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ECONOTE No. 64: MIFID2: Should anyone pay for research? Part I 26/9/2017

Summary

At the outset I should state that this is a personal statement on a contentious issue. My reason for making some very strong claims is based on my experience of earning my living for nearly 46 years mostly by writing and selling research. I stopped doing so in the last three years when I went independent. Whilst working for some of the biggest investment banks in the world, I had no choice but to write research and hope that someone paid for it. With the MIFID2, the days of people paying for research in the way it was done so far, or indeed paying at all, are over. My position is that I would not pay for ANY research except if I had commissioned it specifically for my sole use. Otherwise I believe in free research just like the Econotes.

Investment Conclusions

Very basic Economics teaches that goods or services with zero prices will be over-consumed, free buffet style with piles of leftovers and, hence, over- produced. That simple lesson has passed-by generations of research managers advised by Economics Ph.Ds.! Once an attempt is made to charge for research, no one wants to pay, whether it is the clients or the sections of firms producing the research, which will have to bear the costs. This simple fact has come to roost with a vengeance on the producers and consumers of research, with the rules of MIFID2 which forces clarification on the pricing of research. The responses are simple, and so are the solutions.

The story so far, and MFID 2

Economic and financial research has , so far, been distributed at no explict cost (NB “explicit”) by the producers of research to their clients in return for business, such as placing orders for trading.The MIFID2 (Markets in Financial Instruments Directive) EU and UK rules, coming into effect in January 2018, will change all this.The true cost of the research to the businesess receiving it, and ,hence to their own clients,has so far been unclear, but what was clear was that the cost of research was passed in the form of higher charges for all other services rendered by the producers of research.As there was no direct link between the cost of receiving the research (nominally zero), clients were indifferent as to how much research they receive and binned it happily with no concern over cost.The value added of that research- did it help to make money- was also obscured, as good (money- making) and bad (not money- making) research had the same price, namely zero. Firms producing research competed for business of firms using research by producing even more of the free stuff (while passing the costs in other ways). Analysts were also motivated to write more in order to keep their names (and jobs !) in front of the clients.Result was an avalance of indistinguishable stodge which clients did not value (See Fig. 2) but which producers kept pumping out as it was part of their pricing and competition policy.Under the MIFID2 rules, users of research will have to either pay for it out of their pockets or charge it back to their clients via the commissions received.In either case there will be strict “accounting rules” and segregated accounts to show the the costs charged or paid out.Better still, the users of research will have to justify the price paid on the basis of its usefulness ! As Fig.1 shows the majority of asset managers polled indicated that they would pay for research out of their own pockets. Irrespective of the mode of charging, there is one thing clear, competitive pricing pressures will come like a tsunami on researh producers as research users, including their clients, will try to pay as little as possible for it.

Fig.1: Paying or charging?

Mifid II: how asset managers will pay for research
Data as of 11am on Sep 1 2017

Pass costs on to clients	Declined to comment/ no response	Absorb costs	Undecided
Amundi	Credit Suisse	Baillie Gifford	Allianz Global Investors
BNP Paribas*	Goldman Sachs Asset Management	Brewin Dolphin	Ashmore
Deka	Investec	Brooks MacDonald	Aviva Investors
Invesco**	Morgan Stanley	Charles Stanley	Axa Investment Managers
Janus Henderson	State Street Global Advisors	Evenlode	BlackRock
Man Group	UBS	Hermes	BNY Mellon
Schroders		JO Hambro	Candriam
Union Investment		JPMorgan Asset Management	Deutsche Asset Management
		Jupiter	Fidelity International
		Kempen Capital Management	Franklin Templeton
		M&G Investments	GAM
		NN Investment Partners	Insight Investment
		Northern Trust Asset Management	Legal & General Investment Management
		Pimco	Lyxor
		Rathbones	Natixis Global Asset Management
		Robeco	Nordea
		Russell Investments	Old Mutual Global Investors
		Standard Aberdeen	Pictet
		Stewart Investors	Royal London
		T Rowe Price	
		TwentyFour Asset Managament	
		Unigestion	
		Vanguard	
		Woodford Investment Management	

* Previously said it will charge clients, but now says it is still deciding
** Preferred approach, but says final decision has yet to be made
Source: FT research

