Global Research & Analytics

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A question of answers

Most asset managers are still undecided even as the D-day for MiFID II nears

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Executive summary

The deadline for implementation of the Markets in Financial Instruments Directive (MiFID II) is just a few months away, but most asset managers (AMs) are still undecided on several key aspects of it.

Our recent survey and discussions with AMs indicate they are undecided over nearly all the key facets of the new regime, whether it be best execution, trade transparency and reporting, product control and governance, or research unbundling. They are yet to finalize the appropriate means to demonstrate best execution for non-equity products, deploy the right IT and data management systems to comply with trade and transaction reporting norms, and set up the appropriate research procurement and funding strategies.

We see five key shifts as the AMs go about research unbundling:

1) Smaller AMs or those with relatively small share of European or equity assets appear to be favoring absorbing the research costs; we expect most AMs to eventually absorb research costs
2) AMs are likely to cut their external research budgets by 15-30%
3) Internal research budgets are expected to grow by 10-15%
4) Most AMs will engage with fewer than five bulge brackets for waterfront coverage and instead focus more on niche tie-up with more specialists or regional players that offer specialized research and flexible research pricing options, and,
5) AMs would continue to strengthen their in-house fixed-income research teams.

Research subscription pricing is still in a flux and we expect negotiations to close only towards end-4Q17 or early 1Q18. We reiterate our expectation (refer to our report, *Asset managers face profitability pressure,* published in October 2016) that most AMs would eventually absorb research costs driven by investor and peer pressure and regulatory nudges. While many have indicated they would reduce external research budgets, we believe the benefits of that would be partly offset by the cost of augmenting in-house research teams. Net-net, we continue to foresee 14-27% cut in the operating profits of AMs absorbing research costs.

Most AMs are re-evaluating their operating models and looking to adopt a strategic approach towards MiFID II. Active AMs are understandably focused on reducing costs to minimize the impact of research unbundling. However, it is equally critical to focus on alpha generating opportunities as investors would eventually choose those that generate superior fee-adjusted returns irrespective of who absorbs the research costs.

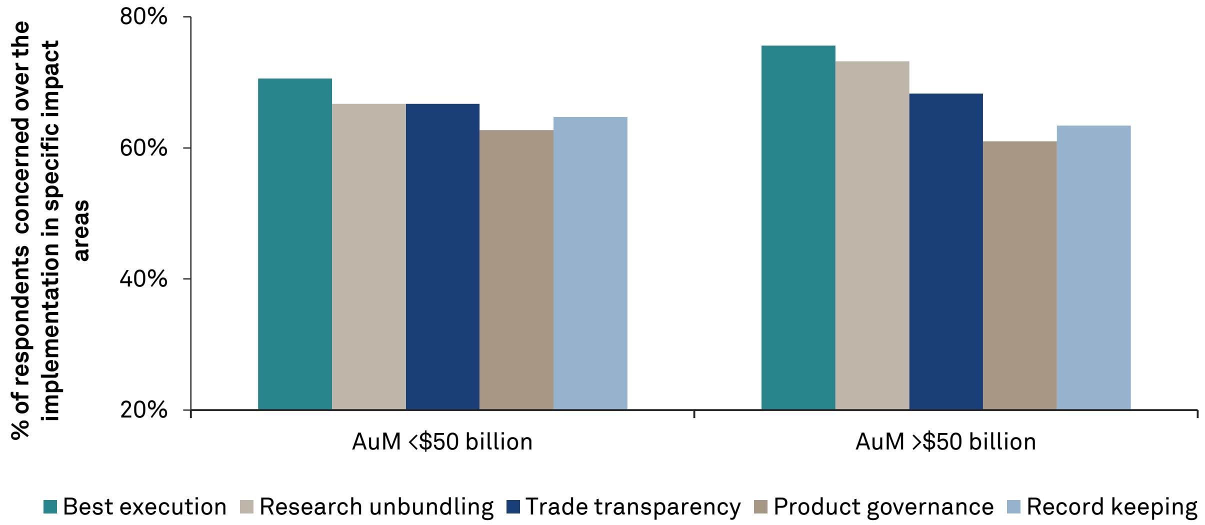
We therefore believe AMs should focus on four things:

1) Marry operational compliance to best practices and ensure value of adherence to asset owners
2) Finalize a balanced research sourcing mix that enhances value and minimizes costs
3) Accelerate investments in data analytics and alternative data for differentiated insights, and
4) Accelerate adoption of advanced technology to enable all-round efficiencies

Many AMs are undecided on wide issues before D-day

While the deadline for implementation of the Markets in Financial Instruments Directive (MiFID II) is just a few months away, we observe that most AMs are still undecided on many key aspects. In a survey we undertook recently, more than two-thirds of the AMs listed all the key areas of MiFID II as ‘challenges and concern areas’.

How do you rate the level of concern across key areas of MiFID II implementation for your firm?



Source: CRISIL GR&A buy-side survey conducted in August 2017. Analysis based on 92 responses, of which 51 were from firms with less than $50 billion and 41 from firms with more than $50 billion.

