



MiFID II- Existential Threat:

Key Victims?

Transparency

European Investors

European ESG Objectives



TRANSPARENCY



INTRODUCTION TO FROST - INDUSTRY ENGAGEMENT

Strategic Solutions for Asset Managers/Owners



Solutions

Research Valuation/Alignment



FrostRB

Aligning Manager Research Budgets With Inv. Process

Research Valuation

RESEARCH VALUATION / BUDGETING

It's not about compliance. It's about Alpha.

Research Benchmarking

FrostDB

Research Spending Database: Research ROI

Research Benchmarking



ESG Integration

ESG Research Valuation/Integration Frameworks



CAREFUL WHAT YOU WISH FOR!



Research Objectives:

- Increase asset owner research spending transparency.
- Reduce asset owner performance risk stemming from manager research “overspending”.

As a result of the widespread move to fund research via P&L by European managers



Asset Owner Outcomes:

- Manager research spending transparency eliminated.
- Significantly greater risks to asset owner returns: drastic research cuts by P&L managers.



Asset Managers have no regulatory requirement to inform clients of changes in fund-level research budgets.



ESG Objectives

MiFID II is an existential threat to European ESG goals.
Cannibalization of already depressed fundamental research budgets.
Massive duration mismatch of ESG objectives and funding.

WHY ARE P&L MANAGERS ARE CUTTING BUDGETS (SO MUCH)

Asset Owner



- Research costs for asset owners are extremely small
- Usually a handful of basis points versus LT equity returns ~ 700 Bps

Asset Manager



- External research costs for asset managers are extremely high
- Usually the largest cost after the #1 cost - staff compensation
- Critical for all managers, but particularly for smaller ones

Cost
Asymmetry

So far, European Asset Manager CFOs are decisively winning the research budget battle.

But what about the war?



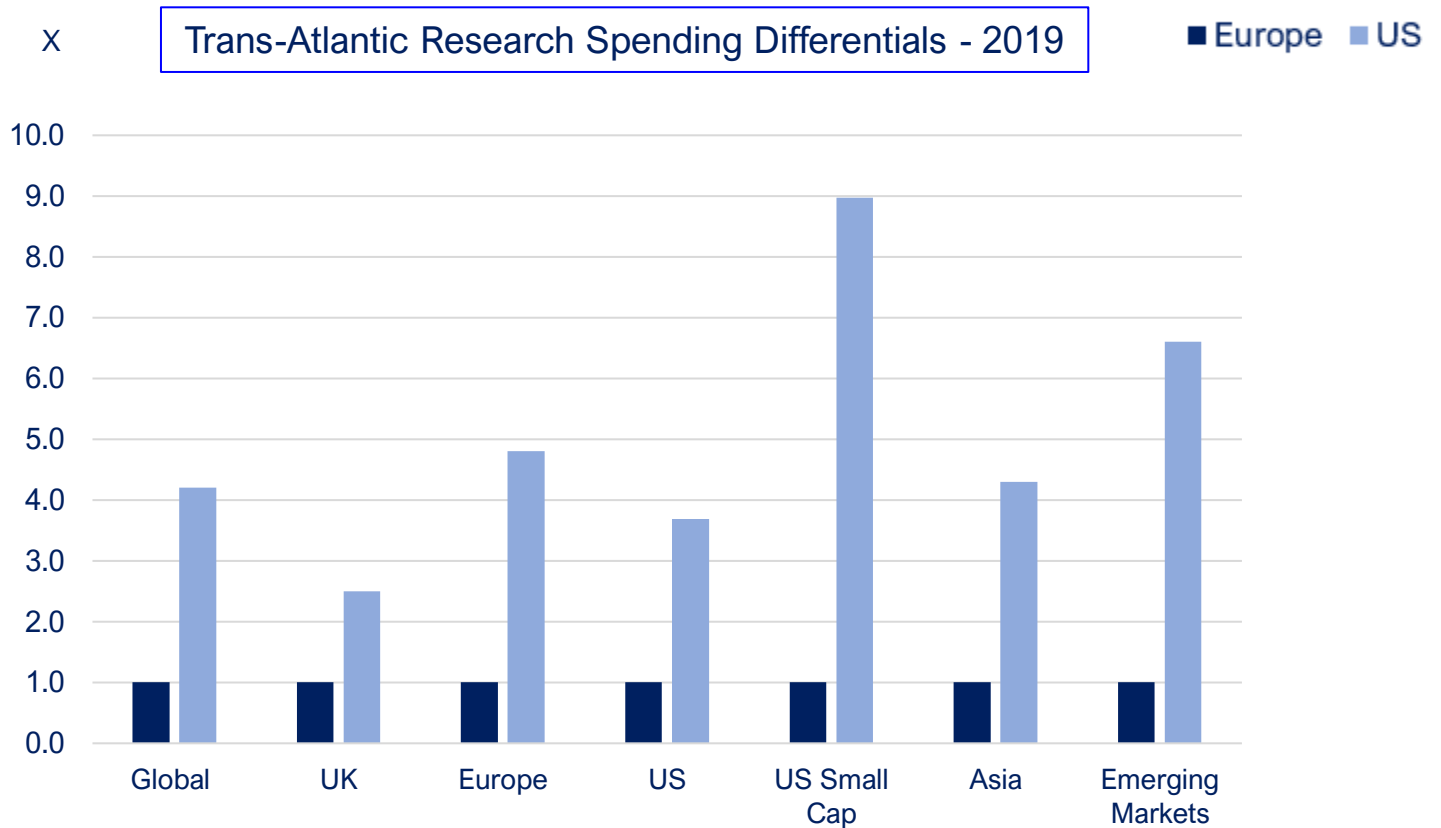
These severe cost pressures existed *before* the scope (and cost) of UK/European ESG/Stewardship initiatives became clear. What now?

