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Reinventing Equity Research As a Profit-Making Business

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Introduction

The traditional business of providing equity research to asset managers has been under pressure in recent years, as managers, challenged to deliver alpha to their clients, seek new forms of research and asset owners turn increasingly to passive strategies. Now, new regulation, specifically the advent of MiFID II in Europe in 2018, is about to escalate these pressures. The result will be an increase in both the magnitude and the pace of change in equity research, reducing the scale of the research business and reshaping its economics. Nonetheless, equity research still offers an attractive business opportunity for banks and broker-dealers that can adapt to deliver the types of research the buy side values and also successfully transform their operating models.

The trigger for accelerated change in the equity research business is the January 2018 go-live of European MiFID II regulations, a broad set of market reforms and investor protections, a part of which call for the explicit un-bundling of charges for execution services and investment research by banks and broker-dealers. Under the traditional bank and broker-dealer operating model, research has been provided without an explicit charge and bundled within trading commission rates. While the new MiFID regulations may strictly apply only to European asset managers, banks and research providers, as well as to non-EU-domiciled entities when they serve European clients, the impact is likely to be broader, as asset managers extend the MiFID II model of separate payments beyond Europe to their global operations. The result could be a sharp decline in the demand for equity research—the consensus view of banks surveyed by McKinsey calls for an industry-wide drop in equity research revenues of 30 percent or more over the next three years. Independent research providers should see a gain in revenues from current levels, suggesting that the revenue pool for banks and brokers will likely shrink even further.

For the first time, bank and broker-dealer equity research will operate as a free-standing profit center, forcing a transformation of the business.

For the first time, bank and broker-dealer equity research will operate as a free-standing profit center, forcing a transformation of the business. The buy side will pay broker-dealers for actionable research that adds investment value, but the demand will fall far short of the mountains of research that banks currently supply "for free." For asset managers, as research becomes an itemized cost, profits could be sharply reduced—by as much as 15 to 20 percent for firms in Europe. The resulting change to research operations will be enormous.

To succeed in this transformed environment and meet asset managers' more exacting standards, banks and broker-dealers will need to focus on the changing nature of the types of research the buy side finds useful and overhaul their offerings. Long-only active managers and hedge funds focused on equities are demanding less in the way of traditional products (i.e., single-stock research reports) and more in services, such as access to analysts and corporate managements. Moreover, investors are seeking new forms of information and analytics, through big data and artificial intelligence (AI), which can complement conventional fundamental research in portfolio decision-making.

Beyond producing quality, differentiated research, banks will also need to adopt new operating models for their equity research businesses. This calls for focusing on four strategic priorities:

- Establishing a research footprint that capitalizes on strengths of coverage in sectors and regions, and extending reach through joint ventures.
- Understanding the scarcity and perishability of ideas, and what value clients place on research in different forms—reports, analyst and corporate management access, conferences, and other forms of information and analytics.

- Translating client preferences and demands into informed pricing structures. Explicit prices must be assigned to research, whether item-by-item for individual products and services or through packages or broad subscriptions.
- Adopting new technologies to generate novel investment ideas and lower costs. The sell side can leverage AI to interpret high-frequency market data in real time, patterns in both supply and demand chains, and social media. They can reduce costs by automating basic financial analysis and maintenance research. For client coverage, analytical tools can discern clients' preferred means of research delivery and service.

Five business models will evolve for the provision of equity research and execution services in the future.

1. A few global banks will lead the industry with both global execution services and high-quality, broad-based research coverage.
2. Another cadre of two to three firms, likely market-makers that are not banks, will be global leaders in execution, but offer no research or only a limited, specialized array.
3. A second group of universal banks will attempt to maintain their current broad research efforts, combined with global execution at a smaller scale than the leaders. In view of dwindling research revenues and the competition for low-cost execution, however, this model is likely unsustainable, although some firms could make up the shortfall in client revenue internally from banking and wealth management units. Accordingly, many firms currently large in both research and execution will have to make significant cuts in one direction or the other.
4. The majority of banks will rationalize their research and execution capabilities by focusing on their "home-field advantage" in local sectors and regional markets. Demand from local and global clients will likely support one to three such banks per region.
5. Independent research firms offering little or no execution should see significant growth in the new landscape, as they reverse the past trend among many research boutiques of offering execution as a means for the buy side to pay for research.

