May 7, 2020

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Another Year of Unintended Consequences

While 2020 Has Brought New Challenges, 2019 was Another Year of P&L Payer Underperformance & Unintended MiFID II Consequences

As asset managers continue their search for the lowest market clearing price in their consumption of sell-side research services, we have completed our 2nd year of analysis on the correlation between lower spending on external research and fund underperformance. While the numbers are a little different, the story remained the same: managers that chose the route of paying for research from their P&L underperformed the equivalent funds that paid from commissions.

Topics we hit on include: Spending differentials (US managers cut but UK a ton more) & performance variances (European managers under pressure); Alpha leakage (how much performance is potentially being left on the table); Additional changes potentially in store for the industry (increased transparency demanded; EU maybe moving toward the US); & Commission distributions and shifts (who's benefitted?). Our analysis looked at ~5,300 funds representing more than $9trn in AUM across 12 equity categories. Once again, we did this in conjunction w/ Frost Consulting, a firm started in '07 to provide analysis & transparency of the global equity unbundled commission mkt. Looking ahead, 1H20 is sure to produce equally interesting results in what is definitely going to be a very key test for active mgmt (early returns potentially a little better), but at least in '19, the recent underperformance trends for P&L payers remained.

Lagging performance far overshadows reduced research spend:

Analysis of 12 categories of US funds showed…

- 10-of-12 fund categories saw US funds outperform capturing 91% of alpha & w/ total US outperformance of 265bps, good for $245bn of alpha generated, better than last year (Figs 3-4)
- Performance ranges between mid-1st & mid-4th quartile performance are multiples of any conceivable research budget – definition of penny-wise, pound-foolish (pg 4)
- The avg of the gaps in '19 was a full ~1,500bps, up from ~1,300bps in '18 (pg 5). The 4-year chart between US & Euro managers alpha capture paints a stark picture of the two regions heading in opposite directions, highlighting the importance of security selection & the unintended consequences of information asymmetry that MiFID II creates. Biggest differentials were in sectors like tech, ESG, the UK & Asia Pac, while more ubiquitous categories like Japan, US LC growth & total US saw the least, but still ~1,000bps ahead. Markets were down in '18, then up a lot in '19, so the trends held in both directions (pg 6)
- Commissions have been cut in half over the past decade. Share has shifted to the biggest players with JPM & MS topping the list of share gainers (pg 10)

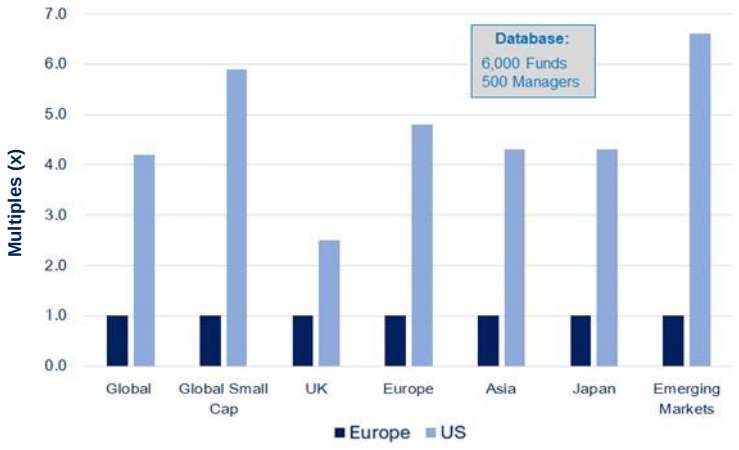
Spend a Little and Outperform A LOT: When you compare the US outperforming by $245bn in '19, against an estimated $6bn of client money spent by US managers on external research (i.e. commission clients spending 4x-5x P&L payers), it seems logical that US managers will be able to meet US asset owners increased research transparency asks, continue the use of client money, & likely enjoy a durable research spending advantage relative to Europe. (Page 7).

Changing Minds & Hearts? In the UK, the FCA is unlikely to back away, but the French & Germans were never wild about MiFID II. The AMF recently released a less-than-complimentary impact assessment & our gut tells us the EU ends up reversing. In the US, the SEC extended its temporary no-action letter avoiding a road it never intended to go down. Some large global firms will stay on path, but we expect to see fewer consultant RFPs demanding it than we were seeing prior.

