

# Thomson Financial Special Report

## Independent Research and the Buy-Side

*In an effort to determine which independent research firms the buy-side is using, Thomson Financial has surveyed over 150 institutional investors in order to help companies get a better handle on who some of the more closely followed firms are within the industry. This report attempts to highlight some of the major players in independent research, and shed some light on this growing and highly fragmented industry. For more information about this report, contact Justin Menza at Justin.Menza@thomson.com or Kara Newman at Kara.Newman@thomson.com.*

In the wake of the global settlement between Wall Street and the U.S. government and state regulators, independent research has gained in importance. However, the growing number of independent research firms present institutional investors with a wide array of choices. Firms have different methodologies, may cover only particular sectors and have specific ratings regimes that may differ from the traditional "buy," "sell," and "hold" that is common among the major brokerage houses.

Who are institutional investors using when it comes to independent research and what are some of the trends in the industry of which companies need to be aware? Thomson Financial has surveyed over 150 fund managers asking them which independent research providers they use.

### The Wall Street Settlement

In an attempt to resolve the conflicts of interest at brokerage firms that have tainted some of the research they provide the investment community, the Securities and Exchange Commission, the New York Attorney General, and other state regulators, along with the NASD and NYSE, reached a \$1.4 billion settlement with the brokerage industry in late 2002.

The terms of the agreement included:

- The insulation of research analysts from investment banking pressure, with firms required to sever the links between research and banking. These links include analyst compensation for equity research, and the practice of analysts accompanying banking personnel on pitches and road shows.
- A complete ban on the spinning of initial public offerings. Brokerage firms will not allocate IPO shares to corporate executives and directors who are in the posi-

tion to greatly influence investment banking decisions.

- Disclosure of analyst recommendations. Each firm will publicly disclose its rating and price target on individual stocks in order to allow for evaluation and comparison of analysts' performance.

Also, the deal forces banks to allocate a combined total of \$432.5 million to independent research offerings in an effort to give individual investors better information.

### The Aftermath

At this point, Wall Street is still grappling with the financial aspects of attempting to pay for independent research. Payments for research can come from hard dollars, or it can come from routing buy and sell orders through the trading desks at some independent research shops, which then collect trading commissions in a "soft dollar" arrangement.

Additionally, the major firms are trying to determine how many stocks can be covered by smaller independent research firms and how that stacks up against the larger independent providers, including Standard & Poor's, Value Line and Morningstar. Under the settlement, each bank must present research from at least three outside providers.

### Industry Trends--Sell-Side

The major brokerage firms have largely selected the independent research providers they will partner with. Goldman Sachs Group will give investors research from Standard & Poor's, Morningstar and Renaissance Capital. Morningstar and S&P will provide coverage of all Goldman Sachs-covered securities and non-U.S. equity securities listed or quoted in the U.S. that the firm covers. Renaissance will provide research of firms for one year after an IPO.

Merrill Lynch plans to provide research from

Morningstar and BNY Jaywalk, a unit of Bank of New York, that aggregates reports from about 80 independent firms. Bear Stearns Cos., Lehman Brothers and UBS also signed contracts with BNY Jaywalk. S&P will make reports on about 300 companies available through BNY Jaywalk, expanding BNY's offerings.

Among the other brokers, JPMorgan Chase has selected BOE Securities, Morningstar and Renaissance Capital, while Credit Suisse First Boston will offer research from Standard & Poor's, Renaissance Capital and BNY Jaywalk. Smith Barney will offer research from S&P, Argus Research, Morningstar and Renaissance Capital. Finally, Morgan Stanley has initially selected eight independent research providers, including Alpha Equity Research, Argus Research, The Buckingham Research Group, Fulcrum Global Partners, IPOfinancial.com, Soleil Securities Group, S&P and Zacks Investment Research.

### Industry Trends--Buy-Side

While the major investment banks have recently finalized exactly which independent research providers they will be partnering with initially, institutional investors have been using independent research from a wide array of sources for some time. Our survey asked over 150 investors which independent research firms they are using. The answers varied greatly, with over 160 unique responses to the question. (A complete list of research providers cited by survey respondents is available on page 6).