Critical questions remain unanswered

1. **Best execution: How to demonstrate ‘best execution’ in general and for non-equity trades in particular?**

   a) **Key MiFID II requirements:**

   - AMs are responsible for taking ‘sufficient’ steps to achieve best execution on orders across a broad spectrum of asset classes. The firm-wide policy should consider multiple factors, including price, speed and likelihood of execution and settlement.
   - Firms must publish data for (a) each of their top five execution venues based on trading volume and (b) percentage of client orders executed on each execution venue. The reports need to break down details further based on (a) retail and professional clients and (b) passive and aggressive orders.
   - Some regulatory relief has been granted in recent months, including (a) exclusion of Alternate Investment Fund Managers (AIFMs) from best execution rules for non-MiFID II regulated business and (b) publication limited to top five venues and a summary of the outcomes achieved in the first year, given the lack of ’full and granular data’.

   b) **Key decisions that AMs need to take:**

   - **Defining best execution criteria for non-equity products**: AMs are undecided over defining the best execution criteria for fixed-income and other non-equity products due to the lack of (a) appropriate pricing references and (b) viable transaction cost analysis (TCA) product for fixed-income and over the counter (OTC) offerings. There are concerns over implementation of best execution while trading across fragmented venues.

- **Addressing data management challenges**: Firms face significant challenges over data management (sourcing, retention, integration, quality and validation) across multiple trading channels.

c) **How are AMs approaching this?**

- Firms are evaluating the usage of low cost trading venues and other liquidity providers, apart from traditional broker execution relationships.
- As a result of increasing regulatory scrutiny, AMs are increasingly playing an active role in trade implementation, especially about how and where they would want to execute their trades based on their best execution criteria. While their reliance on sell-side will reduce, they will continue to depend on them for market access and liquidity sourcing to execute portions of their large trades.
- Firms are reassessing their current equity-centered TCA and moving towards a holistic best execution analysis to accommodate new asset classes, especially fixed income products.
- They are focusing on enhancing their execution policies for specific assets, changing the trading workflow and leveraging analytical tools to achieve full compliance. Firms are looking to leverage pre-trade TCA to achieve and demonstrate best execution, especially for illiquid securities.

2. **Trade transparency and reporting: How to collate data from multiple sources and ensure data integrity and also achieve near-time reporting?**

a) **Key MiFID II requirements**:

- Similar to the best execution, the new rules require AMs to take more responsibility over trade reporting and transparency obligations. Sellers are now responsible for creating the report unless the counterparty is a Systematic Internaliser (SI). While firms may delegate (outsource) the activity to a broker or transfer the details through an Approved Reporting Mechanism (ARM) provider, regulators have clearly indicated that they would not tolerate poor quality of reporting and failures.
- Firms are now required to provide a more detailed transactions report with 65 fields (vs 26 in MiFID I) covering details such as buyer/seller identity and the transaction details for nearly all assets including OTC products. Further, trade details need to be reported on real time basis – equity and fixed-income trades will need to be reported within a minute and five minutes, respectively. The equity transactions have to be reported within T+1.
- There has been some regulatory relief in recent months, with the Financial Conduct Authority (FCA) avoiding gold plating of rules and exempting AIFMs and Undertakings for Collective Investments in Transferable Securities (UCITS) managers from stringent transaction reporting. The European Securities Markets Authority (ESMA) indicated that only OTC derivatives sharing the same reference data details as the derivatives traded on a trading venue will be subject to transparency requirements. ESMA's recent guidelines on transitional transparency calculations (TTC) for all non-equity instruments except for bonds has increased clarity.

b) **Key decisions that AMs need to take**:

- **Reporting – in-house or outsource?:** Firms face dilemma if the activity is to be done in-house or outsourced to third parties, given concerns over regulatory scrutiny. Some AMs worry that delegated reporting (to brokers) could result in conflict with best execution obligations. However, doing it in-house will give more control but will require higher investment in resources and technology.

- **Identifying and capturing the right data:** AMs are worried about sourcing relevant reference data, capturing voice/chat quote, accurate time stamping of large data sets, classification of trading instruments, and lack of a comprehensive global Legal Entity Indicator (LEI) and usage of appropriate International Securities Identification Numbers (ISINs) for OTC derivatives.

- **Reconciling data across platforms**: Firms are finding it difficult to set up robust process to reconcile information at many levels. Firms are concerned over the lack of centralized data flows and adequate access to multiple trading platforms, especially in cases where AMs deal with multiple securities across assets and regions.

c) **How are AMs approaching this?**

- The approaches to reporting are varied. Many AMs prefer in-house reporting and subsequent transmission to a single ARM, thereby removing the liability pertinent to transmission of personal data to broker. They seek to take advantage of ARM providers when trading with a non-MiFID broker or with brokers outside of the European Economic Area (EEA). Other AMs have delegated their obligations to third parties but have strengthened their governance structure to avoid failures. AMs continue to monitor the SI status of their counterparties to evaluate their reporting obligations.

- Most AMs are adopting strategic approach and evaluating the impact of the cross-over with other regulations such as General Data Protection (GDPR) to be implemented in May 2018.

- Firms are augmenting their internal technology stack, evaluating the right third-party reporting tools and realigning their work flow to achieve accurate and near-time reporting.

