

(From left) Glenn Reynolds and Peter Petas, CreditSights; Craig Hutson, Arthur Rosenzweig and David Novosel,



INDEPENDENTS

The research landscape is changing thanks to regulatory pressures and the evolving needs of investors. **Dalia Fahmy** profiles the independent credit research providers who are aiming to capitalize on the new status quo

Peter Petas spent 15 years analyzing credits on Wall Street. As he rose through the ranks, eventually taking charge of global emerging market debt strategy at Deutsche Bank, he found that he was spending more time helping investment bankers court clients instead of doing what he really enjoys: crunching numbers. "There was less and less joy in sell-side research," he recalls. "It was a lot about marketing, a lot of travel, and less about writing research."

In 1999, he mentioned his frustrations to Glenn Reynolds, then global head of corporate bond research at Deutsche Bank, and told him that he planned to venture out on his own. Reynolds had been on both the sell side and the buy side for 16 years, and knew that money could be made selling third-party services to large financial institutions.

The two joined forces and a year later formed CreditSights, the youngest member in a tiny industry of independent credit research providers. One could argue that it's also a growing market, not because there have been any new entrants recently but because demand has been rising. Whether demand can increase enough to help the sector expand remains to be seen.

CreditSights photos: Amy Fletcher

Gimme Credit; Kingman Penniman and Premila Peters, KDP Investment Advisors



DAY

Of the three main players, CreditSights is the largest with a wide-ranging business in high-grade, high-yield and emerging markets credit strategy, quantitative analysis and risk assessment. Reynolds took the title of chief executive officer, while Petas heads up research.

KDP Investment Advisors, which has been around in various incarnations for over two decades (although it only broke out on its own in 1996) is the oldest, specialising in high-yield credit analysis. Gimme Credit, another straight credit shop offering both high-yield and investment-grade research, was founded in 1994.

Beyond these three, the landscape thins. Some firms such as MCM or IDEA Global provide pricing information on new issuance, secondary market commentary or light credit analysis. Then there are the rating agencies, including Moody's Investors Service, Standard & Poor's, Fitch Ratings and Dominion Bond Rating Service, whose long-term perspective is in most cases of limited use to active investors.

In the past few years, independent credit research has edged toward the spotlight, pushed by the increased

scrutiny of equity analysts and demand from a growing hedge fund community. While the \$1.4 billion "global settlement" struck between US regulators and eight sell-side firms in the wake of the WorldCom fiasco in 2002—which included a \$450 million payment to promote independent equity research—didn't cover bonds, some argue that the fixed-income sector is due for reform.

In one of his last speeches as chairman of the Securities and Exchange Commission in May, William Donaldson advised a gathering of financial analysts to ask "whether there is something to be learned" from history. "There are still questions facing fixed-income research that are substantially the same as those that laid the groundwork for the global settlement," he said, hinting that bond analysts might be just as vulnerable to pressure from their investment banking colleagues or even from bond-issuing clients.

Independent researchers say that conflicts of interest on Wall Street make it difficult for sell-side analysts to do their jobs properly. Carol Levenson, director of research and co-founder of Gimme Credit who spent 10 years as a

buy-side analyst at Harris Investment Management, says she started her own business partly because of Wall Street's "reticence to call it as it is with companies".

The problem is not necessarily that particular sell-side analysts are dishonest, says CreditSights' Reynolds, but that conflicts of interest exist across functional groups. "You have the trading desk that's not happy with an investment banking client and that wants to short the bonds. You have an investment banker who writes his ticket in life on his relationship with one issuer. Then you have clients who have portfolios to maintain and want a straight story," says Reynolds. "That's always been very difficult for the Street to balance."

right and to help investors make money," says Margaret Cannella, head of equity and debt research at JPMorgan in New York.

Buy-side portfolio managers aren't convinced. Margaret Patel, manager of the \$6 billion High Yield Fund at Pioneer Investment Management, puts it bluntly. She says that she believes a lot of Wall Street research is meant to encourage clients to trade more or help valued ones get out of illiquid or deteriorating names.

"Independent research is definitely more objective than sell-side research," says Patrick Cassidy, head of investment-grade research at T. Rowe Price, adding that it gives him comfort to know that these firms "live and die" by the research they offer and are therefore more likely to give it their best effort. "You're never questioning where they stand on an issue." The key question is whether demand from firms like Pioneer and T. Rowe Price can help the independent research sector to grow.

Most buy-side professionals say they use independent research to round out their views, but that they can't always justify spending money on it. At the same time, changes in regulation and technology have made it easier for investors to obtain credit information on their own and more difficult for the independents to prove their value.