#### The Top 15 Independent Research Providers

Institution	Percentage Using
Value Line	9.91%
ISI Group	7.21%
Standard & Poor's	6.91%
BCA Research	4.20%
Ned Davis Research	4.20%
CFRA	3.30%
Sanford Bernstein	3.00%
Argus Research	2.70%
Gerson Lehrman Group	2.10%
Morningstar	2.10%
Leuthold Group	1.80%
Applied Finance Group	1.50%
OTA-Off The Record Research	1.50%
Sidoti & Company	1.50%
LJR Great Lakes Review	1.20%

Source: Thomson Financial Survey of Investment Professionals

According to the results, the major independent research providers were among the most widely used, with about 9.90% of respondent using Value Line and 7.21% using ISI. S&P was third, with about 6.91%. Some of the other more popular research firms were BCA Research and Ned Davis. (See Table)

Additionally, because the independent research universe is highly fragmented and specialized, many institutional investors tend to use more than one of the numerous independent research firms. Perhaps indicating the depth of the independent research offerings, there are a number of differences between which firms the buy-side is using and who the sell-side has partnered with.

One energy sector investor said he uses a host of independent research firms, each with their own specialty. For instance, Energy Intelligence Group is consulted for its macro oil/gas research, while Foresight Investment is used as a utility consultant. The same investor uses Gerson Lehrman for its expertise in the energy and industrial sectors, while John S. Herold provides an analysis of valuations in the exploration and production industry. PIRA, Ross Smith Energy Group and SNL Financial are also used, each with their own specific focus.

On the popularity of S&P and Moody's, one investor remarked, "We find them useful for their information. Because we have certain investment criteria based on rating agency ratings, it is important to follow their research to be able to gauge whether or not a rating change is imminent."

Meanwhile, one technology investor offered up an assessment of some of the independent research houses: Sanford Bernstein has good industry models and CreditSights provides good industry insight. Also, Precursor has a good overview of the technology sector, while AFG is strong in software for valuation. Finally, the investor applauds Great Lakes Review's focused and independent-minded research.

ISI turned up in a number of responses, with a couple of fund managers commenting on its excellent economic and political analysis.

CFRA was also highlighted a number of times, and according to one investor, it "adds accounting expertise we would not otherwise have."

## Additional Survey Comments

Other institutional investors also indicated that they may use a handful of research providers, but they are looking for others. According to one respondent, "My firm is predicated on objective analysis of emerging markets. Increasing the use of hard dollar research would allow independent research firms to compete against monolithic investment banks and broker-dealers." He points to Spellman Research, which covers very small stocks, as a solid research provider that flies under the radar of most investors.

This last comment indicates that investors are actively searching for other reliable independent research providers, but because of the highly fragmented and specialized nature of the industry, they are having trouble finding ones that may adequately meet their needs. The trend was also revealed in the survey itself, as only a few independent research providers had a wide following. Many investors were using one or two obscure firms that no one else was using, making it difficult to ascertain any trends as to who the buy-side is gravitating towards with respect to independent research.

## Lingering Conflicts

This sampling suggests that there are an increasingly varied number of reliable sources for investors to use to access research on companies. Still, with the rise of "independent" research, companies must become more cautious when considering who is in fact independent. After the global settlement, a number of companies quickly adopted the independent mantra, with some hedge funds providing research which can still be tainted by ownership stakes. The recent settlement defines independent research as "having no association with investment-banking activities," and does not provide any more guidance beyond that. Many firms touting their research as "independent" could still have conflicts that may not be disclosed under the current Wall Street settlement.

Also, a number of these so-called "independent" research firms may simply be angling for a piece of the \$432.5 million that the 10 big Wall Street firms agreed to spend over five years on "independent" research as part of the settlement. Companies that are being covered by some of these smaller research firms must be aware of the potential conflicts that extend beyond whether or not there is an investment banking relationship.

## Independent Research Firm Profiles

### Value Line Inc.

Produces investment-related periodical publications and provides investment advisory services. Research analysts publish a survey of over 1,700 stocks, and one of 6,000+ stocks which are sold to brokerage firms and on the Street. The company also offers a family of mutual funds.