FROSTDB RESEARCH SPENDING DATABASE - IMPACT OF MIFID II

FrostDB

Database:

6,000 Funds
500 Managers



Significant Information Advantage for Managers Spending More

Impact on Fund Performance??

FY 2019 PERFORMANCE COMPS

FrostConsulting

EVERCORE ISI

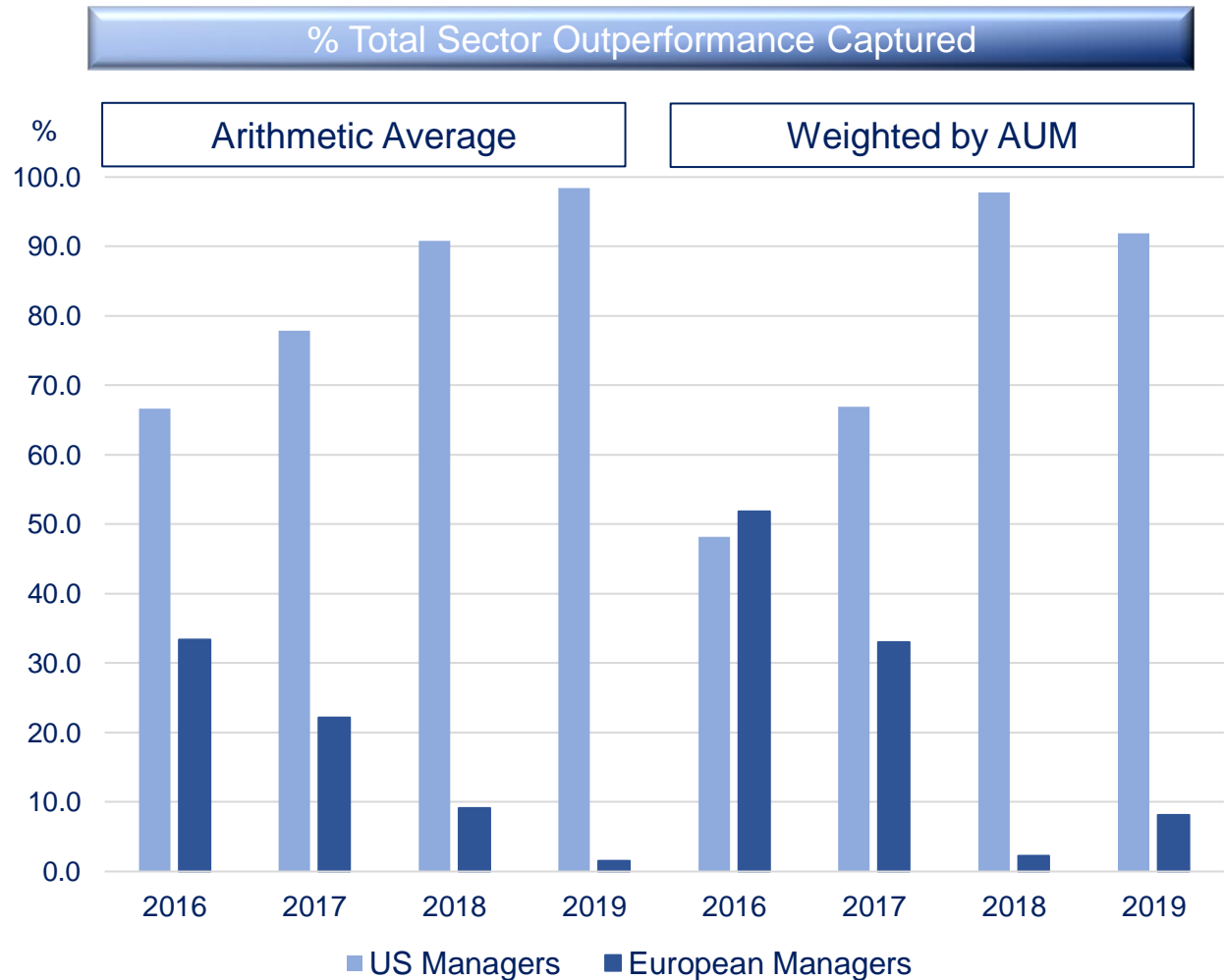
Performance analysis of
~5,400 trans-Atlantic funds
with AUM of \$9.3 trillion.