3. **Product governance and record keeping: How to build a robust scalable data platform that will aid storing and retrieving of large data sets across multiple communication channels?**

a) **Key MiFID II requirements**:

- AMs need to define their target market based on six categories. They must identify at a sufficiently granular level the potential target market for each financial instrument and specify the type(s) of client for whom the financial instrument is compatible.

- Firms are currently required to keep records in a significant number of areas, including: (a) client orders (b) decisions to execute (c) transaction details and (d) client files for period of five years or for the duration of the client relationship (whichever is longer).

- At present, the FCA requires telephone conversations of individuals directly involved in trading to be recorded. The new recording rules covers calls directly related to conclusion or intended to result in a transaction. FCA recently removed the taping requirements for services linked to corporate finance.

b) **Key decisions that AMs need to take**:

- **Arriving at a balanced target market definition:** In product governance, many AMs face significant challenges over establishing and maintaining a prudent target market definition for products that are distributed across countries that might have different definitions. Further, they are yet to resolve the inconsistency over the interpretation of standards by different interest groups.

- **Robust means to reconstruct communications trails:** Firms are undecided about the best means to reconstruct communication trails leading up to trade deals across multiple communication channels, including text message, Skype call and face-to-face meeting.

c) **How are AMs approaching this**?

- AMs are forming industry working groups to ensure standardization of definition within the industry.
- Firms are looking at deploying solutions that can read metadata in multiple format to ensure the necessary compliance.

4. **Research unbundling: How to choose a prudent research sourcing and payment strategy, and develop a robust research valuation policy?**

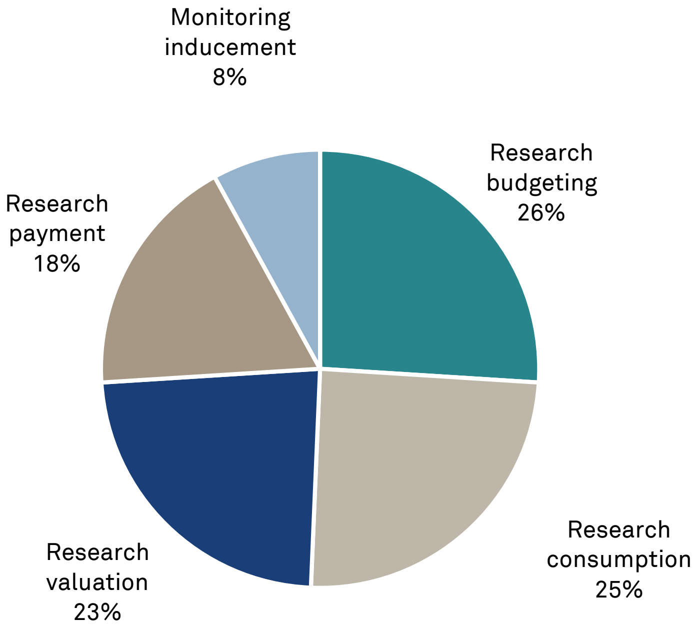
a) **Key MiFID II requirements**:

- AMs are required to either absorb research costs or set-up research payment account (RPA), the cost of which can be borne by investors but entailing additional disclosure, budgeting, reporting and audit requirements.
- There has been some regulatory relief and clarity, including (1) France's Autorité des Marchés Financiers (AMF) and FCA allowing research trial periods for up to 3 months but restricting renewal within 12 months; (2) FCA allowing transfer of funds into a research payment account (RPA) within 30 days and (3) the need to pay for fixed-income, currencies and commodities (FICC) and macro research that underlie investment strategies.

b) **Key decisions that AMs need to take**:

- **Decide on the payment strategy and the right research budgeting methods**: Most AMs are still undecided on whether payment will be done through the RPA or will be absorbed. Even among firms that have chosen the RPA route, most are yet to set budgets at the granular levels and decide as to how research cost will be apportioned fairly among funds.
- **Assessment of research quality and value:** Most AMs are yet to develop a robust research valuation methodology that could be accepted by asset owners and regulators. While buy-side firms have begun to negotiate with sell-side firms, they are facing considerable challenges on arriving at a reasonable pricing for various research services.
- **Choosing appropriate compliance tools:** AMs face difficulty in evaluating, implementing and integrating third-party RPA solutions that meet the stringent regulatory guidelines.

What are the top challenges your firm faces in complying with research unbundling?

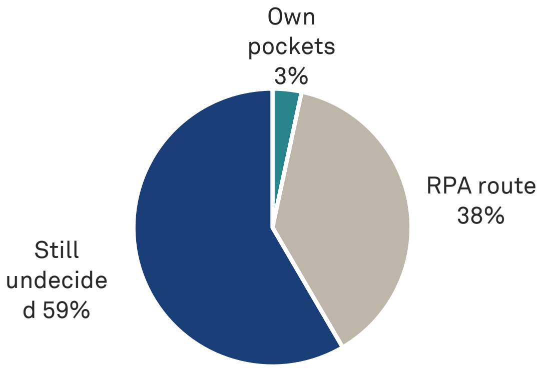


Source: CRISIL GR&A buy-side survey conducted in August 2017. Analysis based on 92 responses, of which 51 were from firms with less than $50 billion and 41 from firms with more than $50 billion.