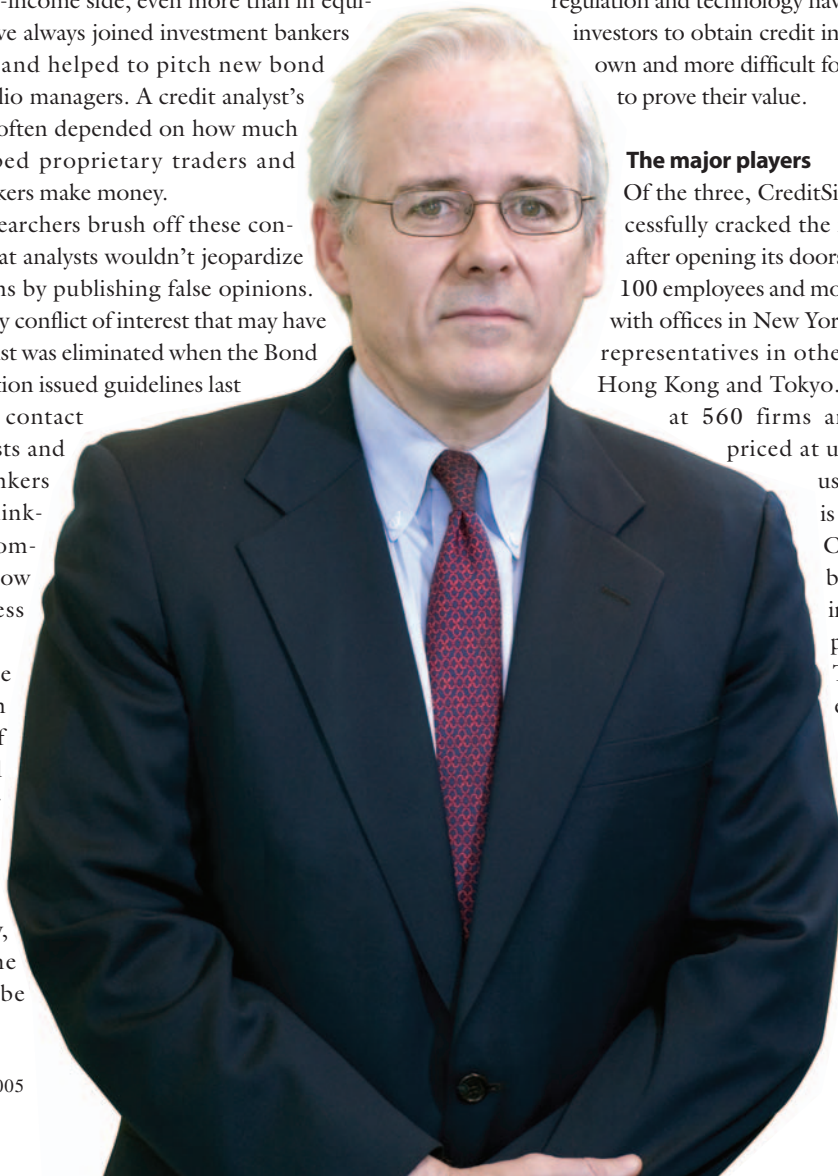
"We tell our analysts you don't need to be a genius every day"

Glenn Reynolds, CreditSights

On the fixed-income side, even more than in equities, analysts have always joined investment bankers on roadshows and helped to pitch new bond issues to portfolio managers. A credit analyst's pay and career often depended on how much he or she helped proprietary traders and investment bankers make money.

Sell-side researchers brush off these concerns, saying that analysts wouldn't jeopardize their reputations by publishing false opinions. They also say any conflict of interest that may have existed in the past was eliminated when the Bond Market Association issued guidelines last year to restrict contact between analysts and investment bankers and proscribe linking analysts' compensations to how much business they bring in.

"We measure our analysts on the accuracy of their calls, and monitor their calls on a day-to-day basis to see if they are accurate. Really, the job of the analyst is to be



The major players

Of the three, CreditSights has most successfully cracked the market. Five years after opening its doors, the firm now has 100 employees and more than 40 analysts with offices in New York and London and representatives in other cities including Hong Kong and Tokyo. With 3,000 users at 560 firms and subscriptions priced at up to \$15,000 per user (or less if there is a group discount), CreditSights booked \$30 million in revenues over the past 12 months. The firm is 80% employee owned; the remainder is held by private equity firms that helped it raise money two years ago.

Reynolds and Petas determined early on

that they wouldn't get far by simply offering buy and sell recommendations, since most firms think twice before spending money on credit opinions. So they came up with a business model that emphasizes maintenance research in addition to credit strategy: the kind of qualitative analysis and risk assessment that helps portfolio managers reduce tedious legwork.

