THE CRUCIAL ROLE OF RESEARCH

WITH SO MUCH MATERIAL FREELY AVAILABLE, WHAT ARE THE BENEFITS FOR FIRMS PAYING OUT FOR INDEPENDENT RESEARCH? ASKS **ROGER BOOTLE** OF CAPITAL ECONOMICS.

At the outset, I must declare an interest. I am the managing director of an independent research company, Capital Economics. So you should expect me to be banging the drum for outsourced economic research, including research and advice on money markets and interest rate positioning – and I will. But I hope that you will not, for that reason alone, dismiss my views as simply the product of special pleading.

THE ECONOMIST'S LAMENT. Let me first set the scene. The outsourcing of research and advice on interest rate issues is part of a wider debate about how investment research is structured and funded. Most top-flight, practical macro-economists find themselves drawn towards the big banks and within those institutions they are usually most closely associated with bond and equity trading and sales. Money markets don't usually get much of a look in.

Most importantly, though, with regard to the provision of investment research on stocks and sectors and economic/strategic or treasury research, there are three key defects. First, there is far too much research, much of it of a duplicatory nature, lacking insight, originality or judgement. Even in the electronic age, the average fund manager measures receipt of investment research by the yard (or perhaps now by the metre). If this stuff were used to paper the walls, it would have some use. Most of it, though, goes straight in the bin.

Second, there is responsiveness. You might think that at least the recipients of this research would have the ability to influence what they get, but alas not. With few exceptions, the provision of research is producer-led. It is the British Rail approach. The researchers decide what to produce and the recipients receive it. The nearest they come to influencing it is by voting in the various surveys which are regularly conducted. This is better than nothing, but it is not a lot. Imagine competition and responsiveness in supermarket retailing relying on regular voting on the comparative merits of Waitrose, Sainsbury and Tesco.

Last, but not least, there is independence. A large part of investment research is produced by analysts employed by well known investment banks which have large corporate finance departments. It has been observed on numerous occasions that analysts seem to find it extremely difficult to issue sell notices on stocks and during the internet and dotcom frenzy there were hardly any major bear pieces issued by the big houses. This shouldn't be surprising. The analysts are paid to produce this material and there is a powerful knock-on effect on economists and strategists.

Yet many clients rely on such research not just for information, but also to help form their view of the economic fundamentals and the outlook for the markets. It is surely both distinctly odd and thoroughly unhealthy that the whole financial services industry should rely for its investment research on the same institutions which make money by dealing in stocks and securities.

This reliance is problematic for smaller fund managers who are not at the top of the investment banks' list, and it is particularly problematic for corporates. But it is damaging for everyone who needs good research.

THE IMPORTANCE OF INDEPENDENCE. Many users of research though, whether corporate treasury functions, investment managers or banks, may naturally wonder why they should pay for outside research. The answer is simple – because research really matters and because you get what you pay for. It was an economist, Milton Friedman, who said: "There's no such thing as a free lunch." And he was right.

Although there is a mass of economic and investment research distributed free by investment banks and brokers, the clients, of course, are paying for this through dealing spreads and commissions. But the investment banks and brokers naturally use the distribution of this 'free' research to further their own objectives.