These strategic shifts are likely to take time, given several barriers to exit. Research is a well-entrenched part of capital markets operations and provides value to banks' investment banking, wealth management and equities units, as well the intangible benefits of burnishing the corporate brand. Some firms will want to keep a hand in research as an option to scaling back up. Evolution will come fastest to European banks, followed quickly by the US, while the Asian market may be slower to change.

Despite the challenges of a rapidly changing economic and regulatory environment, the equity research business has the potential to be an attractive opportunity for banks and broker-dealers that successfully adapt by anticipating and responding to the buy side's needs and by transforming their research business models.

Investment Research: Changing Demand, Products and Competition

The traditional investment management industry—the buy side of long-only active managers and hedge funds focused on equities—has posted persistently weak portfolio results. For the 10 years ended December 2016, more than 80 percent of US active managers underperformed their market benchmarks. Hedge funds did not fare much better, with US funds generating cumulative alpha of -5 percent between 2011 and May 2016, after providing investors with cumulative alpha of 139 percent from 1993 through 2011.

Accordingly, asset owners are voting with their wallets. While active managers of US mutual funds still oversee about three-fourths of the industry's AUM, passive funds are rapidly taking share—for example, growing 18 percent year over year in the US mutual fund market during 2016, versus just 4 percent for active funds. During the year, $400 billion of assets were moved from active to passive strategies. With such trends firmly in place, forecasts of a fund industry equally split between active and passive options seem well within reach, especially with rapid growth forecast for smart beta strategies, and MiFID II's ban on commission payments to independent financial advisors.

In the US hedge fund sphere, about one-third of asset owners surveyed expressed dissatisfaction with their managers' returns in 2014 and 2015. These assets have been in motion as well, and hedge funds saw net outflows of $100 billion in 2016.

In their efforts to improve their portfolio performance—and to justify their fees—active managers are placing greater demands on the providers of a key raw material: investment research. Under the traditional bank and broker-dealer operating model, research has been provided without an explicit charge, and bundled within trading commission rates. The resulting lack of pricing discipline, combined with the prospect of attracting clients with a broad range of ideas, led the sell side to produce too much undifferentiated content.

Even prior to the arrival of regulation concerning the provision of research, institutional investors have been testing the effectiveness of alternative, and lower-cost, research content and services. Competing brokers have been reluctant to risk revenues from the largest clients, and have instead sought to trim smaller clients from their respective coverage lists.

But in an era of scarce alpha, the buy side needs investment insights now more than ever. While active managers are willing to compensate banks and brokers for their research, they are becoming more discerning, taking the best from each and ignoring the rest.

Transformation of products

To meet managers' more exacting standards, the sell side must overhaul its offerings. To be fair, this effort is already underway, with less emphasis on products—the thousands of published research reports opining on single stocks and market developments. The buy side has assumed a greater role in its own investment analysis—a trend likely more pronounced among larger managers—and while many written reports are still valued as sources of company data, only the top tier is truly useful. (For example, about 50 sell-side analysts regularly report on Apple Inc., but it is difficult to imagine that more than a handful offer unique insights. Still, when the extraneous research arrives free of incremental charge, active managers have not turned it down.) And rather than take analysts' investment opinions at face value, buy-side analysts make greater use of the sell side's pre-constructed earnings models, laying in their own assumptions on revenues and profitability.

In another shift, asset managers have developed an appetite for proprietary services that may provide actionable insights, in particular access to firms' analysts, and meetings with managements of the companies they follow. Asset managers, especially hedge funds, are willing to pay high prices for these scarce, time-sensitive, and customized services. (Corporate access is an area of particular concern for regulators, however, who aim to ensure an equal flow of information from issuers to all parts of the investing public.)

Independent specialists

Research from banks and brokers has important competition—independent firms without trading operations that are paid directly for their research.

Buy-side firms are also in search of more distinctive, proprietary data sources to build into their own analyses. Both long-only and hedge fund managers are reportedly hiring data scientists to generate alpha from insights from sources such as mall parking lots, social media, and weather satellites, as well as market data. Within this context, more sophisticated investors recruit data hunters to source and secure privileged access to unique data sets.

