Broker research tough sell on Street
Many money managers <u>simply ignore</u> advice

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Financial Post

Monday, November 28, 2005

Professional investors seem to have soured on investment research from brokers. And they are flush with money. It looks like a great business opportunity. Michael Urlocker is a former Bay Street analyst who recently looked at entering the independent investment research business.

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Sean is a highly opinionated hedge fund manager seldom short of words. But he struggles when I ask him to identify which brokerage has the best stock research. After a rare silence, he explains: "I can get the exact same report written by five different people, but it doesn't say anything."

It's a popular complaint among some money managers, who privately use words like "garbage" and shorter synonyms to describe the stream of brokerage reports tracking every market blip and management burp of every major company in Canada.

Ironically, if you were to read the financial press, you would think that money managers were on the edge of their chairs waiting for the daily wisdom of the analysts.

Not so. Our firm surveyed most major fund managers in Canada and a handful in the U.S. and found that only 10% said the quality of Street research was good. To be fair, the largest segment of respondents, 55%, said quality varied widely, but they emphasized that they had learned whom to trust, and the who varied from sector to sector. A sizeable group, 35%, rated Street research as poor, with a small minority like Sean (he asked to have his name changed) seemingly turning their backs on most Street research. Not that this has hurt his fund's performance -- he's well ahead of the market this year.

There is an army of Bay Street analysts churning out hefty company reports, quarterly earnings analysis, weekly sector updates, daily blast e-mails and up-to-the-minute blast voicemails, but all that volume adds up to nothing in the eyes of most research customers. Institutional investors label most of it as maintenance or "boilerplate reports," worthy of little attention. "Not thinking" is the main symptom in the eyes of Bruce Murray, a veteran portfolio manager at McLean Budden Ltd. Many analysts aren't willing to take a risk by deviating from the management view on any substantial issue, whether positive or negative to a company's fortunes, says Murray.

And so there seemed a great business opportunity: a large group of unhappy customers, and flush with money. Many fund managers we spoke to were growing their asset base and adding staff. And they were receptive to our soft inquiries over the summer.

In early September, we started research to nail down exactly what investors wanted and to develop a plan to deliver such a service. Before starting, we identified one structural risk: Institutional investors are notoriously frugal and may be reluctant to pay.

The needs were easy to identify. Nearly 80% of fund managers decried the lack of digging, the lack of real industry contact analysts have, saying they wanted to hear from third-party sources of information, such as the suppliers and customers of the companies they invested in. Although I was happy to hear this, I also wondered whether this was just flattery because I had spent 10 years as an analyst and digging was my specialty. Thoughts of flattery ended quickly though, as prospects said they had little interest in technology stocks, my area of expertise, which generated a lukewarm interest from 25% of prospects. The resounding strong area of interest, expressed by 75% of fund managers, was in small, neglected or obscure stocks, mainly in the U.S. Prospective customers literally slapped the table, saying they wanted this kind of service. The next largest focus area was in identifying "shorts" or companies headed into trouble, with about 40% interest.

There was also a high interest (55%) in accounting analysis. This was a surprise because two independent research firms had already plowed those fields since the accounting scandals of 2001. Veritas Corp. and Accountability Research Corp. have their fans, but rated low in the customer satisfaction part of our survey. Veritas, the better known of the two firms, rated near five out of 10, with the chief complaint being inconsistency of the work, followed by a perception that Veritas had embarked on a crusade on some accounting issues. Veritas is working on this and has expanded their focus to go beyond accounting, but clearly the old perception lingers. Money managers wanted numbers, not crusades.

The top-ranked independent shop in Canada according to our survey was Ross Smith Energy Group Ltd. of Calgary, which rated eight out of 10. The main comment from investors was that Ross Smith provided the sort of hands-on geological analysis that nobody else on the Street could touch. Add to that, stories that Ross Smith had hired private detectives to follow around Calgary's oil executives (wish I had thought up that one) and we saw a model of completeness of research that is lacking elsewhere. I couldn't help but think that an interesting survey might follow the collapse of oil prices, but that was just jealousy speaking; Ross Smith had found a niche and worked it.

As we proceeded through our survey, we were prepared to become diggers on obscure U.S. small-cap stocks, working industry contacts to develop a unique approach, much as Ross Smith had done in energy. But along the way, yellow warning lights popped up. Only 10% of the prospects said they paid "hard dollars" (what any other industry calls a cheque) for independent research. The bulk pay in a funny-money scheme called "soft dollars," which consists of an allocation of trading commissions. It's a system that works easily enough, but it creates a financial middleman between the research provider and the customer. Also there is political risk because, although legal for research payments, periodically industry regulators threaten to end soft dollar arrangements.

As we got deeper into it, red lights flickered: There was the former mutual fund manager who said, with great amusement, that his firm had been two years in arrears in soft dollar payments to research firms. Then there was the fund manager who bragged that he didn't need to buy Veritas research because if a good report was published, he could rely on his network of friends to send him an illicit copy. Or the pension fund manager who referred to the independent research business as a "charity," explaining that if he allocates funding to a new research firm, he has to cut off another supplier. I tried to not blanch as I wrote down "charity business" in my notes.

Strangely, as we brought more precision to our analysis, especially on pricing and payment logistics, we found the prospective customers became evasive. We had in mind a subscription model, with monthly or annual fees, in return for clear deliverables on a weekly and monthly schedule. "We don't sign contracts," said one prospect. "That's not how we do business."

My experience as an analyst opened nearly every door we called on, but it didn't rate at all as a track record. Many prospects volunteered that a free six-month introductory period was essential to get to know us. Other prospects said they wouldn't pay us unless we scaled up the business first by dramatically increasing staff to compete against larger firms.

Over time, the business model the customers wanted finally dawned on us: Find us some good obscure U.S. stocks, research them in complete detail and see if you can talk us into owning them. If we buy them and if we make money, we will pay you, maybe, in soft dollars. How much we pay depends on how well we do, how big we are and how much we like you. Our conclusion: That's no way to grow a business.

But no surprise, it's the same model the brokerage industry lives on. (Happily, we identified other customer segments, off Bay Street, which operate differently and have provided the base from which to grow a steady business.)

As an entrepreneur with a landlord, three phone lines and a data line, all of which require contracted monthly payments, I wondered whether I could pull that stunt with the telephone company: I'll pay if I like the phone calls I get. But, again, pardon me, that's just jealousy speaking. The real issue is that independent research is competing against a free service from the brokers.

Not many people think it is good service, but the price is great.