"People have significant man-hour needs just to maintain their portfolios. At the end of the day they make their own decisions on risk and how to allocate their capital," says Reynolds. "We tell our analysts you don't need to be a genius every day and come up with a better mousetrap recommendation. What you need to do is be useful every day." Being useful, he says, can simply mean reading a company's 8K filing and summarizing it for clients.

Gimme Credit is much smaller, with about 25 employees and 9 analysts who cover 600 companies, and 3,000 users at 300 firms. High-yield and investment-grade subscriptions are considered separate products and each cost \$18,000, while package deals for large clients with multiple subscriptions start at \$100,000.

The company was started as an investment-grade shop in 1994 by Levenson and Arthur Rosenzweig, who runs a venture called Research Partners that invests in financial information providers. Research Partners still owns a small majority, while Gimme Credit's analysts own the rest.

In 2002 Gimme Credit began a significant make-over, doubling its number of analysts and clients. In 2003 it launched high-yield research. Rosenzweig says he expects to double the number of analysts again in the next few years, boost the volume of research output and expand internationally with an office in London.

The original idea behind Gimme Credit was not just to provide objective research, but to help reduce the clutter. With portfolio managers in mind, Rosenzweig said he wanted to offer original, succinct investment ideas instead of trying to be a "research library".

"We felt that the research portfolio managers were getting from the sell side wasn't balanced enough and wasn't to the point enough," says Rosenzweig, who is also an economist. "We created a venue where we could provide portfolio managers with a concise one-page analysis and bring it to an investing conclusion."

"Our stuff gets read because it's short and it's readable," says Levenson.

KDP Investment Advisors, meanwhile, focuses on high-yield analysis, leveraged loans and crossover credits. Founded in 1996 by a team of high-yield analysts led by Kingman Penniman that started together at MCM and



"You couldn't really start a company like CreditSights in a non-Reg FD world"

Peter Petas, CreditSights

then survived a number of ownership changes, KDP today has 17 analysts—most of them based in Vermont—who cover 350 companies. "We're perceived as the analysts' analyst," says Penniman. "We don't pretend that we can follow 1,000 companies, but the ones that we do follow we know well. People know that when they need to find out what's happening with those credits, they can come to us."

KDP has about 150 clients, and Penniman estimates that the service reaches more than 5,000 users. A subscription costs \$15,000 although most large institutions have discounts.

The three firms consider each other—and the sell side—as competitors. Their clients include investment

“I love [independent credit research]...But how do I figure out how to pay for it?”

Patrick Cassidy, T. Rowe Price

managers, mutual funds, insurance companies, hedge funds and brokerages, among others.

Over the past few years, the environment within which independent researchers operate has changed significantly. For starters, there has been growing awareness of the independent research niche. “With Regulation FD

and the Wall Street research settlement, there is actually an industry of independent research now,” says Gimme Credit’s Levenson. “People know what you’re talking about when you say you’re not a buy-side analyst or a sell-side analyst.”

Regulation Fair Disclosure (Reg FD), which was introduced in 2000 and requires companies to publicly disseminate any information they share with analysts almost immediately, has also made it easier for the independents to obtain information that was formerly reserved for top Wall Street analysts. “You couldn’t really start a company like CreditSights in a non-Reg FD world,” says Petas. “The inside information game has gone from the market. Most companies are very careful about disseminating information to everyone at the same time.”

Money matters

Generally, however, the climate is tough for independent firms. The main challenge is making money. Research has always lost money, and in the past Wall Street firms viewed it as a cost center that helped attract trading and investment banking clients. Petas says one of the lessons he learned when he started CreditSights is that winning customers is not as easy as it looks.

“We thought that because we were writing good research and had a reputation in the market we would instantly have a huge customer base,” he says, only half-joking. “It turns out the subscriptions had to be sold.”

While some of the independents complain that the sell-side customer base has shrunk with acquisitions, others argue that the pool of clients has expanded with the growth of hedge funds. The core audience on the buy side is what matters most, however, and portfolio managers will always be careful with their money.

T. Rowe Price’s Cassidy, for example, who considers independent research “very useful,” believes gaining market share will be tough for the independents. “I love the product,” he says. “But how do I figure out how to pay for it? How do I figure out what it adds to my bottom line? Those are not new questions. They’re the same questions the sell side has dealt with for years.”

The sell side, meanwhile, is keeping its eye on the independents but says they are no real threat. JPMorgan’s Cannella says while the quality of independent credit research may be good at times, its breadth is limited. “It’s not possible for the independent firms to have all of the different resources that the bulge bracket firms have,” she says. Sell-siders say their credit analysts are supported by large teams of equity analysts, economists, derivatives specialists and sector experts.