Independent providers are active in the area, too. Market research firms, such as Foursquare, compile and interpret high-frequency data on hundreds of companies, such as traffic and ticket size at fast food restaurants, and fashion observations into reports with an investment slant. Other innovators have introduced online marketplaces for institutional research (e.g., RSRCHX-change) and corporate access (such as ingage), or automated the analysis of company financials through AI (e.g., Narrative Science).

Regulatory Disruption to Research

As the production and consumption of research on the buy and sell sides have been evolving, the coming MiFID II regulation will impose sudden and sweeping change to the European and UK financial markets when it takes effect in January 2018. Its goals are to increase the transparency of investment management and financial trading on and off exchanges, and protect investors in mutual funds and hedge funds through improved disclosure of fees.

MiFID II will reshape the economics of investment management, pushing the industry toward greater transparency. Importantly, with respect to investment research, buy-side firms will no longer be able to cover the cost of research with bundled commissions. Research will have to be assigned explicit prices, whether item-by-item for individual products or services, or through packages or broad subscriptions.

Specifics vary among countries, but payment mechanisms under MiFID II will likely combine the existing structure of commission-sharing agreements (CSAs) with a new research payment account (RPA). Historically, CSAs have allowed asset managers to designate a portion of their bundled commissions to directly pay for research (either to a broker or an independent firm). Going forward, RPAs will serve as a mechanism to pay for research, but spending must be budgeted in advance, and the RPA must be funded prior to any purchase of research.

Investment managers can choose to pay for research from their own P&L, or charge its cost back to clients. In the latter case, funding RPAs up to the amount budgeted can be carried out in two ways: through CSAs (known as the "Transactional Method"), or through direct withdrawals from investment vehicles they manage (the "Accounting Method," often referred to as the "Swedish Model"). Some country regulators are in favor of the CSA approach (France, for example) while others (such as the UK) favor the Swedish Model, as it strictly separates research payments from trading commissions.

Prices for ideas

Whatever the eventual practical outcome, bank and independent research will have to prove its worth to asset managers. Not only will the economic value of research be under scrutiny, asset managers will face additional costs for compliance, monitoring their consumption and providers' distribution. The combined effect of higher costs for research—to the extent managers pay for it from their own pockets—plus operational burdens could cut the asset management profit pool in Western Europe by 15 to 20 percent.

MiFID II regulation applies to banks, brokers and independent research firms in Europe and—Brexit notwithstanding—the UK. It remains to be seen whether asset managers will adopt separate payments for research as a practice across their operations. Large asset managers running funds that invest globally might find different approaches to their European, Asian and US operations to be too complex, and choose instead to adopt MiFID II practices generally. Other firms, such as hedge fund managers, might ring-fence their MiFID II-compliant operations, and leave their US and Asian operations as is.

McKinsey expects that over the coming three to four years, MiFID II will be adopted as an ad hoc global standard. Although such regulations may not be adopted everywhere, the buy side's interests are aligned with the regulators' intentions, at least with respect to transparency into the cost of research and its overall reduction. Some firms may compartmentalize their different geographies for a while, but as asset managers increasingly trade globally, non-UK and non-EU firms will need to report to clients in those regions in support of their compliance requirements. Thus, for banks and brokers worldwide, in time MiFID II will transform the creation, distribution and pricing of research, as well as how, and how much, clients choose to consume.

Revenue Pressures

The transformation of investment research will exert corresponding forces on the global trading landscape. Through electronic trading, execution is already concentrated among a few powerhouses with high transaction volumes, low cost per trade, and minimal impact on prices. For just the top three global firms, combined market share has climbed to more than 40 percent. In a world where execution and research are decoupled, trading will gravitate to low-cost, low-impact providers, and an ongoing arms race in trading technology will likely concentrate share even further.

Smaller firms will retain an important role in trading, however. Many possess specialized expertise in a region or sector—say, Canadian banks in resources, or Australian firms in metals and mining—and investment managers will seek them out for both research and trading, and willingly pay higher commission rates. Still, if research and trading become fully unbundled, even the valued order-handling and execution services of smaller independent agency brokers may be at risk.