Years: 2016 – 2019

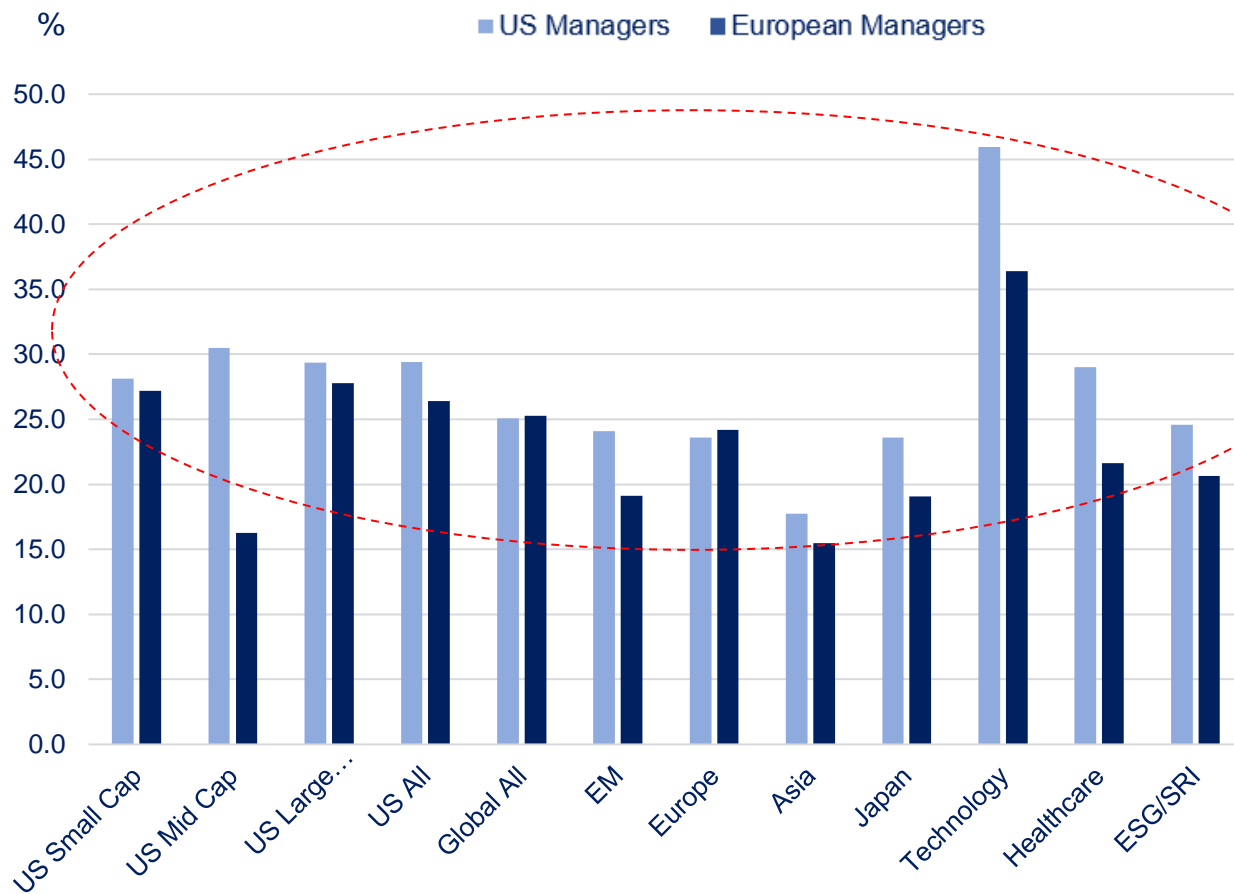
2018 - the first post MiFID II
year of substantial research
spending divergence between
the US and Europe

In 2019 European P&L
managers were outspent by
2/1 to 9/1 by US managers
depending upon the equity
category.

Result?



2019 - US VERSUS EUROPE – AUM WEIGHTED



Sector Outperformance:	
US:	10
Europe:	2
% Outperformance Capture:	
US:	91.1
Europe:	8.9
Avg. Sector Outperformance	
US:	468.9 Bps.
Europe:	138.3 Bps.
Total US Outperformance:	
\$245 billion – 265 Basis Points	
US Research Spend**	
Client Money: \$ 6.2 Billion	

* Indicative Categories (not all displayed): Sources – Frost Consulting/Evercore/ISI ** Source – Integrity Research

EUROPEAN ESG PARADOX

ESG in Europe



Towering Ambitions

Near universal support for ESG objectives, engagement and integration from:

- Governments
- Regulators
- Asset Owners
- Asset Managers
- Retail Investors
- Society at Large

Huge Unacknowledged Execution Risks



Unsustainable Funding Model

MiFID II Research funding cuts (50%+ at P&L managers) pose a critical threat to ESG objectives.