What a Difference a Year Makes? Where We are Now

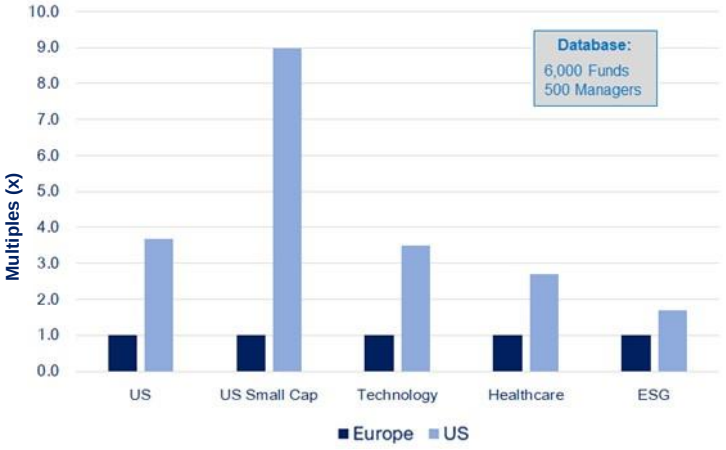
How's the research spending differential tracking: It appears the widespread move to P&L for research in Europe has resulted in significant cuts in research budgets at European asset managers. As we are entering the third year of MiFID II (including the lead-up year of 2017), European manager research budgets remain under continual fee and profitability pressure. As Figs 1 & 2 shows, this effect is not felt equally between equity strategies, made more noteworthy by the fact that some strategies need considerably more research than others.

Figure 1. 2019 Trans-Atlantic Research Spending Differentials



Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI

Figure 2. 2019 Trans-Atlantic Research Spending Differentials (continued)



Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI

What the above charts fail to illustrate is that these are just averages, with the extreme data points very widely removed. There are also extreme spending gaps between P&L managers themselves, by as much as 15-fold in certain strategies. As well, as a result of MiFID II, there's been a deflationary effect on manager research spending globally resulting from greater scrutiny of research spending, even by managers using client money. The swing factor seems to be, if US managers can meet the US Asset Owner research transparency challenge and continue the use of client money, they will likely enjoy a durable research spending advantage relative to Europe (unless or until the rules change).

So there's a performance variance? One of the key findings of academic work Frost Consulting has done with Stanford University is that the cost of research is completely dwarfed by the performance differentials between funds that do well and funds that do poorly. This should be a central factor in asset owner thinking about research funding models. Figs 3 & 4 present some data on performance differentials in a various equity categories from the 2019 data.

Our Methodology: *Using data from Morningstar, Evercore ISI & the Frost Databases and, we have examined changes in regional research spending & performance. The '19 analysis is comprised of ~5,300 funds (managed on both sides of the Atlantic) representing more than $9 trillion in AUM across 12 equity categories. US domiciled managers (overwhelmingly client money) represent 82% of the AUM total with European managers (overwhelmingly P&L) making up the balance. The disparity of the size of the fund (a theoretical disadvantage to the larger managers) should be borne in mind when considering the data.*

Figure 3. 2018 US vs Europe, AUM-Weighted

*Source: Frost Consulting, Evercore ISI Research, Integrity Research***

Figure 4. 2019 US vs Europe, AUM-Weighted

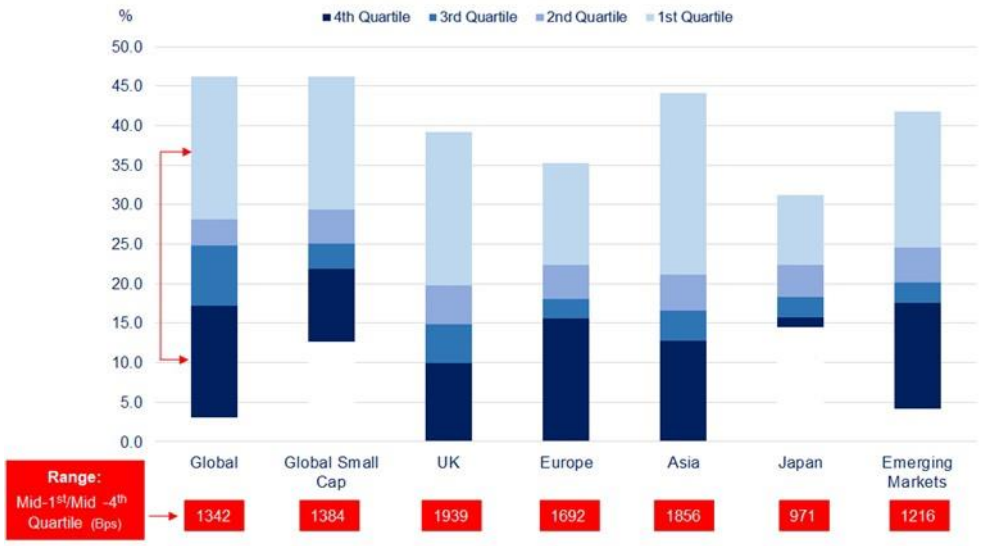
*Source: Frost Consulting, Evercore ISI Research, Integrity Research***