Industry equity revenues have already been under pressure. The top line fell sharply from a peak in 2009, due to a decline in volatility-driven high-frequency trading following the financial crisis, and has not recovered since (Exhibit 1), according to McKinsey's CMIB Revenue Pools. Since 2009, global banking revenues have declined about 20 percent in equity sales and trading, and 10 to 15 percent in investment banking.

Not evident in the flat top-line trend, however, is a significant change in the makeup of equity revenues. Those attributable to payments for research have already fallen sharply—on the order of 30 percent, according to surveys of the buy side.

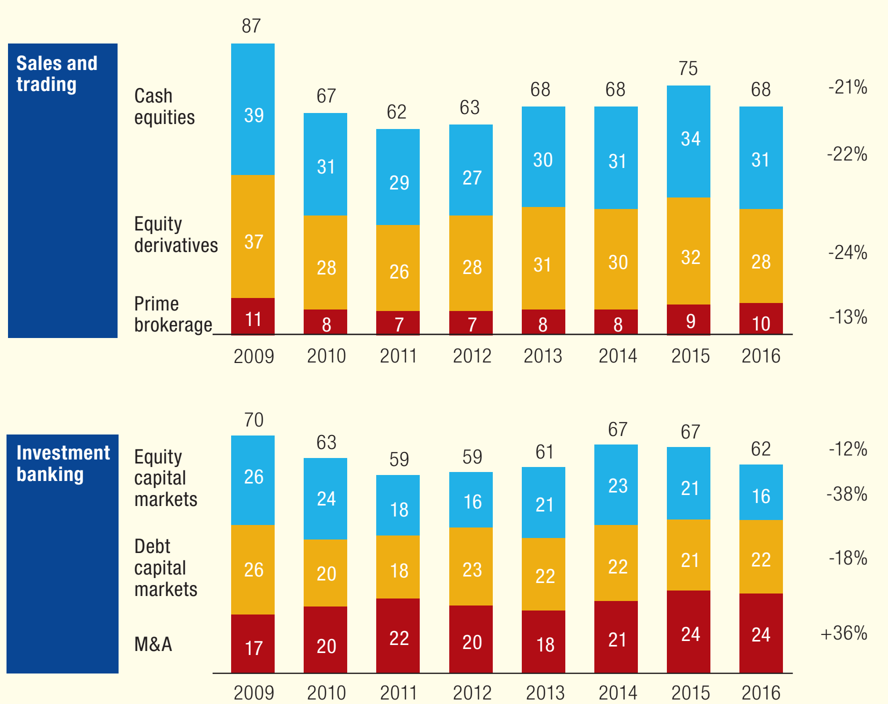
Owing to investments in technology, headcounts have fallen even faster than revenues in equity sales (down 31 percent) and trading (off 38 percent), since 2011. By comparison, FTE numbers in research are down just 12 percent over the period (Exhibit 2, page 14).

Research has not yet been resized for three reasons. First, in many cases, the research function is managed independently of equities, and bank and broker managements have protected research in the interest of supporting their firms' private wealth and banking businesses. Second, in the search for competitive advantage in the eyes of the buy side, the breadth and depth of sell-side research has actually expanded. Third, research has not functioned as a revenue and profit center, but rather on a model of internally-allocated

Exhibit 1

Global equities and investment banking revenues have stabilized with essentially no growth since 2009

Global equities sales and trading and investment banking revenues[1] (pre-writedown)
$ billion