Rapidly rising ESG costs, borne solely by asset managers - (in Europe)

1. Data/Regulatory Costs
2. Hugely ambitious (costly) Stewardship Objectives

Significant competition emerging from the US - with more sustainable ESG input funding.

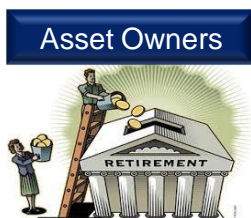
European Asset Owners take zero responsibility for the sustainability of the ESG/Research ecosystem.

European regulators largely oblivious.

WHY DON'T STEWARDSHIP AND TRANSPARENCY APPLY TO ASSET MANAGERS?

...only to the companies they invest in.

Critical Risks for:



Transparency

Both traditional and ESG research budgets are not transparent at P&L managers.

Are they sufficient to meet investment/ESG targets?

How to manage the conflict between client best interest and manager profitability?

Research budget cuts at P&L managers are a serious threat to ESG outcomes.

Research/ESG cannibalization will not affect all clients equally.

Adversarial regulatory positioning of asset managers/owners has reduced critical collaboration.

Key ESG risk.

Sustained bear market with lower index/AUM levels will obliterate P&L research funding.

1Q 20 Covid meltdown was a sneak preview.

The lower markets go, the less research P&L managers can access.

The speed, breadth, cost and complexity of ESG regulation in Europe will be a funding challenge for many managers.

May lead to superficial ESG adoption, denting public trust.

Lightly regulated, asset owner funded US managers may have an advantage.

BEAR MARKET IMPACT ON ESG/RESEARCH BUDGETS – COVID TEST CASE

US and European research budgets are both “pro-cyclical” – but in opposite directions.

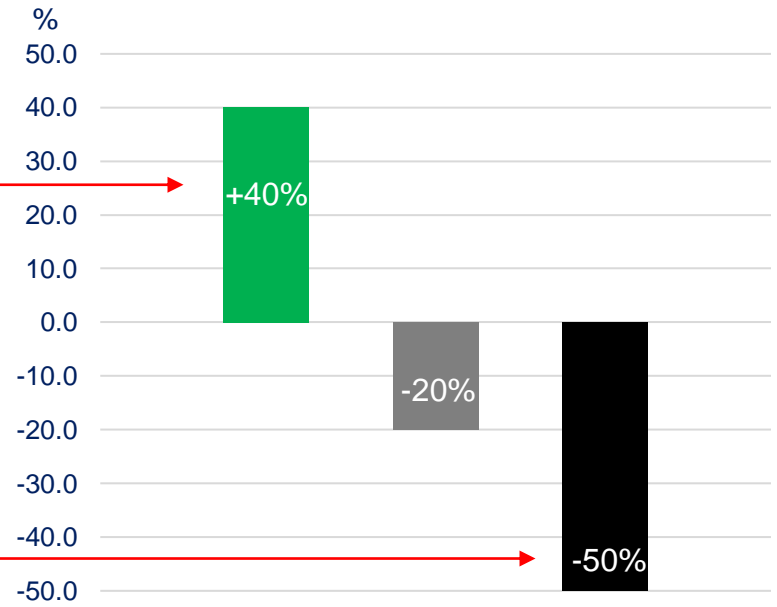
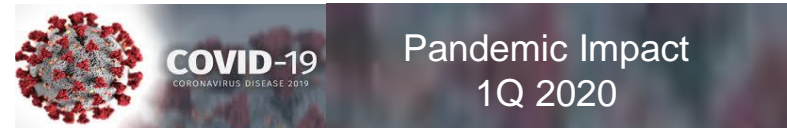
Research Budget
Leverage Factor:



Equity Trading
Volumes



Manager Pre-Tax
Profits



The lower markets (AUM) go, the less research P&L managers can access. ESG Implications?

European Managers

WHY ESG/FUNDAMENTAL RESEARCH CANNIBILIZATION IS A RISK



BNP PARIBAS

THE ESG GLOBAL SURVEY 2019

**ASSET OWNERS AND
MANAGERS DETERMINE THEIR
ESG INTEGRATION STRATEGIES**

To run “sustainable” ESG strategies managers have to create returns alongside ESG objectives.

Both Fundamental and ESG inputs are necessary.

- 9 Most important factors when selecting an ESG manager

IS SUSTAINABILITY “SUSTAINABLE”



The burgeoning costs of meeting ESG objectives for European asset managers.

