Changing Times: Quantifying Research

An analysis based off a selection of the largest global bulge bracket investment banks

By Peter Bentley & Tyrone Jansen
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Research continues to form an integral part of a firm's product offering, although, like all functions, it has come under intense pressure over the past 4-5 years as the dip in firm-wide revenues has pressured margins. While the economics of providing research improved in 2013, driven by a rebound in equities revenue, firms are still considering whether to categorize research as a revenue producing function or a cost centre.

The growth and emphasis of research began in the build-up to the tech bubble. The race for position resulted in numerous firms bolstering their headcount in an attempt to provide coverage across as many stocks as possible, while others bid to get top ranked analysts in focus sectors. This variance in breadth (stock coverage) and depth (quality) resulted in different approaches to research, with the banking-focused platforms emphasizing coverage while those that differentiated on quality having stronger ties with the equities function. In each scenario, the opaque nature of the functions meant both models struggled to truly quantify the value of research.

The fall out following the tech bubble, and the subsequent conflicts of interest that arose, cast a spotlight on the research division and how it works within the franchise. However, as the markets rebounded from 2003 to 2007, so too did headcount across all divisions. Since the financial crisis, research has been surprisingly well protected from the large headcount reductions seen throughout the investment bank.

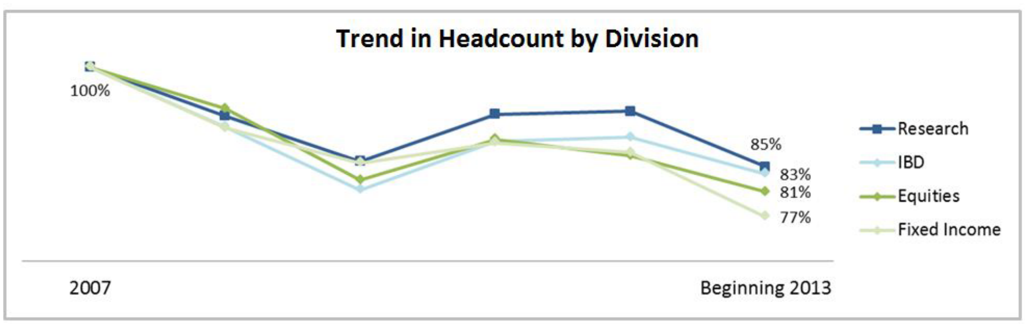

Figure 1

This trend is evidence that in the past, firms have been reluctant to reduce headcount too significantly and most bulge bracket firms still operate a large research function. The fact that research can be leveraged across banking, equities and fixed income has made it even harder to quantify value. It has also made it difficult to manage in isolation, with any changes potentially having broad implications across multiple divisions.

The current convoluted way that research is often paid for by the buy side, and the current size and cost of the research function, raises the question: *Is having a scaled research function worth it if a firm cannot differentiate itself in some way through that function?*

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Quantifying research:

As firms look to improve performance, reduce costs and bolster profitability, as well as consider some of the external regulatory driven pressure, banks need to ensure that they monetise their research offering versus their competitor's or at least consider the function's value add in line with the size and cost base.

To provide some context on the scale of research across the global investment banks:

- The full cost of research, on average and including its infrastructure support staff, is \$500m – \$600m and comprising an average of 12% of the total front office headcount.
- This is on average 5% - 6% of the entire investment bank cost base including infrastructure (9% of front office) and larger than most infrastructure functions except Information Technology and Operations, which has a similar cost profile.
- Research, as a percentage of total front office costs, has grown by 10% since 2009.

