The future of equities research

by Matt Smith | 04 Jul 2017
Equities research is on the precipice of immense change.

Once the backbone of the finance industry, research and researchers within investment banks will see their business continue to change as fast or possibly faster than any other area.

Machines are coming to take people’s jobs everywhere you look, but that’s barely part of the story.

For some time, buy-side firms such as hedge funds and long active funds managers – the main consumers of incremental updates and insights into a listed company’s fortunes – have been feeling the pinch.

Alpha – that thing people are actually willing to pay for – is more elusive than ever and asset owners and retail investors alike have been voting with their feet, choosing to pay less for index exposure, leaving active funds with record outflows.

Active funds have needed to change what they’re doing, and the smarter ones have been bringing their own research and analytics capabilities in-house in an attempt to find an edge over their flailing competitors.

As a result, the traditional notes on company upgrades, or impending revenue target misses or beats, aren’t as valuable as they might have once been.

Game changed

The game has moved on, with professional investors seeking new forms of information.

Funds worth investing in now live and breathe analytics based on big data and artificial intelligence, which they use to complement their own conventional fundamental research in portfolio decision-making. Global consulting firm McKinsey & Company outlines this in new research it published in the last week.

And like an ominous shadow, regulation is drifting alongside where industry dynamics are already heading, with the impending implementation of the long-heralded MiFID II rules in Europe quickening the pace of change.

Markets in Financial Instruments Directive (MiFID), the rules set to come into effect in January, will require research to be unbundled from other services investment banks offer to their clients such as trade execution.

While these new rules are only being implemented in Europe at this stage, their effects will be global, with most outposts of European institutions likely to have to adapt their operations to be compliant with their Northern Hemisphere parents.

New models

Local regulators will need to make a call eventually on how research arms of investment banks will be treated in the future, but it seems the writing is already well and truly on the wall - the old model is under threat.

Onlookers will concede that bank and broker dealer equity research will need to stand on their own two feet as free-standing profit centres at some point in the not too distant future, a change that will lead to a complete rethink of existing investment bank structures. This topic was front and centre at the recent ASIC annual forum in Sydney.

We're not about to see the death of equities research, although the traditional stuff we're used to seeing churned out by sell-side firms likely won't have a role in the not too distant future, McKinsey's senior London partner, Daniele Chiarella, notes.

Independent and bespoke research firms should thrive in the prevailing environment, Chiarella and his McKinsey colleagues, note.

Numbered are the days of dozens of separate sell-side research notes on the same company, which asset managers might have been happy to accept under the old model but not when they'd have to pay for it.

“The crucial point is that the current ecosystem of many banks offering broad, often undifferentiated, research coverage is not sustainable.

“Top-tier research will still have value for the buy side, and any one of these strategic options can be profitable for the long term for the right firm, but over the coming five years, banks will need to make hard choices and play to their strengths,” McKinsey notes.

“Not only will the top ranks be thinned out; there will be shakeouts in regional markets as well,” Chiarella says.

Shake out

This shake out is already well underway, with equities research divisions globally already seeing large scale cuts.

But where there is disruption there's also opportunity, with a new style of research valued highly by asset management clients emerging.

Rather than taking analysts' investment opinions at face value, buy-side firms are making greater use of the sell side's pre-constructed earnings models, adding in their own assumptions on revenues and profitability, McKinsey highlights.

Also, asset managers have developed an appetite for proprietary services that may provide actionable insights, in particular access to firms' analysts, and meetings with management of the companies they follow, McKinsey says.

For these kinds of services, asset managers, especially hedge funds, are willing to pay high prices for these scarce, time-sensitive, and customised services, according to McKinsey.

"Buy-side firms are also in search of more distinctive, proprietary data sources to build into their own analyses".

"Both long-only and hedge fund managers are reportedly hiring data scientists to generate alpha from insights from sources such as mall parking lots, social media, and weather satellites, as well as market data," Chiarella and his colleagues note.

Sophisticated investors are recruiting "data hunters" to source and secure privileged access to unique data sets, he describes.

Independent providers are active in the area, too, he says.

Market research firms such as Foursquare compile and interpret high-frequency data on hundreds of companies, such as traffic and ticket size at fast food restaurants, and fashion observations into reports with an investment slant, McKinsey highlights.

Other innovators have introduced online marketplaces for institutional research and corporate access, or automated the analysis of company financials through artificial intelligence (AI).

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