Source: Financial Times

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Lessons from the academia

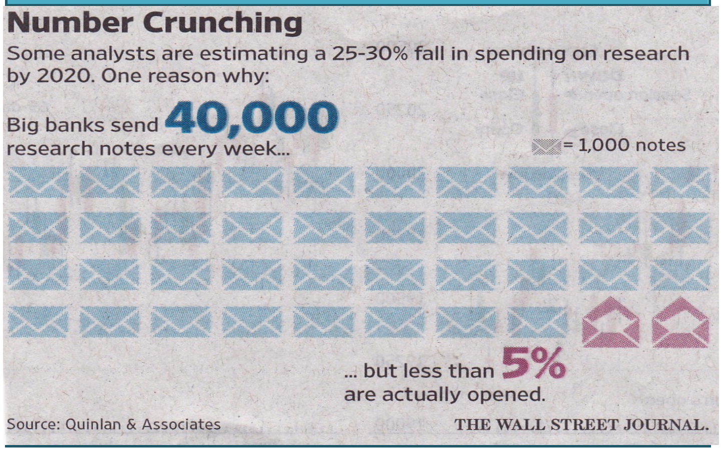
There are plenty of lessons for financial research from the mess of publishing academic research.I speak from experience as I taught Economics for 22 years in universities in London and Hong Kong.Academics get promoted, get tenure and pay rises primarily on their research output.Teaching quality, administration etc rank very low.Pubications, to count, must be in "reputable" journals and must be peer-reviewed.As there a few reputable journals, the competition to publish in them makes, by comparison, competition in the financial markets a Sunday outing of a kindergarten ! Articles that have been rejected by one journal, can be re-written, revamped and changed and resubmitted in some other journal till they get lucky and get published.Articles can wonder around the academic circles for years like zombies, till a kind editor puts them to rest.Numbers count and so does quality, but the latter is difficult to measure and judge.Hence more problems !

Fact Box: Who reads this stuff anyway?

Virtually no one! In the late 1980s the American Economic Association, the main body of professional and academic economists in the US, published studies on the "readability" of academic articles in economics and financial academic journals. Only a tiny percent of articles got even a tiny percent readership from the potential audience. So nearly all the articles were not read by anyone, except by the authors, referees and editors! Same depressing evidence exists for financial research. As Fig. 2 shows, virtually all research is binned unread. Aware of this, Econotes had offered clients a service whereby we deleted the research before sending it out in order to save them the trouble of doing so. No response was received to this offer possibly because no one read it!

The most obvious reaction to this situation was to get more journals published so as to have more venues to get published. Hence a mind-boggling proliferation of journal titles, published/edited by desperate academics in order to have homemade venues to get published. As these may not be "reputable" journals, a publication in one of them is not the same as being published in the top 3-4 journals. Solution? The articles to "count", not only they have to be published in reputable journals, they have to be quoted in the articles of other authors. So an author could point out proudly that his/her article, in a mid- reputation journal, was quoted in the bibliography section of 30 or 40 other articles, hence it was a good and useful article. That "solution" generated immediately a counter-solution. What happened was that "cliques" of academics were formed and agreed to quote each

Fig.2: This way to the dustbin please!



Source: Asian Wall Street Journal

Where to from here ?

others's articles in their own articles in order to boost the numbers of references. Teams also formed which refereed each other's articles and approved them for publication. And then the crooks stepped in.There have been waves of plagiarised articles, something relatively easy to do as no one reads anything anymore and, hence, passing someone else's work as your own is not that risky. But lethally, especially in biology, medical science etc, authors simply cooked,or doctored their data and results. Hey presto,"the cure for cancer" gets published.Reaction was obvious, part of the refereeing now involves results replication, that is the referees do all the tests all over again to see if they can get the same results.Nightmare ? Yes indeed. Sounds familiar with financial markets research ? Yes indeed, proliferation, as the academic research is produced with no obvious cost, no one "buys" it, and the cost of its production is lost in the salary of the professors publishing and refereeing . What is the value of this sea of research ? No one knows as no one "buys it" nor "costs it" nor is any attempt made to measure its value- added to the field it pertains.Not all research, of course, has commercial value-research in literature, art, theoretical physics etc are obvious examples.But where there is a commercial element, the zero pricing approach leads to overproduction and overconsumption. Solution? Give all the finance research for free and charge only for research which is ordered by the client either at the behest of the client or after suggestions by the researcher.More suggestions in Part II of this article including pricing based on the "Greek-Middleastern reverse Dutch auction" model.Andrew Freris (writing completed 26/9/17)