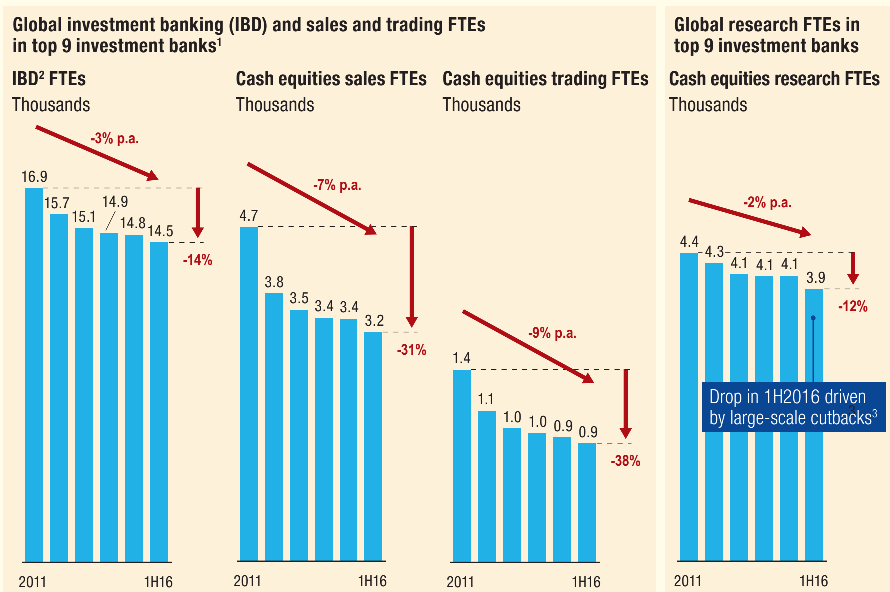


[1] Synthetic financing included in EQD; repo excluded from prime services; excludes corporate derivatives.

Source: McKinsey CMIB Revenue Pools

Exhibit 2

Since 2011, research FTEs have dropped 12%, compared to ~30-40% in sales and trading for cash equities at top 9 investment banks



[1] Bank of America/Merrill Lynch, Barclays, Citibank, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley, UBS

[2] Includes M&A, equity capital markets and debt capital markets.

[3] Barclays shut down its cash equity research, sales and trading business across Asia. It also discontinued stock research operations in the Gulf region, Egypt, Turkey, Greece and eastern Europe, including Poland and Hungary. It is also planning to completely exit local presence in Russia.

Source: Coalition

costs, leading to a lack of discipline in the creation of products and services. The coming transformation of research will force many firms to scale back their broad coverage to a few areas of true expertise, bringing big cuts to research teams in the coming three to four years.

Research Under the Microscope

The market for research ideas has been an essential component of the equity business for decades, and isolating its cost from execution will completely change the industry's economics. Research revenues will be pushed and pulled by five forces:

- Changes to investment managers' operating models, and whether internal research capabilities are built up only in the MiFID II jurisdictions or globally
- Pressure from investment managers' clients on the tradeoff between research spending and investment performance
- Further shifts from active management to quantitative and passive strategies—or a return to favor of active management
- A shift in asset managers' preferences toward research from independent firms
- Reactions to the new framework by both banks and independent research providers, as to the size and shape of their operations, and to a two-tiered operating model that emphasizes high-value, premium products, and scales back lower-value, lower-cost offerings

McKinsey conversations with market participants reveal a range of opinions on the impact to sell-side research. Many expect an immediate drop in research revenues on the order of 10 percent. Over three years, as demand and supply achieve a better-informed equilibrium, the consensus among the buy and sell side expects a 30 percent fall in payments for research, and some firms expect a drop of 50 percent (Exhibit 3, page 16). As independent research firms are likely to gain share, revenues of banks and brokers could fall further than the industry aggregate.

Transformed business models

These forces will transform not only the economics of the research business, but the landscape of players as well. A few banks have started their own transformations—separating research from trading, and bargaining with clients on how research will be delivered and compensated. So far, however, most of the sell side has focused on the many broad changes to trading and compliance infrastructure called for by MiFID II, and only recently turned its attention to the impact of unbundling research and execution. As a result, some banks may arrive at the January 2018 implementation underprepared.

From the starting point—with many banks offering broad, undifferentiated research coverage, and execution with varying scale and profitability—McKinsey envisions a shakeout into five viable business and organizational models (Exhibit 4).

Execution-led businesses at scale with broad equities offering. Two to three global banking players will preserve their status in the new era, winning the

Exhibit 3

In the most bearish scenario, research commission pools could decline another 50%

