research has remained constant or most likely increased over the same period. This demise in the strategy of blanket coverage for all equities may be good for the banks' balance sheets in the short term but markets will lose out in the long term unless we find new ways to provide quality, cost-effective research. While it was easy for broking firms to get away with producing low-quality research, that is no longer the case and it means that we will see more buy side going out of business or being taken over.

We are only just beginning to see a fundamental rebuilding of the model to provide equities research and foresee a future unfolding where the very largest investment banks will continue to provide research but will start charging large fees to companies and institutions. There will still be a demand for good-quality research however expensive, from these big banks, however, fund managers will simply balk at the prospect of paying the equivalent of three or four times the current cost – which they may not see yet as it is hidden in cross-subsidies. The yawning of supply while demand for research remains constant will be filled by the likes of Edison in providing quality in-depth research on a scale that is still affordable, even by today's subsidised standards."

The white paper was carried out in conjunction with Frost Consulting, the leading international authority on global equity commission unbundling and related market regulatory change.

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Notes to editors

About Edison Investment Research

Edison, the investment intelligence firm, is the future of investor interaction with corporates. Its team of over 100 analysts and investment professionals works with leading companies, fund managers and investment banks worldwide to support their capital markets activity. It provides services to more than 400 retained corporate and investor clients from its offices in London, New York, Frankfurt, Sydney and Wellington.

Edison is authorised and regulated by the Financial Conduct Authority (www.fsa.gov.uk/register/firmBasicDetails.do?sid=181584).

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About Frost Consulting

Frost Consulting & Advisory is a leading authority on global equity commission unbundling as well as related changes in market structure and regulation. Frost assists a wide variety of clients in developing commercial and operational strategies to maximise revenue/alpha generation, optimise distribution and mitigate risk in a rapidly changing commercial landscape. The firm was founded in 2007 based on the principle that a dynamic and forward-looking analysis of the market(s) in which clients operate can help them evaluate strategic options and engage successfully with industry transition.