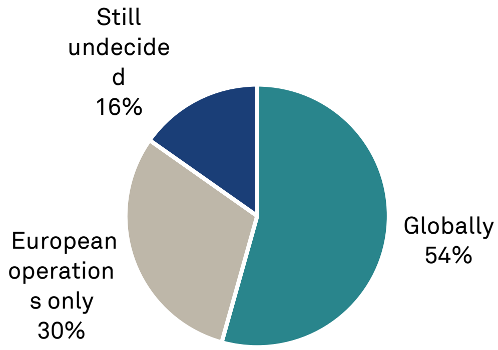
Revamping research practices has its own challenges

1. **Payment dilemma persists:** The dilemma over the research payment strategy has persisted for more than a year and the paths remain mixed. There is still no clarity and the trend is wide open. Our survey indicates that more than half of the AMs are still undecided about their payment strategy. More than half of the respondents indicate they plan to adopt the unbundling globally and nearly one-third plan to restrict it to their European operations.

How do you plan to pay for research?



What is the likely approach toward implementing research unbundling?



Source: CRISIL GR&A buy-side survey conducted in August 2017. Analysis based on 92 responses, of which 51 were from firms with less than $50 billion and 41 from firms with more than $50 billion; Geographical break-up: Hong Kong (7), UK (29) and US (56).

Among the AMs that have publicly disclosed their strategy, we observe that typically AMs (i) with an AuM of less than $50 billion (e.g. Kempen, Woodford); or (ii) smaller share of equity assets (e.g. M&G Prudential and Aberdeen Standard Life); or (iii) smaller share of European assets (e.g. Vanguard) have chosen to absorb research costs, while the rest have chosen to set up RPA and pass on the research costs to their investors. A key factor behind AMs with less than $50 billion AuM absorbing research costs is probably an assessment that the RPA-related reporting and compliance costs would offset most of the potential savings by passing on the research costs to their clients.

In contrast, active European AMs with more than $50 billion AuM, such as Schroders and Janus Henderson that also have a higher share of equity AuM (40-50%) have decided to use client funds for funding external research.

	AMs adopting RPA route			AMs absorbing costs					
		AuM in $ billion	Share of equity AuM		AuM in $ billion	Share of equity AuM		AuM in $ billion	Share of equity AuM
Europe	**>$50 billion AuM**			**>$50 billion AuM**			**<$50 billion AuM**		
	Amundi	$1,312	15%	Aviva Investors	$453	NA	Kempen	$44	16%
	BNP Paribas*	$493	19%	Aberdeen	$397	29%	Rathbone	$41	70%
	Schroders	$525	41%	M&G Prudential	$362	22%	Hermes	$39	NA
	Union Investment	$363	23%	NN Investment	$287	13%	JO Hambro	$38	100%
	Janus Henderson	$345	50%	Baille Gifford	$214	NA	Stewart	$31	100%
	Man Group	$96	44%	Robeco	$172	NA	Woodford	$23	NA
				Jupiter	$61	52%	TwentyFour AM	$13	0%
US	**>$50 billion AuM ****			**>$50 billion AuM ****					
	Invesco	$858	46%	JP Morgan	$1,876	21%			
	Northern Trust	$1,029	56%	T Rowe Price	$904	56%			
	PIMCO	$1,610	2%	Russell Investments	$277	NA			
				Vanguard Europe	$116	NA			

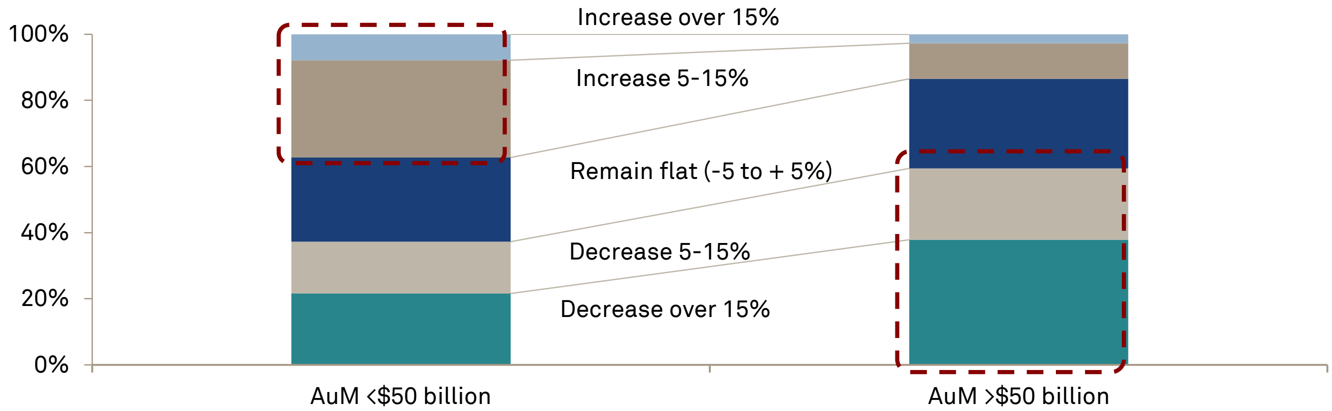
*Source: Company reports, CRISIL GR&A, Exchange Rate- GBPUSD = 1.3, EURUSD =1.2; AuM and equity share of AuM as of Aug'16 for Vanguard Europe, Dec'16 for Kempen, Mar'17 for Aberdeen, May'17 for Woodford, Aug'17 for TwentyFour AM and Jun'17 for the rest; ** Financial Times *indicates that it may switch to absorption; ** Except for Vanguard, it is unclear if the respective AMs would adopt it on a global basis or restrict it to European operations*

It is likely that most US-based AMs that have decided to absorb costs will ring-fence their assets related to European clients. Several large AMs, including BlackRock, Natixis, Franklin Templeton and Investec, are still undecided on the research payment strategy. We believe that their decision will have a significant impact on the broad practices adopted by global AMs.

