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Support after a few gut-punches for research

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Meredith Whitney's efforts at the buy-side ended with a thud. Bloomberg has reported that Kenbelle Capital LP is on the ropes following the departure of several executives, the listing of midtown Manhattan office space for sublease, and the filing of a lawsuit by its lead investor for the return of his capital.

Kenbelle launched in 2013; it follows Whitney's effort at establishing a research boutique, Meredith Whitney Advisory Group LLC, in 2009. In between was her December 2010 interview with "60 Minutes" in which she did not choose her words carefully regarding the timing and magnitude of municipal defaults. She may legitimately claim that the editing of a long interview was unfair. Maybe "60 Minutes" was trying to sensationalize a "what-if" scenario; or maybe the production editors did not understood what she was saying with the caveats that financial types like you and I would understand.

I am sure she has some regrets; we all do, but she is to be commended for trying and mattering. In the U.S., failing is completely acceptable; not trying is failure. Whitney made a great call on Citigroup Inc. and the precarious nature of Wall Street in 2007. She then had enough wits to do what Wall Street really values — she marketed her call into big-time fame and I assume fortune. That she rode an investment in Lehman Brothers "all the way down to zero" is a footnote in her personal investing that did not have to be disclosed.

Leaving the buy-side effort aside, Whitney's efforts at the sell-side raise a question that I think I have heard her raise in the past: what is research worth and is anyone really willing to pay for it? Integrity Research Associates recently had a couple of interesting posts on the subject. One was about the European Securities and Markets Authority (ESMA) backing away from a proposed ban by buy-side firms from paying for research with client commissions. The other, "FINRA Says No to Re-Bankerizing Research," was a throwback to Henry Blodget, Mary Meeker, Jack Grubman and the 2003 Global Settlement.

At some point during the 1982-1999 bull market the loose tether between research and banking became a hard link. Underwriting boomed in many of those years, as has been the case the past two years with a soaring market. Favorable research was a means to win underwriting mandates. Institutional investors knew "neutral" then meant "sell," "buy" meant "hold" and "strong buy" meant "buy"; sadly, most retail investors did not.

The conflicted relationship was not illogical. The cash equities business operates on very thin margins. Banking margins can be very wide when business is good. A team in a particular industry vertical that generates millions of dollars of revenues should create big margins because there is very little overhead — and bonuses are variable depending upon production. This is contrasted with the business of staffing research, sales and trading and incurring clearing, compliance and a myriad of other costs, while the bulk of revenues are based upon a few pennies per share or less of trading commissions.

Research, sales and trading took a gut punch when the SEC required trading to occur in decimals rather than fractions in 2001, which narrowed spreads. Then in 2003 the SEC, NASD, NYSE and other regulators entered into the Global Settlement with 10 large firms, which theoretically created a real Chinese wall between banking and research. The third punch has been the gradual grind lower in institutional equity commissions — i.e., thin margin revenue — which declined for several consecutive years before rebounding 10% in the 12 months ended February 2014 to $10.3 billion, according to Greenwich Associates. But revenues do not speak to margins, at least not directly.

So it should be not be a surprise that the economics have never escaped anyone's mind 12 years after the Global Settlement was instituted; FINRA fined 10 firms nearly $44 million last year for violating NASD Rule 2711. Although the 2012JOBS Act loosened restrictions on analysts' ability to participate in banking pitches for small companies, FINRA found that the analysts and firms involved in the Toys R Us pitch violated Rule 2711, primarily due to implied promises of favorable research. In other words, some eager analysts blatantly crossed a fuzzy line. One analyst said in an email that he would risk self-mutilation to get his bank into the deal.

So FINRA is using the Toys R Us deal to make an example and invigorate compliance efforts that are more robust than portrayed in the press — at least that is my experience. Some might call it a renewed effort at revenue suppression. Integrity Research noted that with equity commissions under (secular) pressure, the temptation for firms is to "re-bankerize" research. "After all, why else would Evercore buy ISI?" Integrity wrote.

Research is also being hit elsewhere. In the U.K., the Financial Conduct Authority has taken aim at "corporate access" whereby research acts as a concierge and arranges meetings between the buy-side and companies, typically with the covering analyst and a salesman in tow. Fund managers can no longer "pay" for corporate access with commissions. I believe corporate access is viewed by most research departments as the largest or second-largest commission generator. The companies know this when choosing who they will travel with. Analysts with "sell" ratings are not on the travel list.

Late last year the European Securities and Markets Authority nixed a plan that would have banned the buy-side from paying for research with commissions. Had the proposal stood, the buy-side would have had to pay for research itself or bill its clients separately. Good luck with that. The final rule has not been adopted, but Integrity Research's view is that the final rule will be close to what is proposed today, which would require the buy-side to budget research expense and get the client to agree to the cost. That does not sound like a regime that will drive European research commissions higher.

So back to Meredith Whitney and the basic question: What is research worth? Her 2007 call was worth billions, or maybe many multiples more, for investors who heeded her word and exited Citi and other financials. Others took on the risk, perhaps thinking that lower prices compensated for the risk. But that still begs the question: What is someone willing to pay for it, especially when the regulatory apparatus seems to be gradually moving the industry to a structure in which commissions solely must be for execution services and other services have to be priced separately, or at least not bundled with execution services?

I am obviously biased, but I think good fundamental research — as opposed to quarterly updates that repackage a PowerPoint presentation with the words "we believe" attached — for underfollowed small-caps and to some extent mid-caps, is additive to investors. I do not know what it is worth, but it is worth more when industry conditions are poised to change as Whitney demonstrated. With the yield curve flattening from the long end and credit spreads widening, 2015 may present an opportunity for an industrious analyst.

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