Tracking the Independents: Interview with Michael Mayhew, Integrity Research Associates, LLC

By Richard Hefter, JM Dutton & Associates, June 2005

Why is independent research becoming more and more critical to Wall Street and who are the research firms to watch? Mike Mayhew, chief executive officer of Integrity Research Associates, addresses these questions as he describes the current environment of Wall Street research. Founded in 2000, Integrity is a syndicated research, ratings and consulting firm whose focus is to help investors identify, select, and monitor research providers that provide a meaningful difference to the bottom line performance of their investment portfolios. Previously, Mike was the CEO and president of Garban Information Systems, the financial information division of $3 billion Garban/United News & Media. Prior to that he worked as the director of strategic planning & business development for Standard & Poor's Financial Information Services Group. Mike started his career with MMS International where he analyzed and forecasted the U.S. real estate sector, ran sales for the firm's east coast region, and helped the company develop new real-time information distribution products. Mike graduated with a B.A. in economics from Stanford University in 1981.

Can you tell us more about Integrity Associates and what you do?

Integrity Research Associates does a couple of things. We provide consulting on the research industry for financial professionals, and that means sell-side firms, buy-side firms, and research firms. We also provide a web-based database of information, due diligence, analysis and ratings of research firms, again for the financial services community. Thirdly, we publish syndicated research reports on topics of interest to participants in the equity research industry.

Why is this kind of service of value and need today?

The kinds of services that we're providing today are of interest and value for a couple of reasons. Number 1, the equity research industry is undergoing significant change over the last couple of years, and likely will continue to do over the next few as well. That's for a variety of reasons starting back with Reg FD and the Global Research Settlement. There has been an increased focus on high-quality research, and we've seen in the last couple of years an explosion in the number of players in the space providing this kind of research to the financial market. Whenever you have this kind of change, there needs to be a way to move through and understand who all the players are and what it means for your business, and that's the kind of thing that Integrity Research does.

You mention a few changes in the research climate. Can you give us a brief history of equity research so we can better understand these changes?

The beginning of the equity research industry as we know it today was in 1959. That was when DLJ decided to bundle this thing called "equity research" into the commission. That had never been done, and providing research as a part of the service of doing execution was started. Of course, it made complete sense at that point in time, where commissions were tremendously high

-- in the 75-cent type range. So, we had very high commissions and this was a value-added service provided to customers.

What was the next big change?

That was the quote/unquote "Big Bang" of deregulation and the uncoupling of fixed trading commissions in 1975. That really started this process of commissions dropping from the, say, 75 cent level to what we've seen today where some execution only systems are at only a penny a share. As equity trading commissions go down, there is not as much revenue to be able to support research.

Next, in the 1980s, you had had a change in the way many financial services companies were structured. Previously, there was Glass Steagall -- this separation between investment banking and broker/dealers, and that was starting to break down during this period of time. So, more and more brokerage firms had the ability to do investment banking. When they had the ability to do investment banking, it became very clear to the investment bankers that there was this under-utilized asset called "research" sitting over there that could be used to help market IPOs. And so, as a result, the investment bankers started to take more and more prominence at these firms, and certainly had more and more influence over the research products.

How did Reg FD in 2000 affect research?

It's my view that Reg FD really was the first major strike to hit the research industry. Prior to Reg FD, you had a scenario where Wall Street analysts, research analysts, had a preferred relationship with CEOs and CFOs of publicly traded companies. As a result of that kind of a relationship, they got information before regular investors did. And so, part of the value of the research product at that point in time was directly a result of this kind of preferred relationship. When a research report came out, you could look at the research report not just to find out what the analysts thought about the company but also what company management was saying about their own prospects. With the introduction of the Reg FD and this fair disclosure, there could no longer be that kind of unequal access to information from a company. The company could not release to an analyst information that it wasn't simultaneously releasing to the general investing public. That did a significant job in reducing the competitive advantage that Wall Street research had over any other kind of research that might be produced. As a result, we look at that as kind of the first major obstacle that Wall Street had to overcome maintaining its research franchise.

