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A Canadian on Wall Street

Calgary firm to supply independent research to U.S. brokerages' clients

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It took more than a year of slogging through introductory meetings, presentations and sales pitches, but independent research firm Ross Smith Energy Group Ltd. has earned a shot at winning over Wall Street investors.

Ross Smith, a Calgary-based firm specializing in the oil and gas sector, has secured contracts to supply research to the clients of four U.S. investment dealers: Bear Stearns & Co. Inc., Credit Suisse First Boston LLC, Lehman Brothers Inc. and UBS.

Allan Ross, chief executive of Ross Smith, started lobbying for the assignments after Eliot Spitzer punished 10 securities firms for hyping the stocks of investment banking clients in fawning research reports.

As part of the US$1.4-billion settlement in 2003, the investment dealers must provide independent research to clients for five years. The cost: US$432.5-million.

Ross Smith is the only Canadian research firm to come forward to say it has won a piece of this business so far. The Calgary firm also made final presentations to two other securities firms targeted by New York's relentless attorney general.

"It's turned out reasonably well for us. They've picked us as having a quality product, which to me is a tremendous endorsement," Mr. Ross said in an interview. "Our product now is getting great visibility amongst the clients of those firms." Ross Smith, founded in 1998, will offer research to both institutional and retail investors.

By targeting Wall Street, Ross Smith is trying to make the jump from being a well-regarded boutique research shop into one of the top-tier providers of independent analysis. It's a move that may one day pay off. Venture capitalists and other investors are currently acquiring stakes in independent firms, betting that investment dealers will increasingly outsource research -- or even eliminate their research departments to cut costs. The beneficiaries of this pullback might be reputable independents with the ability to provide broad research coverage.

"We want to position ourselves with a good product," Mr. Ross said. "I call it 'collateral benefits.'"

"I don't know what the collateral benefits will be, but I know if we're there, if we have a very good brand and people have gotten to know us, then good things will happen."

To some, Mr. Spitzer's mission to separate research from investment banking is helping independent firms build some traction with investors. Despite the uproar over tainted sell-side research, however, many independent shops are still struggling.

Whether an independent firm flies or dies depends on securing business from pension funds, mutual funds and other institutional investors with big research budgets. Most independents lack the size or profile to earn more than an ambivalent shrug from top money managers.

"It's almost like a tipping point. You need to have a certain number of clients that gives your brand recognition and credibility," Mr. Ross said.

But so far, success in independent research has been elusive for many players. To satisfy institutional investors, for example, firms must cover a wide range of companies, which is often prohibitively expensive. It might sound obvious, but research providers have to offer insightful commentary to differentiate themselves from the rest of the Street. That isn't easy, but being different, not just independent, is crucial.

Similarly, it's difficult to get face time with institutional investors, who are constantly solicited by analysts. If all you have is good intentions but no money-making ideas, you're doomed.

Perhaps the most significant barrier is the way research firms are paid. Clients might pay cash for research, but they're often reluctant to add expensive subscription fees to their research budgets. Alternatively, they might direct a portion of trading commissions to research firms, known as soft dollars. But some clients are leery of soft dollars, given the increased regulatory scrutiny of these payments. Some research firms have resorted to charging companies for coverage. Others are asking clients for their votes when their firms decide how to allocate annual payments for research.

"You must have tremendous patience," Mr. Ross said. "Although you might have the best product in the world, people will not buy it right away. It might take years before you actually connect with an account, so you've got have staying power."

For each company Ross Smith covers for the U.S. dealers, it is paid $4,000 to $8,000 a year. At the moment, it researches about 100 companies, but it is adding to its coverage list.

The real value of the contracts, according to Mr. Ross, is exposure to the clients of these U.S. banks. In the next five years, the firm will have a chance to prove its expertise worth to a long list of U.S. investors. That could spur more business after the bank deals lapse.

"The benefit is that if we continue to produce a quality product, we'll have that flow of revenue for five years. However, it's what happens at the end of five years that intrigues us the most," Mr. Ross said.

It is hard to determine exactly what will happen when the banks' commitment to independent research expires.

Maybe they will dump independent shops and rely exclusively on their own research. The bulge-bracket firms aren't independent, but their prejudices and conflicts are dutifully disclosed in pages of fine print and disclaimers, they could argue.

But it looks like the market is reaching a turning point. The long-overdue split between investment banking and research has exposed the heavy cost of analysis. Research has never made money, nor was it expected to. Analysts were paid to cultivate investment banking business. Now that analysts have been cut out of the loop, their paycheques, while still rich, are falling.

All the while, there are still questions about whether there's actually a definitive separation between research and investment banking in most brokerages. Officially, analyst pay should not be linked to investment-banking volume in their respective sectors. But behind closed doors, negotiations over analyst compensation are still often based on this metric.

It's a sticky situation for brokerages. In five years, perhaps investment dealers will have abandoned research to focus solely on investment banking. And by that time, institutional investors might be far more enamored with independent research.

"Our view is that research should be done outside the investment banking environment," said

Michael Palmer, president of Veritas Investment Research Corp. in Toronto, another growing independent investment research firm. "We think the business is going to develop that way."

Mr. Ross is well aware of the difficulties faced by many independents. But given his company's steady expansion to 25 analysts and its opportunity to crack the U.S. market, he's confident that the shop will thrive as independent research evolves from a cottage industry into a mainstream business.

"From our point our view, I don't mind people talking about how tough the market is," he said. "We're growing everyday."