MANAGER ESG RESEARCH/REGULATORY COSTS RISING RAPIDLY

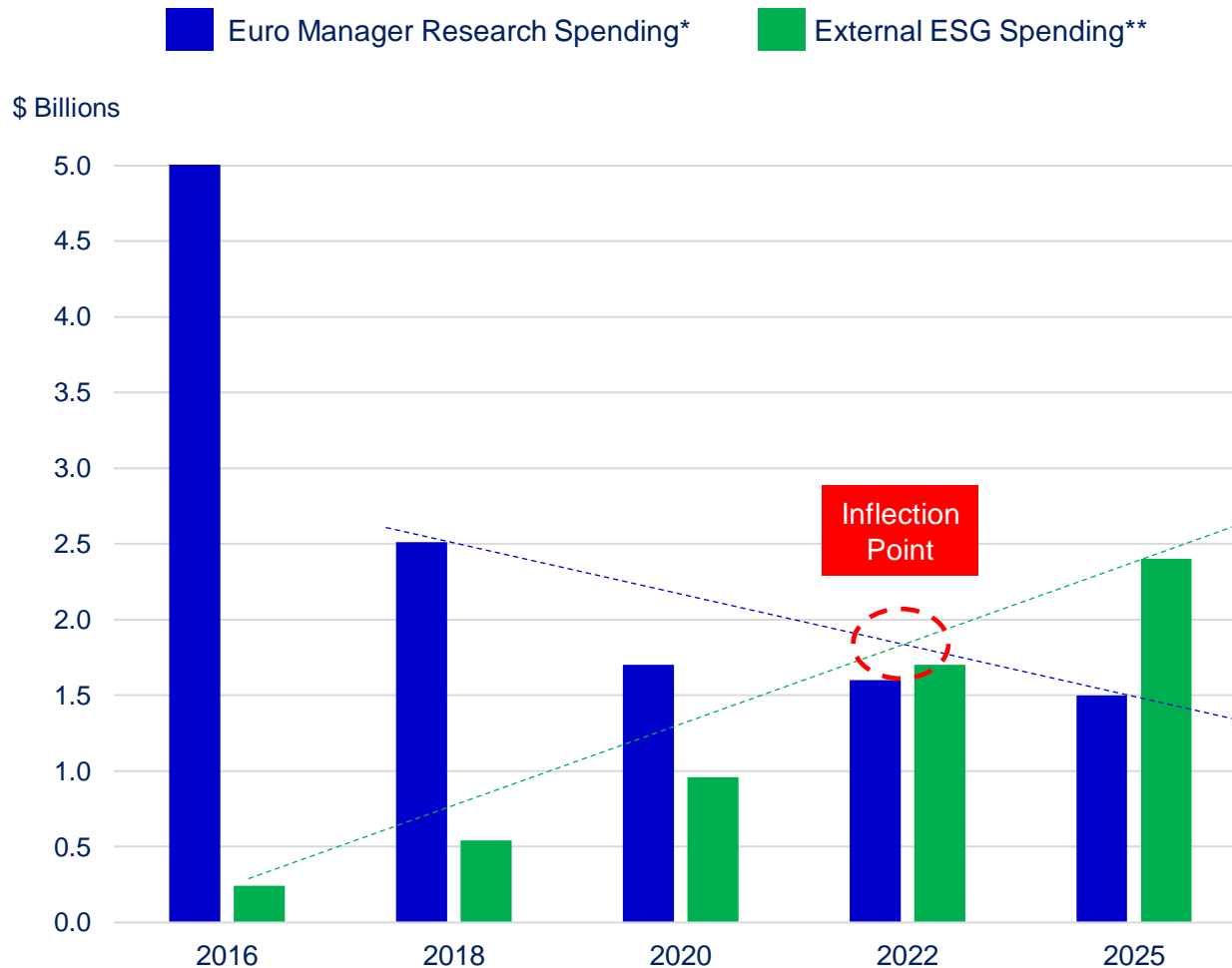


Estimates of Total ESG Spending (by asset managers):

- 2020: \$ 2.1 Billion
- 2025: \$ 5.1 Billion

This will overwhelm current
European Asset Manager
research spending.