** Two large US managers (Capital & TROW) have announced plans to fund research globally via P&L. Our understanding is that Capital has done so in '19 and that TROW aims to complete the process in '20. We have left both managers in the "US" column for the arithmetic average calculation as their cumulative number of funds represented <1% of the total funds surveyed. We have excluded them from the Weighted AUM calculation as the objective was to measure managers using client money (almost all US) and P&L (almost all European). Together, their funds in the sample would have represented ~13% of the AUM of the Weighted Avg. Were we to compare Client Money managers vs P&L managers (rather that US vs. European managers) and included Capital and TROW in the "P&L" column in the weighted average calculation, Client Money managers would have captured 88.54% of 2019 outperformance versus 91.05% captured by US managers in the weighted avg sample that excluded them. Key conclusion is, despite their size & strong performance, they would not have materially altered the observation that US/Client Money managers are capturing the majority of the outperformance.*

To get more of a sense of the relative investment performance difference, we looked at the ranges between mid-1st & mid-4th quartile performance (in the red boxes above) which are multiples of any conceivable research budget. Obviously, the extremes in the ranges are even larger, plus these gaps appear to be widening over time. The average of the gaps in '18 was ~1,300bps. Logic suggests that continuingly widening gaps in research spending may accentuate this trend.

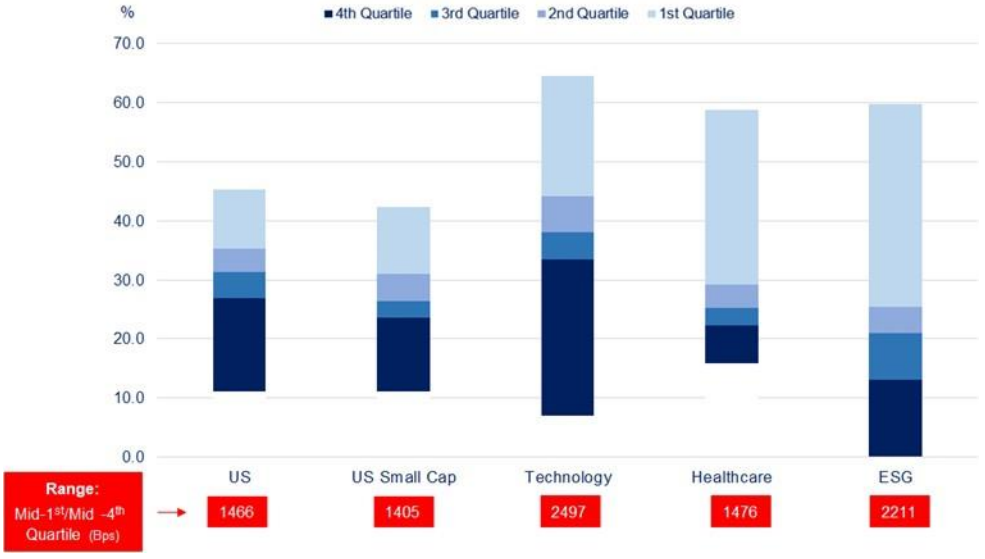
The top-quartile massively outperformed the bottom-quartile, so if a few bps of research spend have an impact – very penny-wise, pound foolish to cut at all ***costs***