Scenarios of cash equity fee pool development and underlying beliefs

	Impact of MiFID II regulation	**Buy side operating models**	**Investor/ shareholder pressure**	**Asset shift from active to passive strategies**	**Buy side research spend**
Bear scenario: Commission pools decline ~50%				Accelerated and sustained shift to passive from active investments	Significant spend reduction driven by global trend towards unbundling
Consensus scenario: Commission pools decline ~30%	Increased transparency on buy-side spend for research resources and execution	Change to be globally compliant and to reduce costs (despite originating in UK, Europe)	Strong pressure to justify research expense with performance	Continued shift to passive investments	Overall spend reduction driven by transparency and unbundling
Stable scenario: Commission pools flat at 2016 levels		Change to be jurisdictionally compliant (e.g., continue to operate outside of Europe and UK as current)	Some pressure to justify research expense with performance	Passive allocation stabilizes at current levels	Constant spend but shift towards higher value/ differentiated research

Scenarios may vary by geography

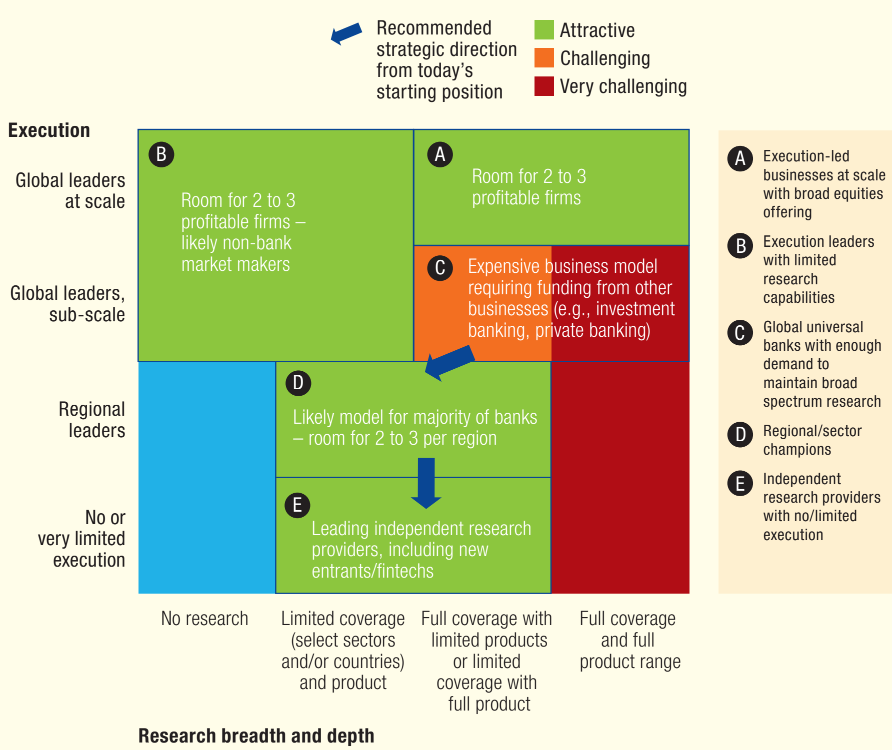
Source: McKinsey research

execution arms race and dominating trading in equities around the globe. Their research coverage will be broad as well, supported by a large buy-side client base, in addition to demand from their institutions' sales and trading and investment banking operations. Much as they do today, these firms will field an array of star senior analysts providing value-added services directly to clients, supported by teams of junior analysts carrying out the day-to-day research. (This model is somewhat reliant on firms retaining their top talent—some star analysts have already begun to branch out on their own.) Nevertheless, some of these leaders may choose to restrict their research products or coverage.

Execution leaders with limited research capabilities. Two to three firms will be global leaders in execution but offer no research—or only a limited, special-

Exhibit 4

Five future business models in equities execution and research



Source: McKinsey & Company

ized array. This forecast assumes they can gain traction in the realm of agency execution at lower commissions, and are willing to make markets for more sophisticated buy-side clients. The market will only support a few such giants that can operate profitably, and their market positions will be fortified by their ability to internalize much of their order flow, and avoid sending business to exchanges. This type of firm does not currently exist in the market, but the most likely contenders will be non-bank market makers, emerging over the next three to five years.

Global universal banks with enough demand from institutional investors, private clients, and corporate businesses to maintain broad spectrum research. Universal banks that enjoy strong demand for their broad research, but operate at a smaller scale in execution, will be challenged by a high cost of supporting the research effort, and may not be viable over the long term. Some banks, however, could make up the shortfall of client revenue internally, from banking and wealth management units.