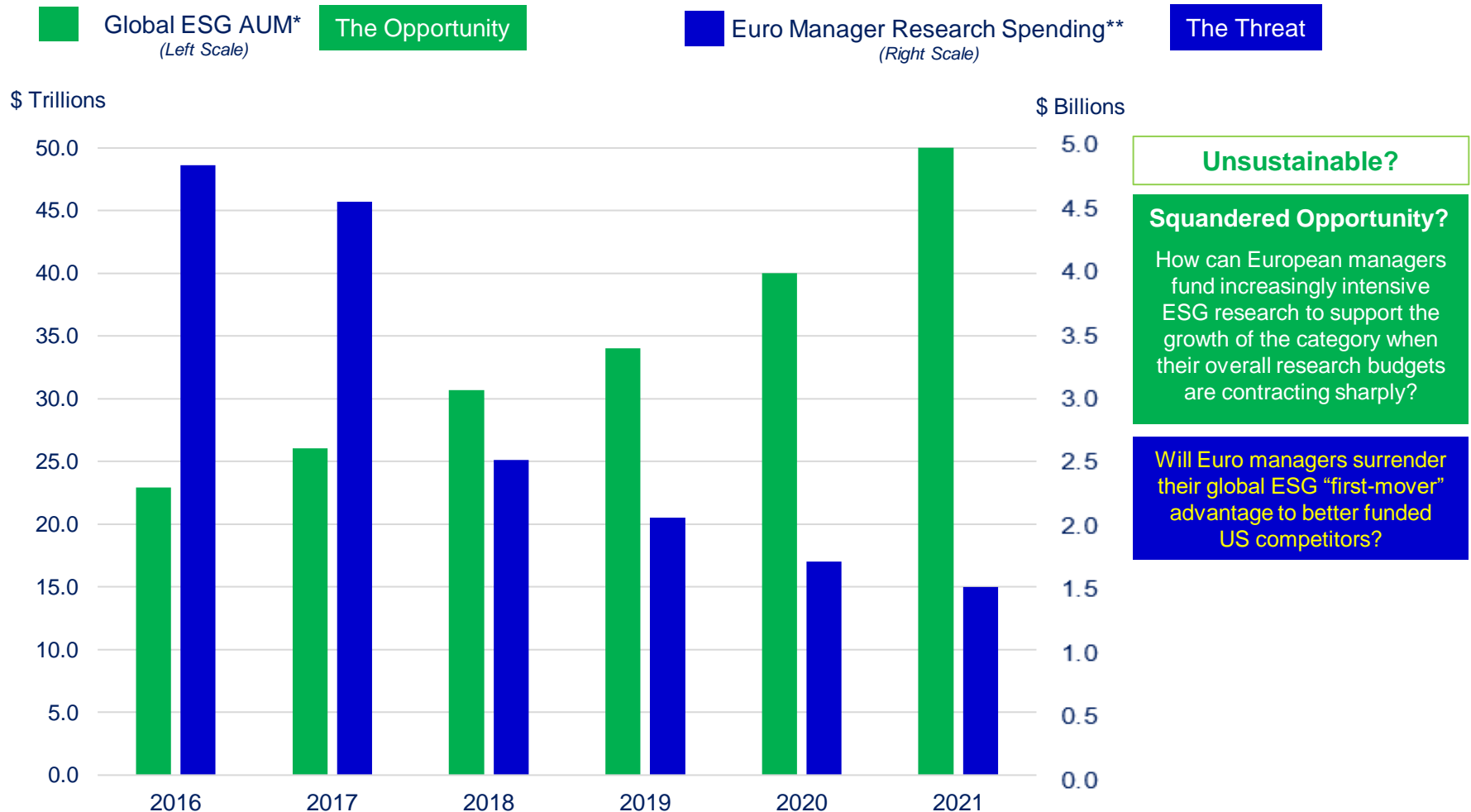
RESEARCH VS. ESG SPENDING (EXTERNAL)



- This represents external ESG spending only.
- Internal ESG costs of managers far exceed external costs.
- This at a time when the fees for active mandates have been falling at a rate of >7% annually.
- This is not sustainable unless European managers become non-profit social enterprises
- This assumes no Bear Market.

* Source: Estimate Frost Consulting – MiFID II European managers ** Source: UBS/Frost Estimates

ESG AUM GROWTH VS. DECLINING EURO RESEARCH SPENDING



Global ESG AUM*
(Left Scale)

The Opportunity

Euro Manager Research Spending**
(Right Scale)

The Threat

Unsustainable?

Squandered Opportunity?

How can European managers fund increasingly intensive ESG research to support the growth of the category when their overall research budgets are contracting sharply?