The second major issue that Wall Street research had to face was the Global Research Settlement.   In 2003, of course, Elliott Spitzer, the NASD, and the SEC found that the research being produced by then 10 and now 12 of the major investment banks was biased and a result primarily of the investment banking relationships that were in place at the time. They questioned whether the investor was getting research that the analyst truly believed in or getting research that was influenced by the fact that the firms were making hundreds of millions of dollars in investment banking fees on the other side. Spitzer, et al, decided that in fact the research that was going out was extremely biased. It was not reflecting what the analysts truly believed, and as a result they implemented probably one of the most significant set of fines in history: $1.4 Billion.   That was split up in a number of different ways, but fundamentally what this did was two things. Number 1, it decoupled investment banking from research. Research could no longer be directed by investment banking, and so that was really the first issue. The second part of that was the tremendous loss of public credibility in the Wall Street research product. Since then, numerous surveys have been done of the buy-side, and really the stature of Wall Street research has fallen significantly in the wake of the Settlement. And thirdly, the Settlement really did support the growth of this burgeoning industry called "independent research."

How so?

Number 1, the Settlement specifically identified independent research as a solution to the biased research problem. So, the very first thing that it did is it actually gave independent research credibility and stature in the minds of investors. So that was a non-economic thing, but certainly significant as far as a marketing perspective. Secondly, however, there was this prospect of getting $432 million that was set aside that needed to be spent by the 10 initial investment banks over five years, and those investment banks had to hire at least three independent research providers to provide research on every single company those investment banks covered. As a result, when after looking at the first year of the Settlement, we found that between 60 and 70 independent research firms had been hired as a result of this Settlement. There were probably three or four dozen independent research firms 10 years ago, and today we have between 350 and 400 independent research firms in North America alone. Many of these firms started as a result of the Settlement and the potential windfalls that the Settlement provided to independent research providers.

How do you define independent research?

We define independent research as any research that does not have investment banking associated with the firm.   So for us it wasn't enough that there was a decoupling of investment banking and research, because in the end it was all coming out of the same pocket. Investment banking has a significant influence on the research that comes out of a firm that has investment banking in it. So, our definition is, any firm that does not have investment banking could be considered independent.

The Global Research Settlement went a step further and they said not only does a firm have to not have investment banking, but it can also not have a direct relationship with the issuing company that they do research on.

Why do you accept paid research in your definition?

If we lived in a perfect world, corporations would not have to pay for research. However, since that is not the case, since we live in a world where research coverage is declining, Wall Street is no longer providing wide access to free research coverage as it did in the past. And in our estimation, the prospect for research coverage doesn't look good in the future. Given that kind of environment where companies are having real difficulty in raising capital in the capital market, and certainly doing it in an efficient manner where they're not overpaying -- given all of that, we look at how best to solve those problems. And one of the ways to solve that problem is the concept of issuer-paid research, which, you know, frankly, is not a new concept. It's the concept that has been used by the credit rating agencies for decades now and to good affect. So we looked at it with the thought: We wish we didn't have to have issuer-paid research, but the practicalities are that we do have to have issuer-paid research so that that the small- or mid-cap company can get the coverage necessary to tell its story and be competitive in the capital markets. That's really our defense of issuer-paid research.

Now, there are good issuer-paid research firms and there are bad issuer-paid research firms. In other words, there are firms that do issuer-paid research that adopt best practices and there are those that don't. And our sense is when you're dealing with a business model that potentially is conflicted because the issuer is now paying for research, then you need to make sure that you adopt practices that heighten the credibility of the product.

What are some of these best practices?