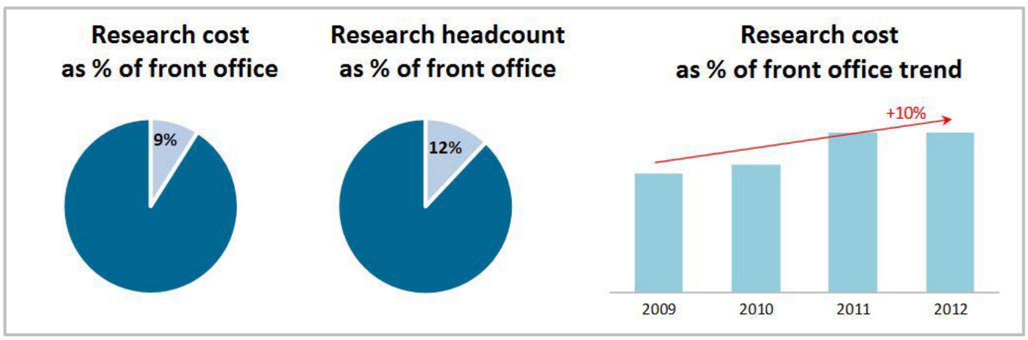

Figure 2

As firms have started to tackle the expense base, cost-cutting strategies have been employed and some firms have moved headcount out of the hub locations and into non–hub, medium cost locations or offshore low-cost regions, such as India. Outsourcing has also been popular. This is highlighted by the fact that 20% - 25% of total headcount are now based in offshore / non-hub locations.

The question that should be asked when considering such a strategy is: *If sales and trading are not leveraging the content produced by research, does that function need to be in a high cost location with the rest of the front office?*

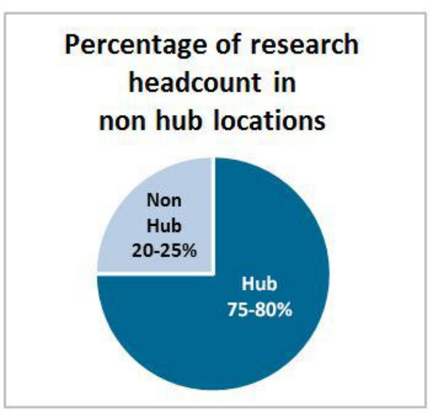

Figure 3

This approach to research is at varied stages in the cycle, but it is worth noting that there does not appear to be a clear correlation between those firms who outsource, or offshore heavily, and those that have lower cost research functions. However, there is a correlation between those that are more banking focused and where the depth of the research is not so prevalent.

It should be noted that viewing research through only this narrow lens fails to take into account the other ancillary and important services this advisory business provides. While it is clearly a differentiator and product for some, it is important for not only the sales force across markets, but also the investment banking business, where it plays an important role in helping banks win equity capital markets mandates. There is also demand for research across other areas within the bank such as the private wealth and the corporate bank. If these benefits, in conjunction with client buy side demand, are big enough to justify a large research business, then the internal allocation of those costs within the bank becomes extremely important when assessing its performance.

Research allocations background:

There is a large disparity in how research is allocated across the bulge bracket investment banks. Some, but not many, have reviewed how to fund research across the group by getting other business lines, outside of the investment bank, to fund its cost as its ancillary benefits to the firm become clearer and more interlinked. This approach is particularly relevant to those firms that have large private or wealth management businesses and have, in the past, leveraged their strength in research.

Indeed, comparing a firm's equities business (or fixed Income / banking) versus its peers without due regard for how research cost is allocated can provide very different results as to the economics of various businesses.

As an example, the allocation of research costs can be the difference between a profitable cash equity business and a non-profitable one, depending on how much the business pays for this service. Or in contrast, if a firm differentiates its cash business through high frequency / algorithmic or DMA trading, should the equity cash business pay less for research?

McLagan's analysis indicates that while all firms allocate their research costs internally to the business lines, there is a marked difference across each firm, with no firm allocating research on a like-for-like basis. Indeed, on questioning, there is no clear, consistent driver or metric used for the allocation of research cost to revenue producing businesses, with some banks allocating on a completely arbitrary basis of perceived value add.

The result being that comparing one firm's business line performance against another, without due regard to the varying allocation methodologies, can return wildly different results. The below chart illustrates the average impact that research has on an investment bank's overall profit margin and on each of its divisions. Assuming research is just a cost, it reveals that a firm's profit margin is reduced by 3% - 4% points on average, which is a 7% - 8% relative reduction. The largest impact is seen on the equities and banking divisions where their absolute margins are reduced by -8% and -4% points, respectively.