AMs choosing to pass on research costs to their investors have to generate superior fee-adjusted returns. Else, in an environment where several active AMs have struggled to consistently outperform the market and where several of their peers are choosing to absorb research costs, asset owners are likely to push these AMs to absorb the research costs.

2. **AMs likely to cut research budgets by 15-30% in the medium term:** AMs are critically assessing the size of their research budgets, irrespective of whether they have chosen to absorb research costs or pass them through to investors. AMs are becoming prudent about the type of research they want to procure at both the firm and fund levels. Our survey indicates that nearly two-fifths of AMs with more than $50 billion AuM expect their budgets to decline by more than 15% and one-fifth expect AuM to decline by 5-15% in the next 1-3 years. In contrast, nearly one-third of AMs with less than $50 billion AuM expect their budgets to rise by 5-15%, while nearly one-fourth expect budgets to remain flat.

How will the investment research budget of your firm move in the next 1-3 years?



Source: CRISIL GR&A buy-side survey conducted in August 2017. Analysis based on 92 responses, of which 51 were from firms with less than $50 billion and 41 from firms with more than $50 billion.

Few of the smaller AMs that are going to absorb research costs have announced research budgets that translate to about 0.4-2.0bps of their equity AUM. We believe that smaller AMs will find it challenging to meet their research requirements with such a reduced research purse.

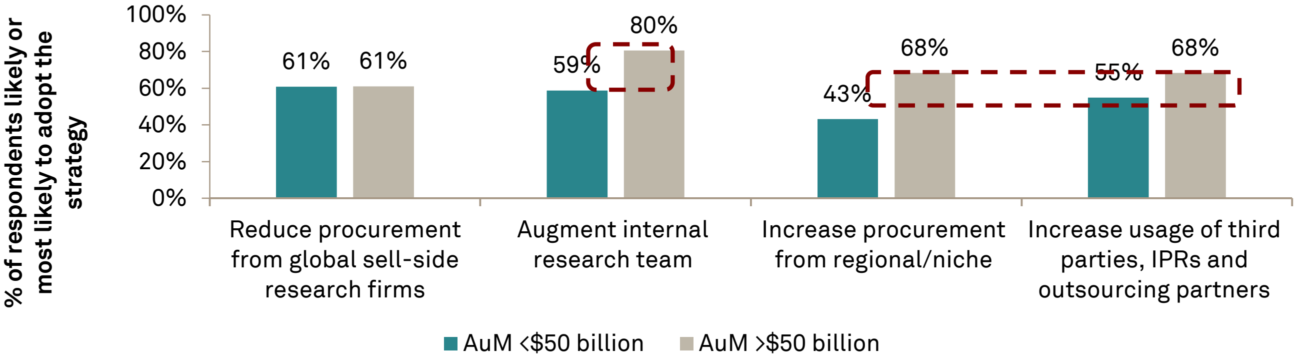
Smaller AMs could find it difficult to fund their research requirements adequately

Asset manager	AuM ($ billion) (as of 30 June 2017)		External research budget ($ million)	Research budget as proportion of equity AuM (bps)
	Total AuM	Equity AuM	Post-unbundling (disclosed)	Post-unbundling (implied)
Rathbone Investment Mgmt	41	29	1.3*	0.4
Jupiter Fund Mgmt	61	32	6.5	2.0
JO Hambro Capital Mgmt	38	38	6.5	1.7
Average	**47**	**33**	**4.8**	**1.4**

*Source: Company reports and fund annual reports, news reports; * based on actual research spend in 1H17 and underlying GBPUSD exchange rate of 1.3*

3. **Internal research budgets expected to increase by 10-15%:** Ahead of unbundling, most AMs have begun to optimize their research procurement mix (internal; in-house augmented with third-party research services; sell-side; independent research providers [IRPs]). Our survey indicates that more than half of the AMs with less than $50 billion AuM and four-fifths of AMs with more than $50 billion are planning to strengthen their internal research team over the near term.

Among different research sourcing strategies, please indicate your firm's likely approach in the next 1-3 years?

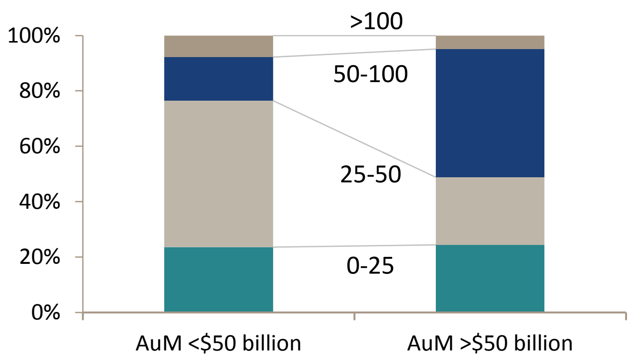


Source: CRISIL GR&A buy-side survey conducted in August 2017. Analysis based on 92 responses, of which 51 were from firms with less than $50 billion and 41 from firms with more than $50 billion.