They include things like how a research firm is paid. You can get paid up front, you can get paid over time, you can get paid in stock or warrants. When you get paid up front, that limits the influence that an issuer has over the research firm. Other ways you get paid can exacerbate the problem by creating an incentive for research providers to tell a rosy story. Payment is not the only best practice. Certainly there are regulations like Reg AC and 2711 disclosure. One that's never been specifically mentioned but we believe is critical is performance measurement. Performance measurement is critical because that is one of the few ways you can determine, after the fact, was the research good or not. Did it actually produce the result it said it was going to produce? And there are some research providers who don't believe in measuring performance and there are others that do.

If research is not resulting in strong performances, does that make it less effective and less viable?

I answer that by asking, Why is the research being produced? Is the research being produced to give analysts jobs or is it being produced to benefit institutional investors, retail investors, and/or the companies that are covered? And I believe that the answer is yes to all of those things. So, if you say that a company is a buy and it doesn't go up, did you provide good research? There is an argument to say that if there insightful analysis, it was helpful to investors. But net-net, if an investor invested as a result of that buy and it didn't go up, then I've got to say that the research wasn't successful.

Do you rank independent firms in terms of their performance?

Yes, that's one criteria. We look at over 30 different criteria when we evaluate a firm and these criteria fall into four major categories. One is the financial stability of a research provider. We do believe that some institutional investors are concerned about the financial stability of one of their major suppliers of ideas. So that is certainly one part of what we look at. The second thing that we look at when we evaluate a firm is the analytical resources that a firm brings to bear. On the fundamental research side, that could be the analysts and their background, experience, degrees, etc. On the quantitative side, it could also be the theoretical underpinnings of the quantitative models that a firm might utilize, the back-test results of those models. So, analytical resources is really kind of the second major component. The third thing we look at is quantitative performance -- the performance of a firm's buy/sell/hold recommendations. And then the fourth thing is what we kind of call the firm's independence. It's all about the policies and procedures that a firm has put in place to deal with conflicts of interest, and it addresses many of those best practices that we talked about before. So, it's really those four areas that we look at when we evaluate a research firm.

How many firms are being ranked and where does J.M. Dutton reside on this list?

We have about 40 firms that are included in our database and Dutton ranks in the top 10 percent -- in other words, the top three or four of these firms -- for all those four categories.

Mike, I'm a company and I say that I don't want to pay for research. I going to wait, I going to get a research from the old fashioned way - the sell-side research. What would you say to that company?

I spoke a little earlier about this trend of commissions falling. Well, this trend is not going away, and in fact, if the FSA and if the SEC have their way and force increased transparency into the market place, it’s going to force asset managers to provide to their boards and to the plan sponsors and to the pension fund managers information about how much is being spent on execution -- i.e., how much is being spent on research. That is only going to exacerbate the problem of commissions. And I suspect that commissions could end up falling from the current level of 4 cents a share to the 2-3 cent range over the next three or four years. That is going to have one consequence: Most sell-side firms in a 2-cent environment will not be able to afford to pay the hundreds of millions of dollars they are spending currently to support the research. And so what's going to happen is they are going to cut fat to cut coverage. Consequently, the firms that get covered by the Street are going to be the largest firms. And so I suspect that while today it's very difficult to get research coverage if you're a small-cap company, in the future it might difficult to get coverage even if you're a mid-cap company.

What are your options, then, if you're a smaller company?

I think there are certainly a couple of options. A number of firms are considering the option of self-promotion -- using both internal and external IR services to get the story out. That's certainly an alternative way to get the story out. But to us, there are only two other alternatives. One of them is to sit back and hope that one of the independents will pick you up for free. We don't think that's particularly likely for a couple reasons. And the second is the issuer-paid research option. I think that becomes a particularly viable alternative if you're careful and select a good research provider. Then that approach is as credible, if not more credible, than doing self-promotion. Perhaps it's not as good as if a major Wall Street firm picked up the research coverage for free. But again, depending on the firm, the quality of the products that they put out could be still be of the level necessary to get the story out in a credible way.