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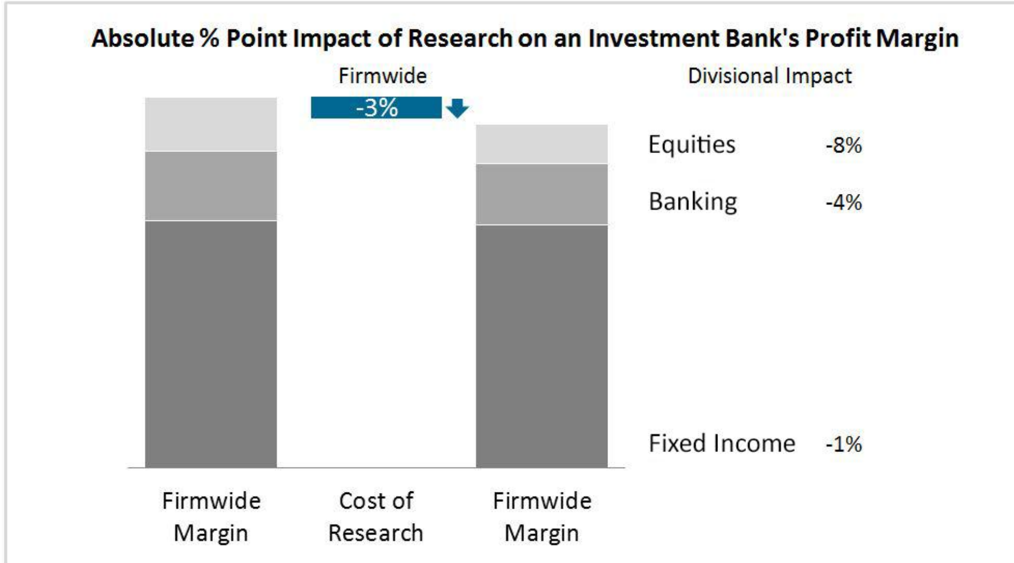

Figure 4

The significant impact on the profit margin highlights the importance of understanding how a firm allocates its research to each of its business units and the value that each business derives from this service.

From our analysis, the average allocation of research to the businesses is as follows:

- 70% of total research spend is allocated to the Markets (equities & fixed income) business.
- The remaining 30% is allocated to Investment Banking.
  - All firms allocate research to Investment Banking, but there is a significant variance - the largest allocated cost of research is most commonly to Equity Capital Markets.
- Within Markets, all firms allocate their research function to equities to varying degrees with some firms up to 90% of total cost and others only 30%.
  - Cash equities receives the largest allocation within the equities products, but the variance across firms is material, with no clear correlation between those firms that are research/content driven businesses versus those that are not.
  - This is followed generally by a more marginal allocation to equity derivatives and then to prime finance.
- All firms allocate cost to fixed income, albeit in much smaller proportion to equities. This is due to the significantly smaller size of their fixed income research focus and the more aggressive focus on trading.

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Figure 5 below summaries the general themes seen across the largest investment banks for the allocation of research.

