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8/F, 2 Exchange Square, 8 Connaught Place, Central, Hong Kong. Tel: 852 3167 4591, Mob 852 9738 0944
Email: afreris@ecognosisadvisory.com Website: www.ecognosisadvisory.com Facebook: @ecognosis

ECONOTE No. 65: MIFID2: Should anyone pay for research?

Part II

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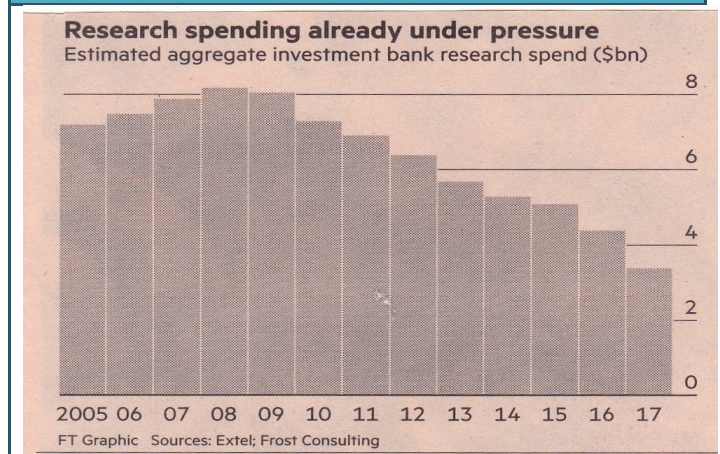
Summary	Investment Conclusions
In Part I of this report we outlined the basics of the MIFID2 rules being introduced in UK and EU regulating, among others, the way that the asset management industry pays for research. The regulations imposed an unbundling of the costs of research from all other service and trading costs. The result of that will be that institutions will need to either charge their clients for research directly, or they will have to pay for it from their own pockets. Either way, research costs are now defined as they never were before, and the implicit cost of research is now explicit with, the predictable result, that less of it will be consumed. (See Fig. 1). We examine some further consequences and the pricing of research.	The MIFID2 may turn out to be a classical case of the law of unintended consequences. Research is used to make money. Asset managers get paid to make money. Now the money-making aspect of research is under the microscope and, as a result, will add to the pressures on asset managers to justify their fees. Their seemingly consistent (in) ability to make money has come under pressure by disillusioned investors as witnessed by the flight from managed to ETF and stock index products. Why pay a management fee if, at a minimum cost, ETF does the job as well or even better. And anyway, define "outperform" and "returns", but after fees!

Forecasting and money-making forecasts

Forecasting has three interrelated components: (1) Direction, such as up, down, no change (2) Quantity: such as X% up of Y% down and (3) Time: such as in three months or three years. As the old tired joke goes, good forecasters never give all three and, in any case, if they are going to forecast they must forecast frequently. Less obvious is, that consistently perfect financial forecasts, spot-on, all time, are impossible. If a forecast turns out to be miraculously constantly accurate it will, eventually, be followed by all market participants and will stop being right. Consider a forecast which predicted correctly that on all Mondays, during the first opening trades, the price of asset Z will always go up by 10%. What will happen to the price of Z on the xth Monday after traders have made enough profits for everybody to notice? Few people get the answer right. Nothing will happen to the price of Z, as there will be no sellers facing the army of buyers. As the sellers will be waiting for the price to rise, there will be no trades and the price of Z will stay the same as that of closing on the previous Friday. This is an exaggerated example, as some sellers will lose their nerve and sell as buyers will be trying to tempt them, but the point is made. From then on, the price of Z will not rise on Monday mornings and the forecast will be wrong. Same goes for a forecast which is so broad as to be always right. "Prices on Monday may rise, fall or stay flat". Another exaggerated example, but near enough common forecast is that the price of Z will rise but depending on X conditions holding (usually X being well over 10 or even 15!).

It would now follow that forecasts to have any value must be frequently wrong. Strange and counterintuitive but true. How frequently they have to be wrong is not really relevant, as long as, on average, they are right on big events rather than on small ones. And herein the Aeolian bag of winds opens as anything goes in proving that forecasts are right. Choosing starting dates for % comparisons are crucial and can make all the difference as well as the selective judgement of the meaning of the forecast.