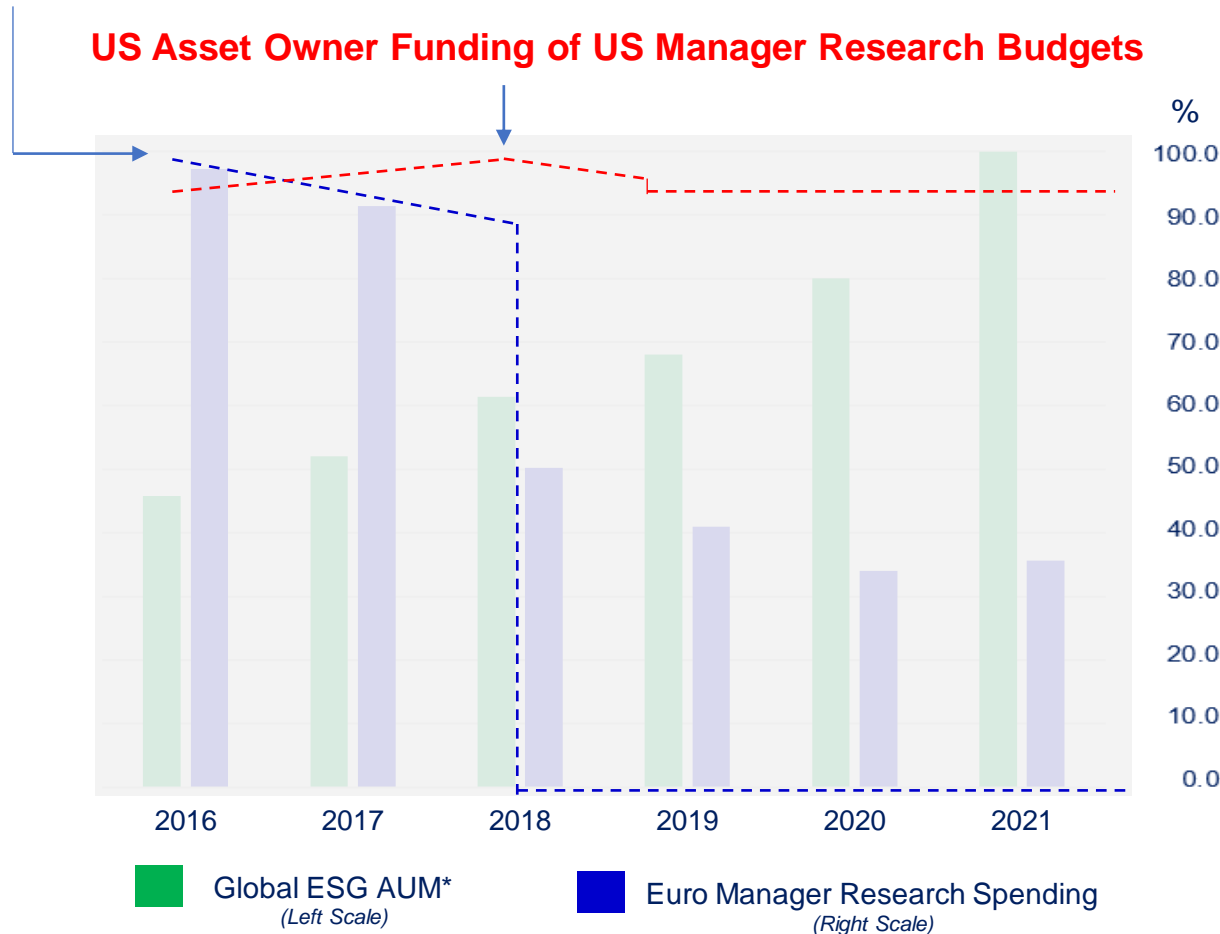
Will Euro managers surrender their global ESG "first-mover" advantage to better funded US competitors?

* Source: FTSE Russell

** Source: Estimate Frost Consulting – MiFID II European managers

THE ROLE OF ASSET OWNERS

European Asset Owner Funding of Euro Manager Research Budgets – including ESG



European Pension Funds insist that managers integrate ESG variables.

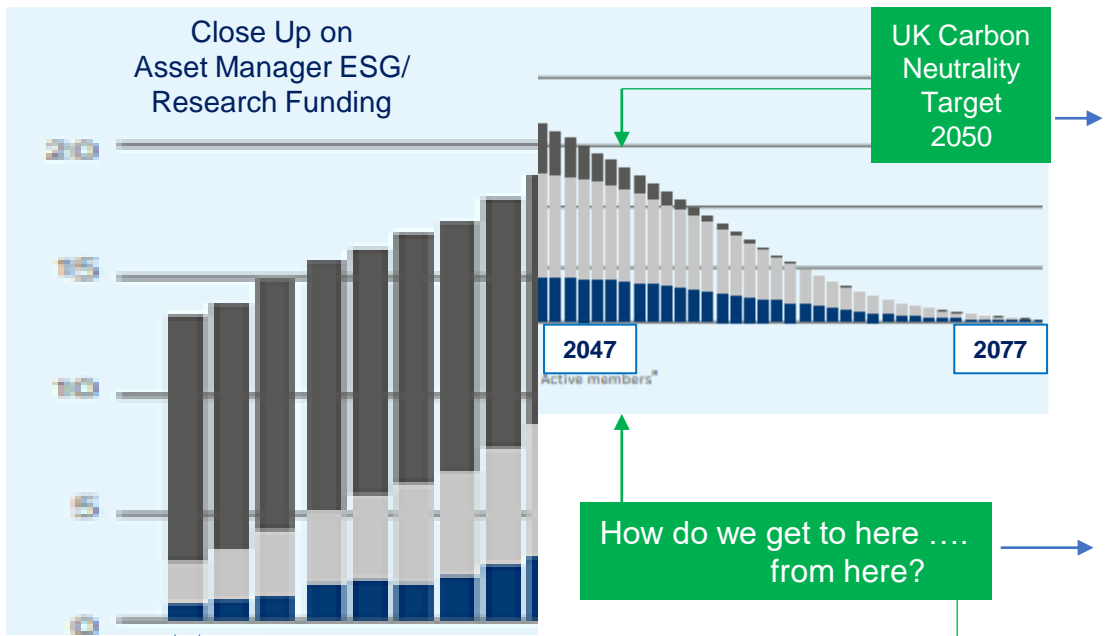
Pension Funds have liabilities stretching decades into the future and therefore have a vested interest in the “sustainability” of the research eco-system. (Fundamental & ESG)

Yet, in Europe, they make no financial contribution towards it, leaving the funding of this critical responsibility solely to the shareholders of asset managers.