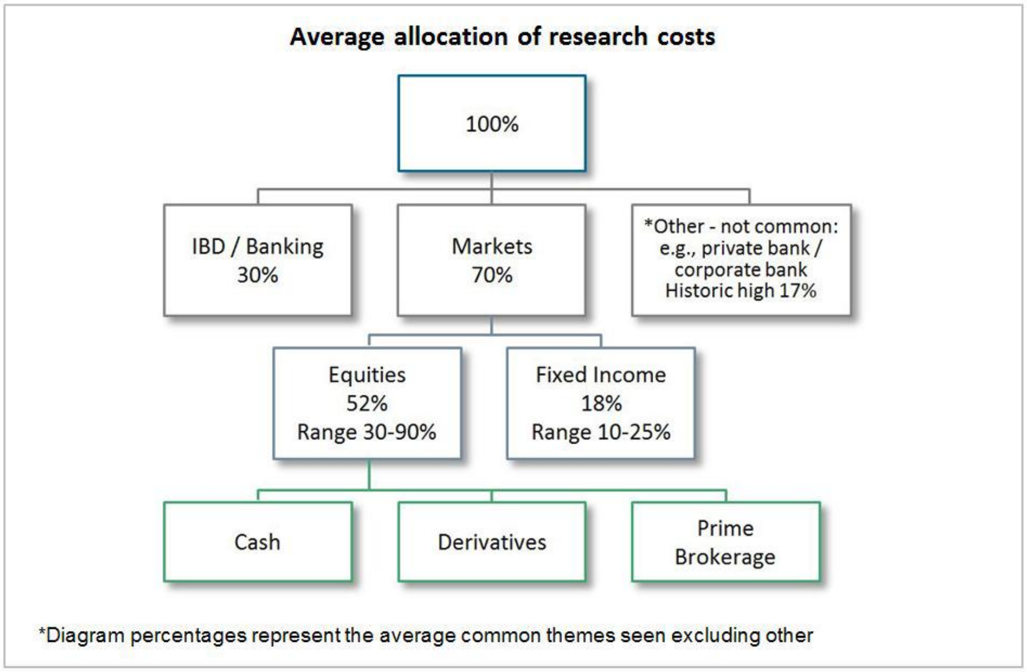

Figure 5

These allocations should also be considered in the context of the current review by the Financial Conduct Authority (FCA) which could have wide reaching implications. The renewed vigour to look at "unbundling" will potentially have significant implications on sell-side research and the ability to run a viable, broad based research function, especially if a firm does not differentiate through its content.

Conclusion

For some, research continues to be an important service amongst an investment bank's product offering. For others, the cost and size of research means that firms need to review how they differentiate and monetise content in relation to an overall product offering. High quality, content led research will become a differentiator and some firms will continue to invest and compete with the buy-side for top ranked analysts that are increasingly being enticed away from the large banks and into hedge funds and asset managers. For those firms that continue with waterfront coverage, even more focus should be given to the size of the business in relation to the benefits from a client revenue perspective, as well the benefits to other areas within the bank.

The important question to consider being: *If research adds marginal value to the franchise (most obviously felt within the cash equities and banking business), then is there an opportunity to significantly reduce a $600m expense base?*

To this end, McLagan can help firms:

- Review internal research allocations versus the market and versus key competitors. Illustrate the impact on profit margins that research has on the various business units, while taking into account different research structures. For example, firms with a combined equity and fixed income research structure versus a separate research structure.
- Understand the overall quantum of research and what is driving it. A firm may have an efficient allocation of costs, but the costs are materially above set benchmarks, making it crucial to understand:
  - Headcount – scale, footprint and location strategy.
  - Compensation – the impact of different models focused on breadth versus depth.
  - Non-Compensation - to focus on a lean approach via expense management.
- Model the impact of potential regulatory driven changes. Helping to better understand the link between the business and importance of research to a firm's overall franchise.

Revising and aligning the above in relation to other firms may have a bigger impact on profitability than any general non-compensation or broad based headcount reduction. It is therefore crucial that firms consider the interlinking nature of research and execute the correct strategy based on the biggest opportunities and competitive advantages.

McLagan is the financial services industry's leading reward consulting, productivity and performance benchmarking firm. Aon Hewitt is one of the leading compensation consulting firms, helping clients ensure their pay strategy is designed and executed to meet business needs, while focusing employees on what they need to do to help the company meet its goals.

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ABOUT THE AUTHORS

Peter Bentley is a Partner at McLagan and head of the Performance consulting practice focusing on serving clients across revenue, headcount, expenses and capital strategies. He can be reached at +1 917 324 5582 or pbentley@mclagan.com

Tyrone Jansen is an Associate Partner at McLagan within the Performance consulting practice focusing on serving clients across revenue, headcount, expenses and capital strategies. He can be reached at +44 20 7086 5057 or tjansen@mclagan.com

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