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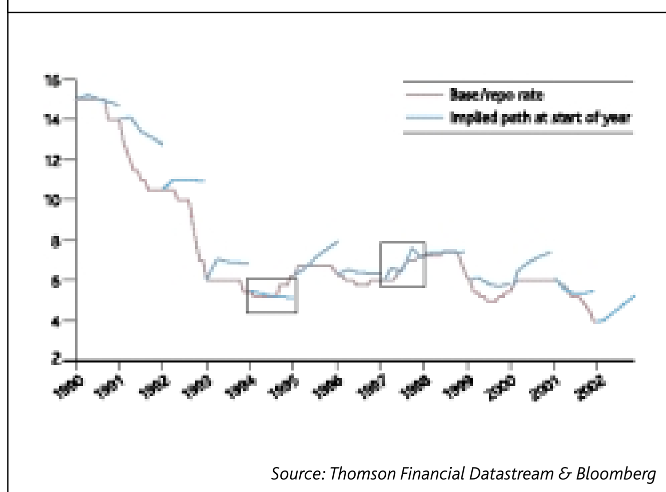
For the hapless corporate client of one of these banks, relying on them for advice and guidance, they face a double problem: the bank economists are not exactly what you would call independent; and by and large they are neither specialists in treasury matters, nor see corporate clients as one of their prime areas of responsibility. Because of these problems, it is hardly surprising that there is a temptation for companies simply to take no economic input at all. You may think this does not matter but I humbly submit that, although economists do not have a great record on many areas of forecasting, on interest rate matters many of us do. To eschew all economic advice when taking key decisions about interest rate positioning or risk management would not be a good idea.

Indeed, in this respect, the chart tells an intersting story. It compares the actual course of UK interest rates since 1990 with the market's forecasts, as implied by the short sterling futures contract at the beginning of each year. In every year bar two, the market has systematically overforecast UK interest rates.

Now, I know that term premia and risk premia can be wheeled out as explanations or justifications, but the size of the errors is simply too great for these explanations to be convincing. The truth is that most participants in the money markets, both banks and corporates, could do with access to good, independent, economic advice.

FIGURE 1

INTEREST RATES & MARKET EXPECTATIONS AT THE START OF EACH YEAR, 1990-2002.



Source: Thomson Financial Datastream & Bloomberg

For corporates, there is the option, of course, of relying on an in-house economist. This may be perfectly okay if you have one, but many corporates, or even small banks, do not – and if they do, he or she is unlikely to specialise in treasury matters. You could, of course, simply go out and hire one, but in general the economics, as it were, do not stack up.

To do the job properly you may feel that you will need more than one of these rare beasts, and I am pleased to say that good ones don't come cheap. It is rarely possible to resource internal research departments fully at the requisite quality. Moreover, it is very easy for an internal research department simply to re-affirm the views of senior executives – thereby defeating the object of the exercise.

In any case, you may not need the services of even one, let alone a whole team of economists, full time. What you need is access, when you need it, to good economists – and, most importantly, to good economists who are not simultaneously working for people who are trying to sell you financial products. So, in this instance, the attraction of outsourcing is not only about saving costs but it is also about the importance of independence.

WHAT IS THE WAY FORWARD? I have no blueprint for how the provision of research should be organised but I do have some guiding principles. First, there should be transparency about who is paying for what. Second, there should be the opportunity not to take something and not to pay for it. Third, there should be a variety of sources of research.

I think the suggestion contained in the Myners Report, that the cost of commissions should be borne directly by fund managers, rather than passed on to their clients, would go some way towards achieving these objectives, but this would not solve the problem over night. In particular, it will be necessary that fund managers get more used to dealing net and that they are able to do so with complete confidence with regard to price, liquidity and execution. Once they are able to reduce the amount they pay in commission for research they have the incentive to get more of what they need from other sources.

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I would like to see an interplay between research provided by the sell-side, fund managers and corporates themselves and independent research houses. For the system as a whole it is not necessary for all investment and economic research to be independent, but rather that some of it should be, to act as a marker and a check on the providers of non-independent research. In such a set up, precisely because there was an outside alternative, the quality and independence of the research which continued to be provided by sell-side houses would probably rise. In particular, with this outside competition, setting benchmarks of independence and integrity, sell-side analysts would find their internal position strengthened against the inevitable pressures which emanate from corporate finance departments.

In my view, independence has always been important in the conduct of research and the provision of advice. These days though, bearing in mind recent history and the pressures on investment banks, it is probably even more crucial. If an independent economic research service helps to make better decisions, as our clients affirm it does, then the cost is a small price to pay – and if this service obviates or reduces the need for internal resources then it represents a large cost saved.

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