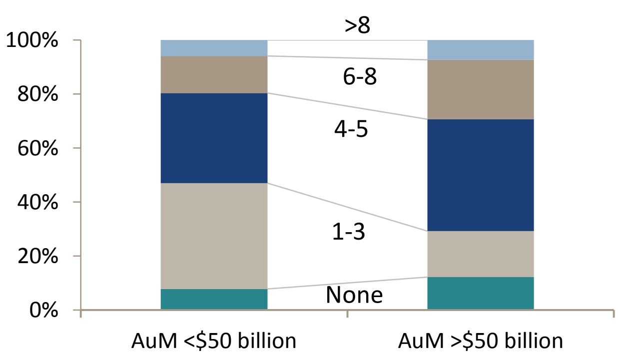
Large AMs are increasingly concerned about the possible research gaps that may arise due to the potential rationalization of sell-side research coverage and the steep costs associated with accessing star analysts and niche research. We therefore observe that larger AMs are taking steps to strengthen their internal research teams. For instance, Schroders has reduced its external budget, and it has progressively built a strong in-house research and data analytics team since 2014. Similarly, BNP Paribas Investment Partners is bolstering the internal team by hiring product specialists. Kempen has indicated that it would absorb the research cost and refocus on strengthening its internal team. We believe this trend will accelerate as active AMs seek to extract maximum value from their research budgets. We expect internal budgets to increase by 10-15% of the current external research spend.

4. **AMs to engage with fewer than five bulge brackets and increase their dependency on IRPs:** AMs are looking to engage with specialists for execution and research. Our survey indicates that more than two-thirds of AMs with less than $50 billion AuM and nearly half of the AMs with more than $50 billion AuM are likely to engage with fewer than 25-50 brokers in the next 1-3 years. AMs with a large number of fund mandates spread across regions are likely to engage with only 50-100 brokers. For instance, Union Asset Management, Germany's third-largest AM, expects to reduce its overall research span from 200 to less than 100 brokers ahead of unbundling.

Likely research providers to be engaged by your firm over the next 1-3 years



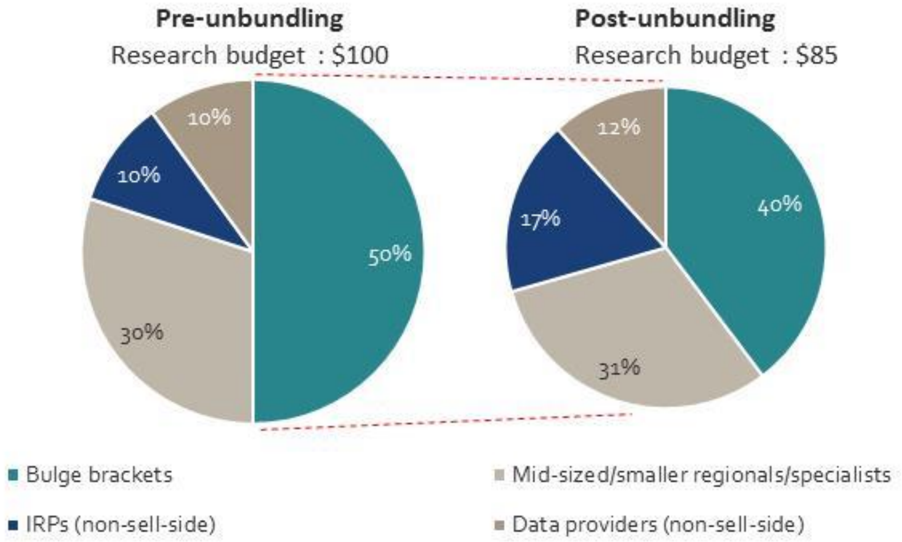
Likely number of bulge-brackets to be engaged by your firm over the next 1-3 years



Source: CRISIL GR&A buy-side survey conducted in August 2017. Analysis based on 92 responses, of which 51 were from firms with less than $50 billion and 41 from firms with more than $50 billion.

We believe that the share of sell-side research within the AM's external research budgets is likely to reduce to ~70% (vs. current share of 80%) as AMs reduce the research they consume from bulge brackets and increase allocation towards independent firms.

Independent firms to gain research wallet share as sell-side research consumption declines materially



Source: CRISIL GR&A estimates

We expect the wallet share of IRPs to increase as firms are likely to tap boutique firms, IRPs and independent online market places (OMPs) for thematic and low coverage stocks. AMs will increasingly use the three-month trial period to evaluate numerous IRPs/niche brokers that meet their specific needs pertaining to a sector, region or investment style. AMs sparingly use OMPs in the current environment, but this could change materially in an unbundled environment. We believe that while the adoption of OMPs could be slower, AMs will eventually source a significant portion of their research needs from such research platforms as a larger pool of smaller and specialist research firms begin to enlist their products on such OMPs.