Another challenge is attracting the right kind of talent, without being able to offer the high salaries and prestige of working on Wall Street. All three independent firms are



Craig Hutson, Gimme Credit

partnerships, so instead of offering big financial returns upfront they are asking analysts to take a bet on the future of the industry.

Rosenzweig says that Gimme Credit is competitive with Wall Street on salaries, but that it offers employees additional perks: analysts can spend all of their time writing research instead of having to worry about sales meetings; they are encouraged to stick their necks out and develop strong views on their credits instead of being forced to toe the company line.

“We offer more intellectual freedom and stimulation, and that has a lot of value for a certain kind of analyst,” says Levenson. “You’re really your own boss; nobody is looking over your shoulder to see what you’re writing about.”

The next step

So what will the research landscape look like in five years’ time? In the end, it will all depend on demand. Most investors say they look at independent research to supplement their own work, but few rely on it exclusively.

Pioneer’s Patel says the independents can offer her a good overview of the basics, but when it comes to making a market call she relies on her own homework and Pioneer’s proprietary research. “I prefer to do my own research and go down in my own leaky boat, instead of going down in someone else’s,” she says.

T. Rowe Price’s Cassidy says independent research is one more tool that tells him what others are thinking and how that thinking may influence valuation. “We don’t want to sit there and think we are all-knowing about everything that’s going on in the market,” he says.

Sell-side demand, meanwhile, is fickle. One Wall Street executive says sell-siders only subscribe to independent research to see what the buy side is reading, arguing that by the time sell-side analysts see independent research, their own reports are already out.

But sell-side research in its present form may not be around much longer. Market participants expect that sell-side firms will cut back significantly on the amount of research they publish, given how expensive it is to maintain. Some Wall Street firms have already reassigned top credit analysts to the trading desks where they can help the firms make money, leaving junior staffers to publish client research. Some people also predict that Wall Street will publish less maintenance research which requires extensive labor, and focus more on strategy.

Other changes have been transforming the landscape as well. Debt and equity research are becoming increasingly interconnected as more investors play with different parts of the capital structure, and interest in hybrid assets has grown. More and more Wall Street firms have responded by offering more relative-value research, or



“We created a venue where we could provide portfolio managers with a concise one-page analysis”

Arthur Rosenzweig, Gimme Credit

even combining their equity and debt research teams under one leadership.

While Reg FD and new technologies have helped level the information playing field, they have also added to the work load of analysts, making it more difficult for independent firms with small staffs to keep up. “Now there are more places I have to look before I say anything,” says Gimme Credit’s Levenson.



Premila Peters (left) and Kingman Penniman, KDP Investment Advisors

Penniman also says Reg FD has made it more difficult for the market in general to obtain the information it needs. If a rumor hits a credit, the company may choose not to publicly comment on it because it is bound by stricter communication rules, which leaves analysts trying to guess the truth.

New demand

At the same time, the growth of hedge funds and the exploding popularity of credit derivatives have increased the demand for fast-paced, real-time research. All these factors pose new opportunities and challenges for the

12 months, and expects to add another six or so later this year, including a derivatives specialist. The firm is also starting to issue more hybrid equity and debt research.

Gimme Credit has responded by increasing the frequency of its research reports, publishing intraday commentaries that include buy, sell and hold recommendations for the first time earlier this summer. Rosenzweig says Gimme Credit has always offered relative-value research and recently introduced a derivatives service, although it plans to stay away from equity products. At the same time, Gimme Credit plans to double the number of analysts in the next couple of years, and expand its high-yield offering. It also plans an international expansion by opening an office in London and courting more clients in Europe, where it currently derives about 20% of its revenues.

Like his competitors, Rosenzweig is betting on the independent research space to continue growing and says investors are already more accustomed to the idea that there's not just a buy side and a sell side, but also "an independent side". And while nobody expects a shake-up in the debt research world similar to that which gave independent equity research a shot in the arm, they have high hopes for a bright future. "It's a wide-open space and it's still in flux," says Petas. "There is a lot of speculation that as baby boomers retire they will increasingly invest in corporate bonds instead of equities. It would be interesting to see how that develops."

When that day comes and investors start looking for more alternatives to credit research, CreditSights, Gimme Credit and KDP Investment Advisors will be waiting with their calculators charged. ■

“I prefer to do my own research and go down in my own leaky boat, instead of someone else’s”

Margaret Patel, Pioneer Investment Management

independent research sector. KDP's Penniman says hedge funds, which are very active in the high-yield market, have significantly boosted his business. In addition, KDP is launching its own derivatives product this summer.

CreditSights has been meeting the new challenges forcefully. The firm has added 40 employees over the past