Figure 5. 2019 Category Performance Quartile Ranges



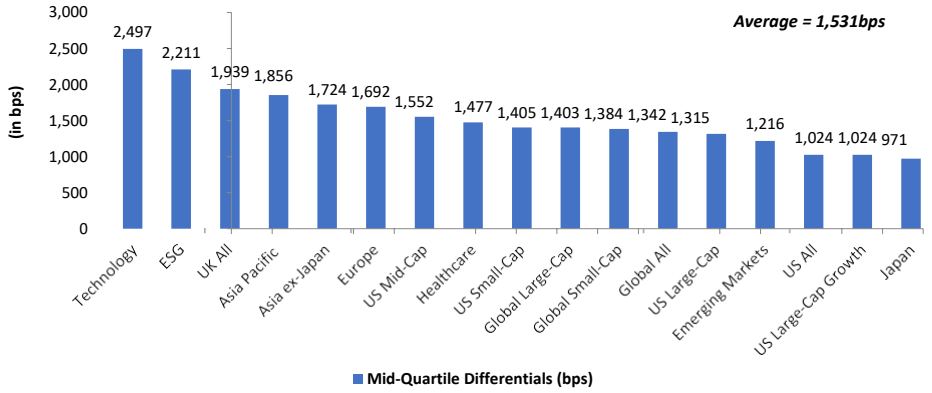
Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI Research

Figure 6. 2019 Category Performance Quartile Ranges (continued)



Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI Research

Figure 7. Ranked Mid-Quartile Differentials



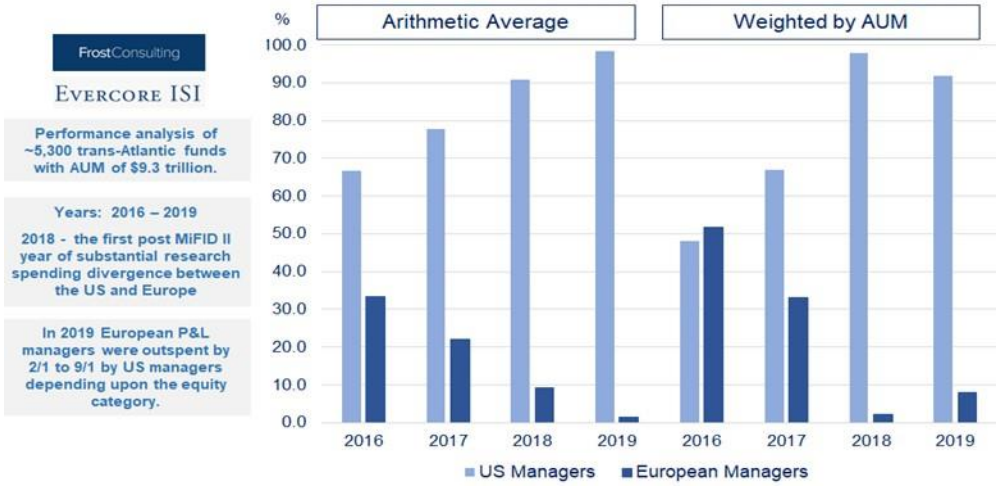
Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI

The chart that follows illustrates the thorny question of the ultimate impact of research spending on performance, and clearly the relationship is not linear. However, given the magnitude of the research spending differentials by equity strategy, longer-term performance data series may offer some insights. The four-year chart of the breakdown between US and European managers alpha capture is shown in Fig 8. It calculates which portion of the relative alpha generated each group is harvesting.

The 2019 sample has ~5,300 trans-Atlantic funds with AUM of ~$10trn across 16 equity categories. While there are many factors that can influence performance, we believe that differences in research spending are potentially important. The clear break in trans-Atlantic research spending began in 2017 but accelerated through the MiFID II implementation phase, may be at an inflection point. The longer the time series and the greater persistence of the directionality of the results, the greater attention this will receive from asset owners (and regulators).The results look one-sided, so the following chart has the detail from 2018 expressed by category.

While the outperformance in individual categories does not appear overwhelming, the cumulative effect is. The dollar relative alpha generated is significant, particularly compared with the estimated client money research spend of US managers. Also interesting was that big changes in the direction of the indices didn't change the apparent impact.

Figure 8. Percentage of Total Sector Outperformance Captured



Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI Research

Figure 9. MiFID II Performance Monitor (Weighted by Fund AUM)

	Equity Category	# Funds	US Managers Avg. 2019 Return (%)	European Managers Avg. 2019 Return (%)	US Manager Outperformance (Bps)
1	US Small Cap	275	28.13	27.21	92
2	US Mid Cap	293	30.51	16.26	1425
3	US Large Cap	951	29.34	27.77	157
4	US Large Cap Growth	338	33.29	30.67	262
5	US All	1622	29.40	26.42	298
6	Global Large	727	24.88	25.31	-43
7	Global Small/Mid	96	25.19	23.87	132
8	Global All	915	25.07	25.29	-22
9	EM	216	24.07	19.13	494
10	Europe	490	23.59	24.21	-62
11	Asia	117	17.76	15.47	229
12	Technology	70	45.94	36.41	953
13	Healthcare	52	29.02	21.64	738
14	Japan	41	23.58	19.05	453
15	ESG/SRI	1832	24.59	20.65	394
16	Asia Ex Japan	42	14.58	18.84	-426

Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI Research

Figure 10. Results Compared in Light of Market Direction for 2018 & 2019

Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI Research

What's Being Left on the Table?

