MiFID II – Asset Management Gamechanger
New Research Process Rating Service

Scope Analysis and Frost Consulting have launched a Research Process Rating Service to allow asset managers to demonstrate to clients that their investment processes have successfully adapted to the MiFID II environment.

Fund marketing documents have long cautioned that past performance may not be indicative of future returns. This is about to become a dominant consideration for European investors.

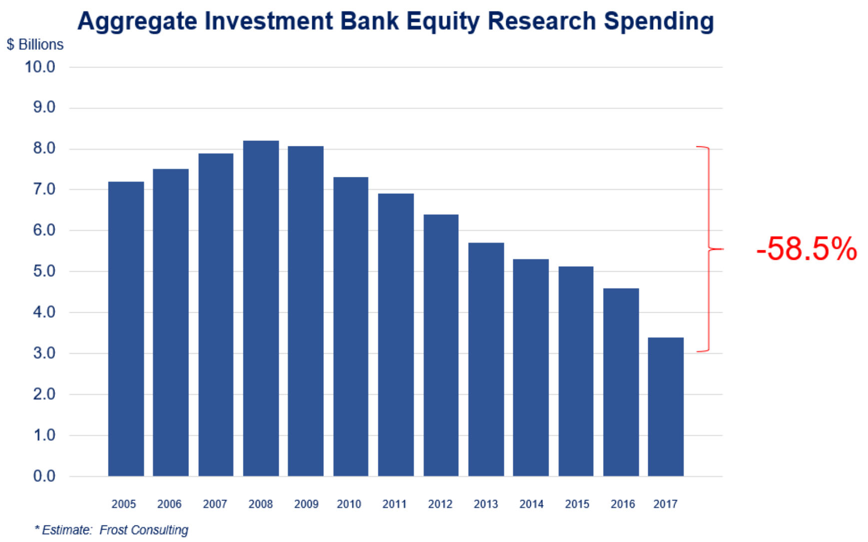
The breadth of the regulatory changes will have a profound impact on the long-established investment processes of many investment managers, potentially creating an unprecedented dispersion of performance winners and losers. The ability for managers to sustain and maintain their investment process in the face of significant new regulation will be a key determinant of future success.

MiFID II - transforming the investment research ecosystem

MiFID II is in the process of transforming the investment research ecosystem with significant implications for fund investors on a global basis. The widespread move to pay for research via P&L in Europe might reduce the research spending transparency that European regulators aimed to achieve. (P&L managers have no regulatory requirement to disclose research spending.)

For investors, this introduces uncertainty at best; significant performance risk at worst. There has been well-documented downward pressure on virtually all research budgets, but this seems particularly pronounced at P&L managers where the delta of the change is unknown externally. A major (global) European investment bank has estimated that the average P&L manager in Europe has cut 2018 research budgets by 50% versus 2017.

Compounding this challenge is the fact that investment bank research budgets have already fallen sharply, beginning during the financial crisis. As the following chart suggests, IB research budgets had already declined by close to 60% since the financial crisis – and that was before the impact stemming from MiFID II.



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Further Publications

Top 10 fund-quality rankings
May 2018

Institutional investor survey
March 2018

Active versus Passive
February 2018

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Furthermore, European P&L managers are competing globally for finite external research resources against other large managers that continue, primarily or entirely to fund research budgets using client money.

The net result is that a) the research operating environment has changed significantly, b) fund investors have no easy means to understand what the implications are for the investment/research process for their current or prospective investments.

This analysis will be at the investment team level, not the firm level, reflecting the actual product(s) owned by the investor.

At the very heart of the covenant between the asset manager and the asset owner is the agreed investment process behind the investment product. This is the “investment DNA”, the catalyst for the purchase of the product, sitting alongside the product’s historical returns. Both are potentially heavily dependent upon continued access to external research.

In the MiFID II environment, the burden of proof that the agreed investment process is still intact lies squarely with the asset manager – particularly if they are funding research via P&L.

Managers with a defined and rigorous investment process will anticipate this new investor requirement and will understand the benefit of engaging recognised third-party Investment Team Rating services to systematically verify their research processes. By doing so, these managers demonstrate a commitment to investor transparency and, as such, are sending a strong signal to clients, regulators (and competitors) that they are confident that their investment process is robust and sustainable.

Changes in Asset Manager Research Procurement

For most active asset managers, external research is a critical raw material in their investment decision-making. It potentially has a significant impact on asset manager returns and offers substantial cost efficiencies versus funding all investment research internally.

MiFID II considers the receipt of research by asset managers in the absence of a contractual relationship as an inducement. This fundamentally changes the information flow for asset managers. PMs and analysts at asset managers are used to calling any analyst at any research producer at any time to seek information – and to reward them retrospectively. Post MiFID II, in many cases, compliance departments at asset managers may forbid *any* contact with research providers with whom there is not a contract in place.

The manager’s real-time need for new (and impossible to anticipate) information, based on volatile market conditions, does not easily align with the new regulation. MiFID II’s contractual requirements for research ended the previous laissez-faire system in which most managers had access to most (investment bank) research services on demand (without any pre-agreement) – and at prices they could afford.

This abrupt change to a long-established research procurement regime has introduced an unprecedented series of information asymmetries.

Given the complexity of the neural information flows in the investment process, assessing a manager’s ability to successfully adapt to this new environment requires:

- A detailed understanding of the specific investment strategy
- A deep-dive into how their investment/research process has changed

This is impossible to determine from outside the asset manager, thus illustrating the importance of specialist, independent third-party analysis. Managers undertaking this external rating process are demonstrating a long-term commitment to sustainable transparency and are investing in their client relationships.

Asset managers that are unable or unwilling to explain how their research processes have adapted to the MiFID II environment represent an unquantifiable risk for investors.

Risks for Asset Owners

- Investment Process Risk
- Information Asymmetry
- Relevance of Historic Return Data
- Performance Variance

The Burden of Proof

The Scope/Frost process is a comprehensive analysis of the investment team's process and how it continues to meet its original investment premise (and promise) and operates within the context of the wider asset management organisation.

Outputs

The objective of the exercise is to inform investors as to potential risks arising from MiFID

The Scope/Frost analysis will produce:

- An assessment of the resilience of the investment team research process post MiFID II implementation
- Qualitative and quantitative Assessment of research process/access adjusted for the "Research Intensity" of the strategy
- Analysis of future performance risk factors
- Benchmarking of fund research spending and Research ROI (on targeted returns) versus peers.

Conclusion

MiFID II represents a global inflection point for the asset management industry. Active managers have recently been challenged by competing products, and regulators, to demonstrate their value.

Fundamental research is at the heart of most active strategies. MiFID II may provide active managers with an opportunity and an incentive to better articulate their process and the value they add.

Providing independent verification of the continuity and robustness of active management strategies demonstrates that the manager is putting the interests of the client first. These managers will deliver research transparency not because it is a regulatory requirement but because it demonstrates a commitment to their clients – and confidence in their process.

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