5. More AMs to take fixed-income research in-house

Fixed-income research pricing by sell side is in a flux. The initial indications were that it could cost upwards of $5,000 per user for access to basic FICC research services from the bulge brackets. However, the pricing has continued to trend downwards as investment banks have sought to reduce prices to take market share. For instance, news flow suggests Deutsche Bank has halved the price of its FI and macro research, while both Danske Bank and Credit Suisse would offer basic FI research for free to institutional credit investors.

This pricing pressure on FI research would accelerate the trend of sell-side firms trimming or shutting down their FI research desks and AMs strengthening their in-house FI research teams.

Indicative subscription fees for fixed-income research products based on recent news flows

Research provider	Annual research subscription fees	Comments
Investment banks		
Bank of America	• Basic: $15,000 • Premium: $100,000	• News flow suggests that Bank of America could offer its 'limited service' for $15,000 per firm (permitted users not known) • News flow suggests that the bank could charge up to $100,000 per firm for an ultra-high service for up to 30 users
Deutsche Bank	• Basic: $3,600/user	• News flow suggests Deutsche Bank halved the price of its FI and macro research to $36,000 per year for up to 10 users
Credit Suisse	• Basic: Free	• News reports suggest Credit Suisse could offer its basic fixed-income research for free
Credit Agricole	• Premium: $144,000	• News reports indicate Credit Agricole could offer premium currency and rates packages for $144,000 (€120,000) and EM research for $96,000 (€80,000)
Nomura Holdings	• Premium: $144,000	• News flow suggests Nomura Holdings could charge up to €120,000 ($144,000) per year to access their favorite analysts • The number of permitted users is unknown
JPM	• Basic: $50,000	• JPM is expected to charge $50,000 for basic access to FI research • The number of permitted users is not known

Source: Bloomberg, Reuters, Financial Times, CRISIL GR&A, news reports, Exchange rate- GBPUSD = 1.3, EURUSD =1.2

Profitability of European AMs could eventually decline 14-27%

Uncertainty over research prices weigh on research budgets

AMs are facing a wide range of pricing quotes from various research firms. News flow suggest basic site access to equity research ranges between $4,000 and $9,000 per user based on the client user base and the premium services (includes access to analysts) could be upwards of $15,000 per user and could extend up to $80,000 per user for ultra-premium services. The wide range of pricing quotes would have a significant impact on the research budgeting and sourcing decisions of AMs.

Indicative subscription fees for equity research products based on recent news flow

Research provider	Annual research subscription fees	Comments
Investment banks		
Macquarie	• Basic: $5,000/user	• Pricing for smaller clients: $25,000 for 5 users to access the firm's equity-research portals
Bank of America	• Basic: $4,000-6,000/user • Premium: $15,000-80,000/user	• Basic research services pricing based on client size: <10 active users $6,000/user; 10-99 $5,000/user; and large $4,000/user
UBS	• Basic $7,000-9,000/user	• Pricing for smaller clients: $35,000-45,000 for 5 users to access basic research
JPM	• Basic: $10,000	• Mostly likely for small clients. The number of permitted users is unknown
Barclays	• Basic: $39,000 • Premium: $450,000	• $450,000 (£350,000) for premium access for small and medium-sized clients. The number of permitted users is unknown
Independents and Specialists		
Autonomous	• Basic: $50,000 • Premium: $330,000	• $50,000 for 'read-only' service for its European equity product, $330,000 for access to analysts
Moffett Nathanson	• Premium: $100,000	• Annual fee of $100,000 includes phone access to analysts. The number of permitted users is unknown

Source: Bloomberg, Reuters, Financial Times, news reports

We believe that sell-side firms would look to keep the cost of basic subscription (website access) low to sign up more AMs and recoup the sunk costs linked to published research. However, it needs to be seen as to how the pricing for premium services such as access to ranked analysts and one-to-one management meetings evolve over the medium-term. We believe pricing negotiations would continue till late 4Q17/ early 1Q18 as both the AMs and sell-side endeavor to extract the best possible deal for themselves.

Profitability of European AMs to remain under pressure post-unbundling

While most AMs are yet to finalize their research funding strategy, we continue to believe they would eventually absorb research costs driven by investor and peer pressure and regulatory nudges. We have performed a pro-forma financial analysis of a typical active AM in Europe as a proxy to assess the impact of unbundling on European AMs' profitability under three scenarios assuming they absorb the research costs.