ESG FUNDING: DURATION MISMATCH

UK Pension Funds – Long-Tailed Liabilities

Close Up on
Asset Manager ESG/
Research Funding



Despite their apparent advocacy of “long-termism”, pension funds are so desperate to avoid diminutive short-term research costs that they may be endangering longer-term objectives.

There is a fundamental disconnect between long-term ESG objectives and the current asset manager research/ESG funding mechanism.

Unless asset owners are willing to take advantage of their long duration and very low research costs to support this process, these efforts will fail, unless:

1. Governments fund this entirely, or
2. Asset managers elect to become not-for-profit social enterprises.

Asset Manager
Revenue Re-Sets:
Quarterly

Asset Manager
Research Budgets:
Annual

Key Risk:
If there's a Bear Market
before 2050 all bets are off.

What do we tell investors
in ESG funds?
Oh well

BENCHMARKING ESG SPENDING: INFORMING THE FUNDING DEBATE



Achieving ESG/Stewardship goals will require the collaboration of many:

Benefits/Outcomes:

- Managers have little idea of how actual and projected ESG/Stewardship spending compares to peers.
- If asset owners/consultants knew the costs that their increasingly ambitious ESG objectives entailed, it would enable them to better align duration and incentives in contracts with their asset managers.
- Greater transparency on ESG costs might foster a more collaborative, adult discussion between asset owners and asset managers on how best to ensure that the research ecosystem (ESG and otherwise) is “sustainable”.

Key Question:

Do European governments, regulators, asset owners (and future generations) want the achievement of critical long-term ESG objectives to be held hostage to the short-term direction of financial markets?

This is the situation as it stands currently

SHOULD SHARED ESG GOALS FACILITATE COLLABORATION?

An ESG Framework for Asset Owner/Asset Manager Research Collaboration
Integrating ESG Approaches into the Asset Manager Research Process

Manager research transparency will become a "stewardship" issue as asset owners integrate ESG variables.



Executive Summary:

- Both asset managers and asset owners are committed to integrating ESG principles into their investment processes. Yet neither have considered the ESG, Sustainability and Governance implications of non-transparent asset manager research budgets.
- Research costs for asset owners are far outweighed by the variance in returns between funds that do well and those that do poorly.
- Research budget cuts by P&L managers may endanger returns for asset owners.

Asset Managers and Asset Owners are not adversaries.
Their interests are aligned.

Both parties want the asset manager's investment product to achieve its targeted returns *and* ESG objectives.

Mapping Research Issues to the CFA/PRI Integration Framework

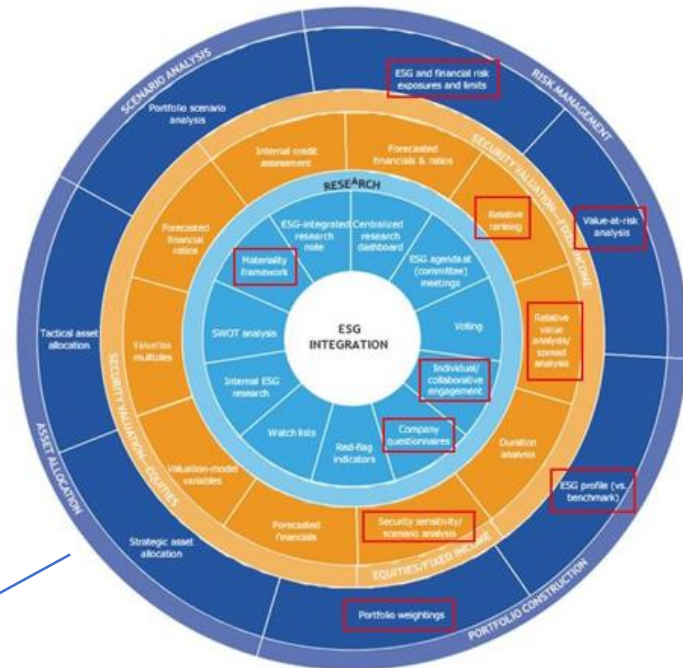


CFA Institute



Principles for Responsible Investment

ESG Integration Framework



Portfolio Level ■ Security Level ■ Research Level ■

ESG SOLUTIONS?

Common Ground for Asset Managers And Asset Owners?



Shouldn't European Asset Owners, as key systemic stakeholders, make a contribution to the "sustainability" of the research eco-system? (as they do in the US?)

If managers construct reasonable and transparent research budgets that directly support the asset owners' return and ESG objectives, shouldn't they be willing to fund them? (at very small cost to themselves?)

The attitude of some European asset owners mirrors that of the Climate Change deniers:
"ESG/Research Costs are not my problem", until of course, they are.