Regional/sector champions. The majority of banks and brokers will rationalize their research and execution capabilities to capitalize on home-field advantages in their native sectors and markets where they have a unique value proposition, such as execution liquidity or access to corporate managements. Demand from local and global clients will likely support one to three such banks per region. Trading and research efforts will be limited to their specialties, calling for smaller teams, but providing asset managers with the same access to scarce analyst and company meetings, in addition to conventional published research.

Independent research specialists should see significant growth in the new landscape, if from a low current base.

Independent research providers with little or no execution. Independent research specialists should see significant growth in the new landscape, if from a low current base. Assuming, that is, that they offer differentiated research ideas. Those that do not will face reduced demand, be forced to consolidate, see their teams lifted out by asset managers, or disappear altogether.

Some independent firms have added execution to their business models as a currency for paying for research. In many cases, however, that choice may be reversed, and these firms will no longer carry out trading to the extent they have in the past, and therefore operate without bank overhead and capital needs. Revenues will consist of hard dollar payments, and the price agreements they reach with asset manager clients will provide important signals to all players in the transformed research landscape.

The crucial point is that the current ecosystem of many banks offering broad, often undifferentiated research coverage is not sustainable. Top-tier research will still have value for the buy side, and any one of these strategic options can be profitable for the long term for the *right* firm, but over the coming five years, banks will need to make hard choices and play to their strengths.

Not only will the top ranks be thinned out; there will be shakeouts in regional markets as well. In particular, many firms that start in the red zone of Category C, with large research operations supported by sub-scale execution, will likely have to trim their research and retreat to Category D. Similarly, many regional banks facing the high cost and uncertain demand for research may have to abandon their in-house execution efforts and convert to a more modest, free-standing research model (Category E).

Grappling With the New Regime

Although the MiFID II unbundling mandate has been imposed on the buy side, banks and broker-dealers face the biggest challenges in a world where research will need to pay its own way. A few of these challenges must be addressed immediately, simply to be able to do business with the buy side when MiFID II takes effect. The others are more strategic, but still call for immediate and careful consideration, as decisions now will establish firms' research business models and positions on the competitive map.

Infrastructure

Both investment managers and the banks and brokers that provide them with research have to hit the ground running on January 3, 2018. MiFID II requires the buy side to have research budgets and RPA structures in place. In addition, sound business management demands systems that track budgets, consumption and spending on research, as well as allocation of research costs to the fund strategy, region and investment team levels. The sell side will need complementary systems for tracking payments, metering what research clients are entitled to, how much they actually take, and the attribution of costs to their various products and services.

Both sound like straightforward accounting and tracking systems, but they will be complicated to the extent that only some of a manager's funds, or some of a broker's clients, are MiFID II-compliant. (This complexity creates an additional source of competitive advantage among brokers, in automating and outsourcing compliance requirements for buy-side clients.)

Advances in technology will be crucial to the transformation of research:

- General automation of basic knowledge work through machine learning and natural language processing can reduce the cost of maintenance research, allowing human capital to focus on differentiated thinking and customer interaction.
- With an eye toward mass customization of client coverage, behavioral analytics can capture customer interests and proactively deliver content in desired formats. Advanced analytics and query tools can help brokers navigate the shift from the current regime of supply-push to more cost-effective demand-pull and reverse inquiry.
- Last, logistical infrastructure can be shared among firms: Multi-dealer platforms with improved consumption analytics can save brokers from overinvestment in their own systems.

Pricing

One of the biggest challenges brought about by MiFID II's unbundling rule is the need for the buy and sell sides to jointly arrive at initial prices for research. The buy side will be focused on the value of research—in other words, the incremental investment return that a report, or meeting with company management, or a conference can deliver. The sell side will want to ensure that costs of production are adequately covered, and to minimize the opportunity costs of mispricing.

Neither concept will be easy to measure, and will be complicated by the fact that the quality and type of services available from brokers vary widely, as does demand from the buy side. Initially, buyers and sellers will negotiate tentative starting price points, relying to some extent on the deals struck by independent firms for hard dollars.

A free market for research ideas

Ultimately, however, the price for specific research products and services will be determined by the marketplace, rather than by any one provider or consumer. Understanding the dynamics of supply and demand for research, and quickly adapting price and production, will be crucial to success.