Pro-forma financials		Bull	Base	Bear	Comments
Net revenue [A]		100	100	100	Net revenue assumed as 100 for pro-forma analysis
Pre-unbundling operating profits [B] = [A] * Operating margin		32	30	28	Operating margin of AM estimated to be 28-32%
Research costs pre-unbundling [C] = [L]		3.5	5.3	7.6	Refer to the assumptions table below
Change in external budget [D] = [C]*[M]		-1.2	-1.6	-1.1	Expected decline in budgets are a proportion of pre-unbundling research costs
Change in internal budget [E] = [C]*[N]		0.2	0.5	1.1	Expected increase in budgets are a proportion of pre-unbundling research costs
Research costs post unbundling [F] = [C]+[D]+[E]		2.5	4.2	7.6	
Post-unbundling operating profits [G] = [B]-[F]		30	26	20	
Change in operating profits [H] = ([G]/[B]-1) *100	**%**	**-8**	**-14**	**-27**	Operating profits of AMs could decline by 14-27% after unbundling in our base and bear cases
Assumptions					
Share of equity AuM [I]	%	30.0	35.0	40.0	Equity share of AuM estimated to be 30%-40%
Pre-unbundling external research costs as proportion of AuM [J]	bps	1.2	1.9	2.7	We estimate the research commissions as proportion of total AuM to be 1.9bps = equity AuM (35%)* portfolio turnover (50%) *2* blended commission rate (10.6bps) * research share (50%)
Net revenue margin as proportion AuM [K]	bps	35	35	35	Net revenue margin assumed to be 35bps for the AMs at the aggregate level
Pre-unbundling research costs as % of net revenue [L] = [J]/[K]	%	3.5	5.3	7.6	
Change in external budgets [M]	%	-35	-30	-15	External research budgets to decline 15-35%, based on our survey and client conversations
Research brought in house [N]	%	5	10	15	We expect AMs to increase internal budgets by 5-15% of the existing research spend
Net change in research budgets [O] = [M]+[N]	%	-30	-20	0	

Source: CRISIL GR&A estimates

Key takeaways

- In our base case, operating profits of active European managers could decline by around 14% in case they choose to absorb research costs, assuming a net decline of 20% in research budgets. In our worst case, operating profits could decline by about 27%, assuming a 15% drop in the external research spend offset by a corresponding increase in internal research spend. We believe that the impact could be higher if AMs begin to ramp up their investments in data analytics and alternative data, which has not been considered in our current analysis.
- We believe that large AMs will be better positioned to retain large and diverse sources of research. However, only firms that bring in efficiencies in research sourcing and production will be able to minimize the impact of unbundling on the profitability. We believe that smaller AMs could face the brunt in the medium term as they are most likely to both absorb the research costs and might find it difficult to procure adequate quality research services from either the bulge brackets or sector specialists.
- The profitability impact is marginally lower than our earlier estimates of 17-29%, as we factor the declining research commission pool on account of the increasing adoption of low-touch trading and also incorporate a higher cut in AM's external research budget.

The road ahead

While full-scale compliance across multiple impact areas is necessary, it would be necessary for firms to focus on the key impact areas that are likely to draw more scrutiny than others. For instance, firms need to avoid poor quality reporting, given that FCA has been quite vigilant about it in recent years. Since 2007, the FCA has imposed fines amounting £33million on 12 firms for inaccurate reporting and non-reporting.

Firms need to focus on research unbundling, too, given that it has been the most profound and widely expected change among investors. Regulators, especially the FCA, have already been critical of misuse of client commissions for research.

Active AMs are understandably focused on reducing costs to minimize the impact of research unbundling. However, it is equally critical to focus on alpha generating opportunities as investors would eventually choose AMs that generate superior fee-adjusted returns irrespective of who absorbs the research costs.

Net-net, we believe AMs should focus on:

- **Marry operational compliance to best practices and ensure value of adherence to asset owners:** At the broad operational level, firms need to (1) develop comprehensive data architecture and solutions to aggregate, process and validate data across multiple platforms (2) establish and document execution processes and procedures to demonstrate best execution policy to regulators and clients trades (3) identify single golden data source for trade testing and regulatory reporting (4) capture granular time-stamping and transaction data using advanced monitoring system and (5) ensure collaboration between front office and compliance teams to identify potential deficiencies.

  On the research front, AMs have to build holistic IT solutions and consistent firm level processes to (1) monitor inducement and consumption (2) centralize research administration (3) integrate processes and solutions to rate multiple research services (4) coordinate with RPA service providers for seamless integration and (5) deploy automation for reporting.

- **Finalize a balanced research sourcing mix that enhances value and minimizes costs:** AMs will have to become more judicious about the research they procure and how they value it/ pay for it. AMs should look to have a good mix of global sell-side firms (for waterfront coverage), regional sell-side firms (for on-the-ground intelligence) and boutiques for differentiated research. AMs would also have to relook at and strengthen their internal research teams, either by increasing their in-house research teams or by leveraging third-party service providers who can operate as extension of their research teams.

- **Accelerate investments in data analytics and alternative data for differentiated insights**: While there are concerns about investor pressures linked to the pass-through of research costs, AMs will be eventually judged by their ability to deliver alpha (adjusted for the research spend) compared with their benchmarks. In this context, we believe that AMs will need to integrate alternative data (such as transaction data, satellite imagery and social media) with the traditional data sets to provide their models with additional input factors that could help influence alpha generation.

  We believe AMs should simultaneously look at (a) implementing big data analytics internally through pilot projects and (b) explore off-the-shelf solutions and collaborate with external consultants to generate proprietary and differentiated insights on a sustainable basis. We believe only AMs that use advanced AI technology tools will be able to generate differentiated insights on a sustainable basis in the long run.

- **Accelerate adoption of advanced technology to enable all-round efficiencies:** We believe it will be vital for AMs to embed technology in their research process to bring in cost efficiencies. At the basic level, it will be necessary for them to automate their structured/ maintenance research activities to achieve cost efficacies and fill research gaps.

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