These levels of US manager outperformance seem noteworthy. It remains to be seen to what degree asset owners will persist with managers potentially underperforming by hundreds of basis points. We have included an example below of what asset owner decision trees might look like in the case of institutional mandates in an equity category with a wide dispersion of returns.

Figure 11. Focus on Technology Equities

Source: Frost Consulting, Evercore ISI Research

Figure 12. US Research Transparency – High Stakes for Active Managers

Source: Frost Consulting, Evercore ISI Research

What Might Happen Next?

France & the EU more in common with the US than the UK? First-off, recall that originally both the French & German governments/regulators were not supportive of the research "inducements" regime championed by the FCA in the MiFID II policy-making process. Fast-forwarding a post-Brexit world, the AMF, which has assumed the mantle of the chief national securities regulator in the EU, recently released an independently authored (but AMF-sponsored) review of the impact of MiFID II on research. Theirs was a less optimistic assessment of MiFID II's impact than the UK's, particularly noting pressure on the supply of small-cap research. The report made several interesting observations/recommendations.

1. **Research budget cuts?** French Asset Mgmt association estimates that French managers reduced research budgets by 53% to 75% from 2017 to 2019;
2. **Under-priced research may be an "inducement"?** There was a suggestion that minimum price standards for some services could be developed at the European level;
3. **French research marketplace?** Create one to encourage independent research;
4. **ETF providers/issuers would pay some of the research bill?** It's not clear how, but AMF suggested it & views them as having no role in equity price setting yet benefiting from it;
5. **Establishment of "representative prices" for research services?** A question here is will this challenge the research unit consumption model;
6. **Some exemptions?** The thought is possibly exempting stuff like small cap stocks, smaller asset managers and independent research producers (with no execution capacity) from MiFID II research requirements. It's worth noting that "small" is not defined; &
7. **Review of "inducements" related to research at a European level by 2020?** You never know but this last one could potentially represent a wholesale review of the key research provisions of MiFID.

Not surprisingly, the UK's FCA, which championed the aggressive interpretations of the MiFID II research regime, considers the regulation a success. In a recent report, they noted limited evidence of a reduction in research supply, even in small cap names (availability may be a red herring in light of European P&L asset managers steeply cutting research budgets…). The FCA estimated that MiFID II had reduced (primarily equity) research costs by an estimated £80 million in 2019. This was considered a good outcome by the FCA. For context, the UK Investment Association estimates that UK-domiciled managers run ~£2.2 trillion in active equity mandates. The FCA's estimated research savings represent approximately 3.6bps of the active equity AUM. However, the cost side is only half of the equation. The FCA made no estimate of the impact of these research savings on performance.

The FCA must hope that any performance drag associated with the research cuts were less than 3.6bsp. To put this in perspective, in 2019, our numbers suggest that the gap between mid-1st and mid-4th quartile performance in UK equities was 1,939bps. The gap between the best and worst UK funds exceeded 6,300bps.

To be sure, the FCA will continue to study the effects of MiFID II, and it's too soon to know whether a new UK (Conservative majority) government & a new prospective FCA CEO will have any bearing on the FCA's regulatory stance on this issue. But Brexit has also introduced a complex negotiation between the UK and the EU regarding "regulatory equivalence", which theoretically governs access to EU markets. Negotiations, however, have two counterparties.

Meanwhile across the Pond, US market participants and the SEC have been watching the unfolding events in Europe with great interest. The US has the "second mover" advantage in that it has been able to observe the evolving outcome for two years before changing any domestic regulations. In fact, the SEC recently noted that part of its reluctance to emulate MiFID II, or to change any US policy as a result, stemmed from the fact that the European regulatory environment was still evolving. Based on both public and private commentary, the SEC is believed to be cautious on many aspects of MiFID II, particularly in relation to the research funding model. In Europe the widespread move to P&L by managers has resulted in substantial aggregate research budget reductions. The SEC fears that if that were to happen in the US, it would have a negative effect on the US research ecosystem. They do not appear to be eager to make it operationally or legally simple for US managers to adopt P&L.