Brokerage firms are already working on packages of products and services designed to maximize revenues. In addition to simple à la carte pricing, likely arrangements are: subscriptions for published research, either from a single analyst or a bank's entire research menu; bundled pricing that combines published reports and regular access to analysts; and combinations of bundles for larger clients. For resources that are truly scarce and perishable, such as private meetings arranged with corporate managements, research firms may choose to hold auctions among interested clients.

Banks' design of research packages could be guided by the analogous market for television services. Cable TV service is offered in packages of basic channels of broad interest, higher-value premium channels (films, for instance), and thematic or niche offerings (such as channels devoted to soccer or golf). Astute design of packages, based on market research to learn preferences and price sensitivity, followed by simulation of customer behavior and choices can significantly increase revenue per cable subscriber—in one instance in the European market, by as much as 30 percent.

Surveys indicate that among both long-only managers and hedge funds, access to analysts and access to corporate management are ranked as the most important research products by 20 to 30 percent of firms, while single-stock reports are cited as most important by only 10 percent, with industry studies barely moving the needle. Interest in industry conferences is similarly distributed, with a few highly-sought leaders trailed by many others of marginal value.

These observations suggest that the product most widely available today, traditional company reports, will be assigned a low value by many clients. However, published reports may still prove valuable to a bank's internal constituencies—private wealth managers or internal investment banking units and their issuer clients. On the other hand, while in-person meetings can fetch high prices, opportunities are limited in number and appeal to a smaller client audience. The future is uncertain, both for research prices and quantities.

Strategies for survival and growth

Research must be managed like any other business unit—generating its own revenues in a competitive market and earning a profit. This shift in orientation from an allocated cost center to a free-standing profit center will force a series of difficult, disciplined decisions throughout the organization: to establish a new mission and culture; understand customer demand; define a firm's strongest set of products and services; price them intelligently; and control the costs of production.

Sell-side firms should consider the following four elements as they set their strategic responses to the transformation of research:

- Positioning of coverage: When customers have to pay for research, they will flock to top-tier products, so banks and brokers must identify those sectors and geographies where they possess proven expertise and can effectively compete. For other regions which are attractive, but where firms have no natural advantages—such as foreign firms operating in the Asian markets, which have proven a challenge even to leading US and European banks—they should consider joint ventures with local firms, both for research and execution.
- Understanding client needs: The move to fully priced research will force buy-side firms to set budgets on their spending, and justify prices with the returns they realize. To understand what research clients will buy, the sell side will have to solve that same price-to-alpha equation, and go on to identify the reports, conferences and access that customers need and will pay for.
- Value-added pricing: Succeeding in the new regime will demand excellence in pricing, packaging, invoicing and client-consumption tracking. Banks should look to the example of Amazon, which sets prices through sophisticated algorithms that track conditions and customer reactions in sub-segments of markets. Customers will pay what they find research to be worth, and the industry can develop its own market to determine optimal pricing levels.
- Automation and alternative data sources: The transformation of research calls for leveraging the entire production process of research. Novel investment viewpoints can be created based on applications of AI to conventional and new data sets, while the cost of production of conventional research can be cut through automation, such as robots that perform basic financial analysis.

* * *

Providing research ideas to long-only managers and hedge funds as a companion to execution services has been at the core of banks' equity operations for decades. Imminent MiFID II regulation requires that research be distinct from trading, and that each be paid for separately. Some observers propose that these combined forces will render the business unprofitable and bring about the end of broker research.

McKinsey's view is that there will be an end to equity research as we know it. The buy side will have to discover the value and price of research that justifies separate payments, whether funded by investors or the managers themselves, and cut back considerably on its consumption of lower-value research.

This shift of research to a free-standing profit center will alter the industry's economics, and raise some difficult decisions. And the intelligent pricing of sell-side research services, along with the effective delivery thereof, will be at the center of these changes.

In five years' time, sell-side equity research will likely still play a crucial role in the fundamental investment processes of the buy side, but most firms' research functions will be smaller and more focused, governed by a strategic appreciation of the buy side's need to produce alpha. The ultimate size of each bank's research revenue pool, however, will be determined by its ability to efficiently deliver quality, differentiated research, set realistic prices, and control distribution, all through a very different operating model.

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