#### Contact

220 E. 42nd St.  
Sixth Floor  
New York, NY 10017  
212.907.1500  
[www.valueline.com](http://www.valueline.com)

### ISI Group Inc.

A broker-dealer specializing in economic research, policy research, quantitative research, company surveys, client projects and investment strategy. The research reports are provided to institutional equity and bond clients globally. ISI also has a money management arm.

#### Contact

535 Madison Ave.  
New York, NY 10022  
212.446.5600  
[www.isigrp.com](http://www.isigrp.com)

### Standard & Poor's

A subsidiary of McGraw-Hill, S&P is a global provider of highly-valued independent investment data, valuation, analysis and opinions. They also provide investors with the independent benchmarks, such as the S&P 500 Index.

#### Contact

55 Water Street  
New York, NY 10041  
212.438.2000  
[www.standardandpoors.com](http://www.standardandpoors.com)

**BCA Research**

BCA is an independent provider of global research, providing regular analysis of global markets, business conditions and investment prospects. They also provide recommendations for investment strategy, backed by their proprietary indicators. Coverage includes equities and fixed income.

Contact

1002 Sherbrooke St. W.  
Suite 1600  
Montreal, H3A 3L6, Canada  
514.499.9706  
[www.bcaresearch.com](http://www.bcaresearch.com)

**Ned Davis Research Inc.**

The company produces commentary, charts, models, equity ranking systems and marketing timing services in the equity, bond, economic and international areas. Their proprietary software allows them to develop timing models that mathematically blend the best and most reliable timing indicators from both technical and fundamental research. The firm also manages a hedge fund.

Contact

600 Bird Bay Drive West  
Venice, FL 34292-4020  
941.484.6107  
[www.ndr.com](http://www.ndr.com)

**CFRA**

CFRA is a leading financial research organization serving the investment community. It produces quality-of-earnings analysis on more than 1,900 North American, Japanese, and Asia ex Japan companies daily to over 4,000 institutional clients around the world. CFRA warns investors, creditors and other stakeholders about companies displaying deteriorating operational indicators.

Contact

11140 Rockville Pike  
Suite 640  
Rockville, MD 20852  
301.984.1001  
[www.cfraonline.com](http://www.cfraonline.com)

**Sanford Bernstein**

Bernstein provides top-quality investment research to institutional investors, with its research defined by its "blackbook" reports, known for their in depth company and industry forecasts. Their research employs fundamental, quantitative and macroeconomic methodologies. Bernstein also provides portfolio strategy services and offers full-service discretionary money management services.

Contact

1345 Avenue of the Americas  
New York, NY 10105  
212.350.8400  
[www.bernsteinresearch.com](http://www.bernsteinresearch.com)

**Argus Research Group**

Argus offers fundamental equity research to brokerage firms, money managers and institutions, with research judgments based on macroeconomics, industry economics and company analysis.

Contact

61 Broadway  
17th Floor  
New York, NY 10006  
212.425.7500  
[www.argusresearch.com](http://www.argusresearch.com)

**Gerson Lehrman Group**

Gerson Lehrman Group is a primary research firm providing the investment community with customized tools to accurately analyze markets and industries. The firm provides clients with knowledge and insight through "The Councils," a proprietary global network of over 60,000 industry professionals and thought leaders in a wide range of industries.

Contact

850 Third Ave.  
9th Floor  
New York, NY 10022  
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[www.glgroup.com](http://www.glgroup.com)

**Morningstar, Inc.**

Morningstar tracks the 6,500 stocks that trade on the major U.S. exchanges, and provides more than 250 data points for each stock and produce daily online reports. For the top 500 stocks, analysts prepare detailed qualitative "analyst reports."

Contact

225 W. Wacker Drive  
Chicago, IL 60606-1224  
312.696.6000  
[www.morningstar.com](http://www.morningstar.com)

**The Leuthold Group**

A division of Weeden & Co., Leuthold produces a number of in-depth reports on the equity and fixed income markets. Additionally, the firm provides quantitative stock screens, covering earnings disappointments, undervalued stocks and growth. The group is headed by Steve Leuthold, a recognized market strategist and researcher.

Contact

Weeden & Co., LP  
145 Mason Street  
Greenwich, CT 06830  
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**The Applied Finance Group**

AFG is a leading innovator in making Value Based Metrics relevant for institutional investors. The innovations include: systematically linking economic profit to corporate value; developing intuitive value driver models to explain economic profit; empirically linking competitive advantage periods to company specific fundamental factors, developing market-based discount rates that mitigate the problems with CAPM.