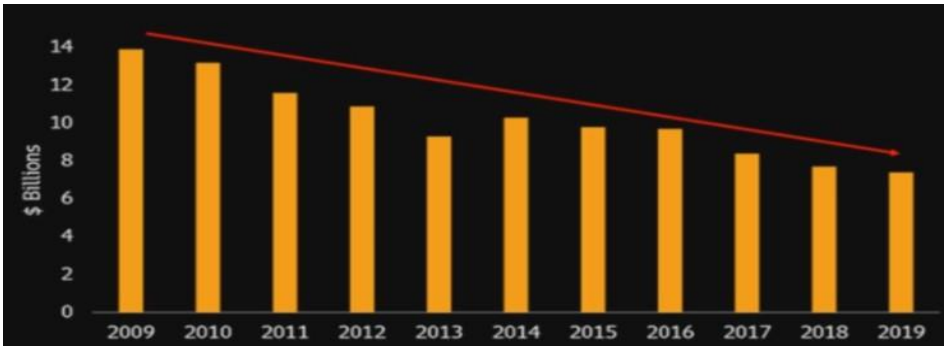
As far as US asset owners mind set, MiFID II has been a wake-up call for US asset owners particularly on the research payment issue as many US managers pay for research via P&L for their European clients but still charge US asset owners for it. Last summer, a series of US Asset Owner and Industry organizations made recommendations to the SEC on US research funding issues and manager research transparency (these included the Council of Institutional Investors, Healthy Markets, the CFA Institute and the SEC Investor Advisory Committee). Broadly, they recommended that: (1) the SEC should retain the research commission model; & (2) managers should not be required to pay for research via P&L – even for those US managers doing so for European clients.

In return, asset owners requested managers inform them of the research charge (on a-per-client or per-fund-basis) & demonstrate that their research commissions were not subsidizing other investors (no cross-subsidization). It seems that US asset owners, as well as the SEC, were taking a deeper look at the impact of research spending – beyond the S-T cost considerations. It would have been easy for US asset owners, whose asset managers were paying via P&L for Euro clients, to demand reciprocity. They haven't as of yet.

This was likely a win for the US asset management industry as it provided a blueprint for manager's continuing to use billions of their clients' dollars for research, supporting client returns, manager profitability and global competitive advantage. However, to meet asset owner transparency demands, US managers will have to budget at the fund/strategy level in order to inform asset owners of their specific research charge. They will then have to map research services to those funds to avoid cross-subsidization. While this represents an adjustment to the process of the vast majority of managers, this must be weighed against the estimated $6.4bn of client money spent by US asset managers on external research in 2018, according to Integrity Research. For their part, Healthy Markets is in the process of rolling out a Manager Research Transparency Questionnaire for their US asset owner members.

We've now had the benefit of seeing the European asset managers resist research transparency & getting (extremely) hostile regulation in return. US asset managers have both a mechanism, and the historic MiFID II hindsight, to be in a position to make better-informed decisions. Providing additional research transparency seems a small price to pay given the alternatives.

Figure 13. US Commissions Ended The Decade About Half of Prior Pool



Source: Bloomberg Intelligence, Evercore ISI Research

Figure 14. Big US Firms May Sustain or Gain Global Equities Share

Equities	2019	2019 vs. 2015	Share Chg PPT (2019 vs. 2015)
Global Peers	38,452	-14%	
JPMorgan	6,494	14%	+ 4.1%
Citigroup	2,908	-8%	+ 0.5%
Bank of America	4,505	3%	+ 1.9%
Morgan Stanley	8,056	-1%	+ 2.7%
Goldman Sachs	7,391	-5%	+ 1.8%
Credit Suisse	2,700	-43%	- 3.5%
Deutsche Bank	532	-86%	- 6.9%
UBS	3,453	-16%	- 0.3%
Barclays	2,413	-17%	- 0.3%

