



Products Pave Way for Greater Soft-Dollar Transparency

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By Beagan Wilcox

Software systems that firms have rolled out in recent years are helping fund groups measure the value of specific research and services purchased from brokers.

Boards, in turn, are using this data to get a better grasp on their funds' soft-dollar expenditures — an area that regulators, fund boards and industry watchdogs have long considered murky.

Soft dollars are the amount funds pay for research and services they obtain from brokers. Yet, much to directors' chagrin, this amount is never clearly broken out from the total cost of executing a trade. Consequently, boards struggle with understanding exactly what the value is of the research and services the funds buy with trading commissions.

Indeed, SEC Commissioner Annette Nazareth has called the documentation of brokerage and research services that the advisor gets with soft dollars "scant."

These new software systems — sometimes called alpha capture systems — differ depending on the company that created them. Essentially, though, they track the investment decisions portfolio managers make based upon the research they purchase with soft dollars.

The result is an assessment of the value of that research. Some companies also use hypothetical trades and models to measure the investment ideas that are not acted upon.

"I think any attempt, any valid algorithm that tries to value research, as far as portfolio trades and their resulting profits, is of use to trustees," says Jeff Keil, principal at Keil Fiduciary Strategies, an industry consulting firm.

But Keil notes that the value of investment ideas and services may be in the eye of the beholder. In other words, the value for different portfolio managers could diverge fairly substantially.

Industry experts also say that such products are only one weapon in the board's arsenal to evaluate brokerage, soft dollars and best execution.

"I want to be emphatic in saying I certainly don't think some board is failing to do its duty if it doesn't have this [product]," says Robert Zutz, partner at K&L Gates. Fund advisors must determine that research and services qualify for the safe harbor, and boards have the duty of monitoring those soft-dollar arrangements, he adds

Still, a growing number of fund firms, prompted in part by greater scrutiny of soft dollars by fund directors, are turning to such software systems.

Firms Offering "Alpha Capture Systems" or Similar Products

- Code Red
- Cogent
- FactSet

- First Coverage
- StarMine
- Tamale Software Inc.

First Coverage, a privately held Canadian company, rolled out software of this type in the last quarter of 2006. Several weeks ago, the firm's CEO, Randy Cass, says he met with the chairman of one of the largest mutual fund companies in North America to explain the product to him.

The chairman told Cass that every trade that goes above the cost of an electronic execution rate — one or two cents per share — is getting questioned by the board to understand the value they're getting in return.

First Coverage will return to present to the entire board, says Cass. In fact, boards or board committees are often involved in the process of deciding whether to contract with First Coverage, he says.

"They want to be able to demonstrate with data what they paid for," says Cass.

The product is sold to buy-side firms which then ask their sell-side counterparts to provide their information through the software system.

"It's turning the sell side into a meritocracy," says Cass. "It's turning the buy side into a much more aggressive seeker of alpha, not just among the trusted relationships they have today, but among all the potential relationships they could have."

Another software provider, StarMine, a San Francisco-based firm has created such a product, which measures the performance of sell-side analysts based on the accuracy of earnings estimates and the profitability of buy/sell recommendations. The firm also "provides tools to aggregate the value add for each broker, customized to the holdings or stocks of interest to each fund manager," according to Mary Morgan, spokeswoman for the firm.

The result of these programs is that there should be a "clean audit trail" of investment ideas and how valuable they were to the fund, says John Wiseman, director of AlphaMetrics, research software products developed by FactSet, a financial data and analytics provider. Alpha Network, one product that mutual funds are using, was created about five years ago.

These services are being developed at a time when soft dollars are in the spotlight. Last year the SEC adopted additional guidance that narrows the parameters of what soft dollars can pay for. Lately, however, there's been a flap over the future of soft dollars because SEC Chairman Christopher Cox has asked for the repeal or revision of the legislative safe harbor that allows their use.

In a May letter to congressmen, Cox stated that money managers spent \$1 billion last year on third-party research and services. A Greenwich Associates survey finds that mutual funds reporting soft-dollar expenditures for third-party research declined from 75% in 2005 to 65% in 2006. Figures for the amount spent on the other significant part of the soft-dollars equation — proprietary research — are harder to come by.

Meanwhile, boards and the industry have been waiting for the SEC to give further guidance on the disclosure of soft dollars — something the agency has said it will deliver by year's end.

It's difficult to determine precisely how diffuse the use of these products is among mutual fund groups at this time. StarMine has about 400 clients, of which about half are mutual fund groups, according to the firm's spokeswoman.

First Coverage currently has 100 clients for the two facets of its product: First Coverage Buy-Side Edition

and its Sell-Side Edition. Cass declined to give the exact number of mutual fund groups using his firm's product but said their clients are a "very good mix" of hedge funds, mutual funds and pension funds.

And FactSet's Wiseman notes that the idea that only hedge funds use these products is a fallacy. The firm's products have a "fairly even distribution" of hedge funds clients as well as long-only managers, including top global mutual funds, he says.

Other companies that are marketing these types of products to mutual funds, and which have a number of mutual fund clients, are Tamale Software Inc., Code Red and Cogent.

"I think systems like these are healthy," says John Meserve, director of BNY ConvergEx Group, a brokerage and investment technology provider. "They help money managers understand why they pay what they do."

Meserve is a member of The Alliance in Support of Independent Research which recently sent a letter to SEC Chairman Christopher Cox urging him to reconsider his strong stance on soft dollars. (BNY ConvergEx Group entered into agreements last year with Code Red and Tamale Software which allow BNY Jaywalk, an independent equity research consultancy of The Bank of New York, to disseminate its research reports through Code Red and Tamale's software systems.)

One question of boards and advisors that are unfamiliar with these products is whether they actually generate profit. Cass says that First Coverage has seen that the sell side does add alpha with this system in place.

Marshall Wace, a UK hedge fund manager that may have been the first to develop a proprietary alpha capturing software system, has generated returns ranging from 16% to 28% per year, according to Financial News. The firm created its "Trade Optimised Portfolio System" about six years ago.

But one industry expert says he doesn't see much value in these products. "The insights don't come from the [broker] recommendation," says Wayne Wagner, an independent consultant operating under the name Om/ni and former president of Plexus Group, which provides best execution data, "but from the information underlying the recommendation — insightful information into the company's prospects."