Contact

11 East Adams  
Suite 601  
Chicago, IL 60603  
312.362.9903  
[www.economicmargin.com](http://www.economicmargin.com)

**OTA-Off The Record Research**

Off The Record Research offers unbiased research to supplement and counter traditional Wall Street analysis, while OTA is a full-services broker. Off The Record employs quantitative and qualitative methodologies in its research.

Contact

One Manhattanville Road  
Purchase, NY 10577  
914.460.4022  
[www.otaotr.com](http://www.otaotr.com)

**Sidoti & Company, LLC**

Sidoti provides fundamental research coverage primarily for equities with market capitalizations below \$1.5 billion. The company covers nearly all economic sectors, for a purely institutional client base.

Contact

317 Madison Avenue  
New York, NY 10017  
212.297.0001  
[www.sidoti.com](http://www.sidoti.com)

**LJR Great Lakes Review**

The company offers investment strategy for both value and growth-oriented investors. The objective is to make money for the long-term fundamental investor by gradually accumulating a diversified portfolio of medium-sized growth companies headquartered in the Midwest that meet a number of specific criteria, including a high earnings and sales growth rate, a self-funding balance sheet, substantial insider ownership, minimal institutional ownership at the time coverage begins, immunity to foreign currency volatility, a reasonable valuation, and confidence in senior management.

Contact

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Suite 800  
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Research Firms Cited	
13D Research	Ford Equity Research
21st Century Research	Foresight Investment Strategies
Applied Finance Group	Fourteen Research
Argus Research	Fulcrum Global Partners
Asset Analysis Focus	GARP Research
Atlantic Venture	GaveKal
Avian Securities	Gerson Lehrman Group
Barra	Gimme Credit
BCA Research	Glen Rock Associates
Behind the Numbers	GN Evascu
Blackfin Capital	Grant's Interest Rate Observer
Bondedge	Green Street Advisors
Boston Energy	Greenwich Research Analytics
Bradley, Woods & Co.	Harris Trust
Buckingham Research	Independent Perspectives
Bullseye	Inferential Focus
Auerback, Pollack & Richardson	InFocus Research Services
Callard Research	IRG
Camelback Research Alliance	ISI Group
CFRA	JB Hanauer & Co.
Channel Trend	John S. Herold
Chicago Analytics	CL King & Associates
CL King	Kudlow Market Methodologies
Columbine Capital Services	Leuthold Group
Craig-Hallum	LJR Great Lakes Review
Crandall Pierce & Co.	Lowry's Reports
CreditSights	Macro Mavens
Cutter Associates	Market Trend Investors
Daniel Morton & Co	Marwood Group
Di Biasio & Edgington	McDep Associates
Dick Arms	First Midwest Securities
Hays Advisory Group	Miller Tabak Roberts Securities
Dorsey, Wright & Associates	Moody's Investors Services
Dow Theory Letters	Moors & Cabot
Earnings Quality Analytics	Morningstar
Econoclast ,	Ned Davis Research
Empirical Research Partners	New Street Research, London
Energy Intelligence Group	Nollenberger Capital Partners
EVA Research	Northern Trust
Fidelity Independent Advisor	Northfield Information Services
Fitch	OTA-Off the Record Research

Research Firms Cited (Cont)	
Off Wall Street Consulting Group	Second Opinion Research
Pillette Investment Management	Sidoti & Company
PIRA Energy Group	SNL Financial
Plexus Group	Soleil Securities Group
Polyconomics	Spelman Research Associates
Precursor Group	Spin-Off Report
Prudential Equity	Standard & Poor's
Real Money	Starmine
Retail Intelligence Group	Stone & McCarthy Research
Rochdale Securities	The StreetView
Rockhouse Securities	The Robins Group
Rosetta Management Group	Tier 1 Research
Ross Smith Energy Group	Value Line
Royalist Independent Research	Vandham Securities
Russell	Welling@Weeden
Sanford Bernstein	William O'Neil & Co.
Safian Investment Research	Zacks Investment Research
SEC Insight	

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