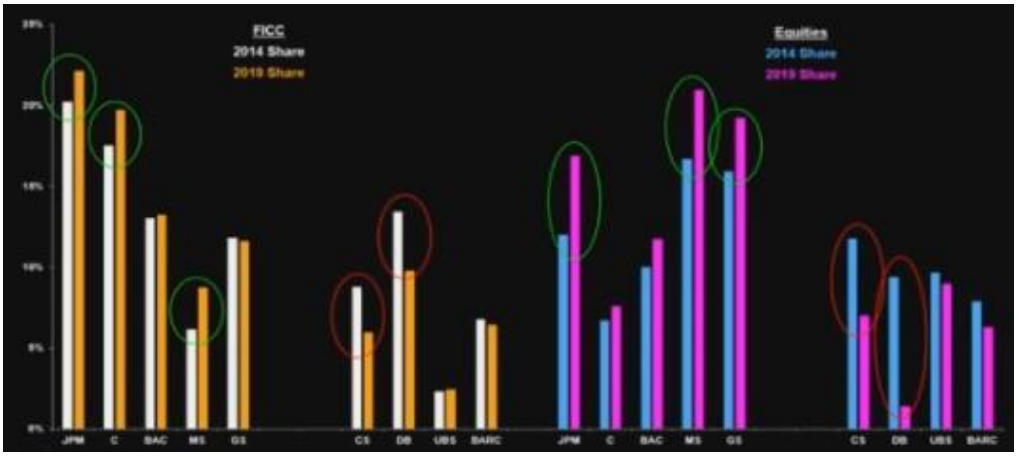
Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI

Figure 15. Big US Firms May Sustain or Gain Global Equities Share (continued)

Equities ($ Millions)	2018	2019	2020E	2021E	2019 % Chg	2020-21 CAGR
Global Peers	48,715	43,500	44,523	45,693	-11%	2%
Morgan Stanley	8,976	8,056	8,471	8,592	-10%	3%
Goldman Sachs	7,453	7,391	7,784	7,763	-1%	2%
JPMorgan	6,888	6,494	6,792	7,332	-6%	6%
Bank of America	4,920	4,505	4,607	4,950	-8%	5%
UBS	3,849	3,453	3,534	3,531	-10%	1%
Citigroup	3,427	2,908	3,138	3,126	-15%	4%
Barclays	2,726	2,413	2,480	2,505	-11%	2%
Credit Suisse	2,635	2,700	2,774	2,815	2%	2%
Societe Generale	3,124	2,802	2,782	2,860	-10%	1%
BNP Paribas	2,397	2,247	2,160	2,219	-6%	-1%
Deutsche Bank	2,320	532	-	-	n/m	-

Source: Frost Consulting, Strategic Insight Simfunds, Evercore ISI

Figure 16. FICC & Equities Market Share (2014-2019)



Source: Bloomberg Intelligence, Evercore ISI Research

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Time of dissemination: May 07 2020 10:26 AM ET

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Rating Suspended- Evercore ISI has suspended the rating and target price for this stock because there is not sufficient fundamental basis for determining, or there are legal, regulatory or policy constraints around publishing, a rating or target price. The previous rating and target price, if any, are no longer in effect for this company and should not be relied upon.*

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Buy- Return 10% to 20%
Neutral - Return 0% to 10%
Cautious- Return -10% to 0%
Sell- Return< -10%

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Stocks included in the model portfolio will be weighted from 0 to 100% for Long and 0 to -100% for Short. A stock's weight in the portfolio reflects the analyst's degree of conviction in the stock's rating relative to other stocks in the portfolio. The model portfolio may also include a cash component. At any given time the aggregate weight of the stocks included in the portfolio and the cash component must equal100%.

Stocks assigned ratings under the alternative model portfolio-based coverage system cannot also be rated by Evercore ISI's Current Ratings definitions of Outperform, In Line and Underperform.

FINRA requires that members who use a ratings system with terms other than "Buy," "Hold/Neutral" and "Sell," to equate their own ratings to these categories. For this purpose, and in the Evercore ISI ratings distribution below, our Long, No Position and Short ratings can be equated to Buy, Hold and Sell respectively.

Evercore ISI rating (as of 05/07/2020)

Coverage Universe			**Investment Banking Services I Past 12 Months**		
Ratings	**Count**	**Pct.**	**Ratings**	**Count**	**Pct.**
Buy	409	53	Buy	95	23
Hold	279	36	Hold	38	14
Sell	43	6	Sell	6	14
Coverage Suspended	23	3	Coverage Suspended	8	35
Rating Suspended	13	2	Rating Suspended	2	15

Issuer-Specific Disclosures (as of May 07, 2020)

Price Charts

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