Fig.1: Just the beginning!



Source: Financial Times

"Greek-Middle Eastern negative reverse Dutch auction" (GMENRDA)

GMENRDA can be an extremely effective pricing model for research products leading without haggling and/or bluffing to mutually acceptable prices. The model is **loosely** based on an old Turkish and Greek traditional pricing practice, particularly among builders in Greece up to the 1960s, whereby the buyer stated in detail the project, the supplier ensured a clear understanding, gave no price but at the end of the job, and having delivered the project, asked the buyer to pay "what the day's work was worth". The risk to the seller was that the buyer would offer nothing or something well below what was deemed to be a reasonable price. The buyer would have then bought something at a "bargain" price. More complex deals would include that any further work done, would be done on a "take it or leave it" price offered by the buyer to which the seller could only say Yes or No with no haggling permitted. Although this model appears to be

Fact Box: GMERDA and the pricing of research

The next issue in MIFID2 will be to negotiate research prices, with the buyers already aggressively bidding prices down. What the research is worth is, of course, a totally subjective issue. Hence the value of GMERDA, which emphasizes the subjectivity of the deals struck. For an asset manager overweight in telecommunications research on property is possibly worth nothing. Furthermore research is bought for one and one reason only, and that is to make money. Hence the value of the predictions of research can only be assessed over time and frequent deals, tempered by the counter-intuitive notion that predictions, which are always correct, are worthless. To be worth something they have to be occasionally or even frequently wrong.

unfair to the seller, consider the following. A buyer consistently offering below market price deals, will get a few for "free" but, subsequent offers for projects or work, will not be accepted. For the suppliers all they need to do is accept a few deals at zero or very low compensation and then refuse any further offers. Once a payment has been made, any subsequent offers by the buyer can be tempered by introducing the "take it or leave it" condition. The fact the a supplier has agreed to enter negotiations for an additional deal proves that he/she was not too disappointed by the price paid, but any temptation by the buyer to offer a very low price would risk refusal, and no further bargaining. Hence the risks in this negotiating process are basically equally and evenly spread.

Fig 2: The men who forecast the 2008-9 crisis

My pet hate, NOT because I did not forecast the 2008-9 crisis but because the claim, made by some consultants still going around bragging about it, is self destructing. Anyone claiming this prodigious feat of forecasting should have been able to make a killing by going massively short. That person should now be a billionaire and not needing to give lectures or write weekly and monthly reports. Never trust someone who has no faith and does not put money on his/her forecasts. Same goes for the hundreds of authors of books of "How to become a millionaire", especially if they claim that the book has sold "millions". Who wants to pay money for a secret which is known to millions of people? And also why are the authors such philanthropists as to let everyone else know their secrets? The truth is that a good way to become millionaire is to write a best seller about it.

Into unknown territory? Not at all....

The GMENRDA once again. First deal is done on a price paid at the discretion of the buyer. Any further offer to the seller, which can be refused, can be done on the basis of a price offered by the buyer on a "take it or leave it" basis with no negotiation permitted. Greedy buyers will find that the sellers will refuse them constantly. Sellers run the risk of doing some work for free but then may also receive the benefit of offers, at prices higher than they would have accepted, by buyers worried that they may be offering prices below an acceptable level. The absence of haggling is essential here in that sellers can be offered higher prices than they would have accepted, and buyers offering higher prices eager not to miss the deal. Hence the "negative Dutch auction" bit. Good research will command premium prices as buyers will make repeat offers at prices that they would not risk offering unless they felt they are well above those acceptable. Sellers will do some work for free and, if there are no return offers, this will signal them that their research is not worth anything, even a zero price. Return offers can be rejected, if the sellers get greedy and offer too low a price or if the buyers get greedy and reject a reasonable price. The risks are symmetrical here. Traditional haggling will force both parties to show how much they think research is worth. This is a system based on individual assessment which will lead automatically to too high prices asked by sellers and too low prices offered by buyers. Not so under GMENRDA where the prices are known only after, but not before, the event.

Andrew Freris (Writing completed 22 /10/2017)