

# The financial analyst of the future: it's not all about data!

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## INTRODUCTION

The Belgian economic newspaper De Tijd recently published an extensive article (2019) on how alternative data are being used more and more by analysts to develop a more detailed recommendation on a listed stock. A recommendation that stands out from the rest, as alternative data like satellite images and surveys are being used to provide that unique extra insight. This article signals a trend that is becoming more visible; the way to conduct financial analysis of companies is changing – and it's changing fast.

In the last two decades, the way companies disclose their results generally has undergone an intense process of computerization initiated by the field of accounting, with the use of management systems such as Enterprise Resource Planning (ERP) systems and Customer Relationship Management (CRM) systems. On top of that, data can be tracked about any side-effects on their business. When Nike launches new shoes, the number of credit card transactions in its stores thereafter says something about the success of the launch. When it's a hot summer, the number

of visitors to ice cream stores says something about the revenue development for ice cream producers. These are just 2 examples of how alternative data can provide additional information.

Next to these technological developments, the financial analysis industry has been facing a number of regulatory developments in recent years as well. MiFID II is the latest example and has had the biggest regulatory impact. Analysts in Europe have to adapt to new circumstances, where unbundling of payment for order execution and equity research has led to fundamental discussions about the role of the analyst and the product offering of banks.

In this article some insights will be shared from the position of an Investor Relations Officer (IRO) of a publicly listed company on the role of analysts. As technological developments improve the access to financial market and more data becomes available, the role of analysts and IROs changes. Research shows (Exane BNP Paribas, 2018) that the number of direct engagements between IROs and asset managers is growing rapidly. Engage-

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ment that until recently was more directed towards analysts. In this article I will highlight regulatory- and technological developments in financial markets and how this affects the asset manager's point of view and what this means for analysts and IROs going forward.

### IMPACT OF REGULATION IS SIGNIFICANT ...

MiFID II was implemented in the member states of the EU in 2018 and this has had a big impact on the broker industry. MiFID II has not only had an impact on the commission income of brokers, but also it emphasizes the role technology plays in the ability to analyze and process data. Asset managers have developed their analytical skills in recent years, following the ever growing availability of data and technology to use that data. Following this development, asset managers are better able now than in the past to make their own investment decisions, based upon the models they run and the data they have access to. They no longer base their investment decisions only on analyst reports about companies or sectors.

The impact of MiFID II is visible when observing the analyst coverage universe. Between 2002 and 2017, the average coverage of stocks in the Numis Smaller Companies Index (which excludes companies which simply invest in other companies) rose from two analysts to almost six. A year into MiFID II, the average has dropped closer to five, which could imply something of a knowledge gap in the market (Numis, 2019). When speaking to other IROs, it is said that companies have tried to compensate by hiring more staff in investor relations, so that they can make pitches to investors directly. Some are retaining so-called "sponsored research" firms like Edison and Hardman, which produce research reports signed off by the Investor Relations department. Those reports can be distributed to investors of all kinds for free, without falling foul of MiFID II. Meanwhile, there are plenty of listed companies that have never really courted analyst coverage, on the basis that regular financial statements should give the market enough to go on.

The impact of MiFID II could become clearer in the years ahead. Anecdotal evidence suggests asset managers' research budgets could fall another 20 to 30 per cent, in addition to heavy cuts in the first year MiFID II was effective. That will probably make life more uncomfortable for the analysts – and, perhaps by extension, the companies they cover. For now, the only clear trend visible is that banks have put a price on their research and asset managers are paying it. Pretty much as the EU intended, i.e. bringing transparency on pricing of research.

### ... BUT IMPACT OF TECHNOLOGICAL DEVELOPMENTS IS BIGGER

At a financial symposium (Morgan Stanley, 2018) that took place in London, *The Economist's* Kenneth Cukier talked about big data and its impact on the financial industry. The room was populated with IROs and financial experts, and the first question he asked the audience was: "Who thinks algorithms can replace what you are doing?"

Of course nobody rose their hand – including myself. After all, how does an algorithm determine the interest of an investor? There is still a great deal of interpretation and interaction with a company needed before an investor makes a decision and executes an investment strategy that will bring him the best returns. Right?

Mr. Cukier elaborated on the impact big data had on NASCAR as now information about tracks, temperatures and compound of tires can be deciding factors in the outcome of races. Not only are the aerodynamics of the car important, but also the right tires! Data about tire erosion, combined with data about the different types of pavement and temperatures, provide new insights in how to improve the performance of the cars by putting the car on tires with custom made rubber compounds. The outcome of this research changed the focus in the NASCAR competition dramatically. Data gathering was crucial for future success.

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### SO THE QUESTION IS, WHAT DOES THE FUTURE OF THE FINANCIAL ANALYST LOOK LIKE. WILL ANALYSTS CONTINUE TO BE ABLE TO ADD VALUE TO THE INVESTMENT COMMUNITY?

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According to Mr. Cukier, next to Adam Smith's (1776) assumptions of division of labour, productivity and free markets (Wealth of Nations), data is the new pillar for today's economies. It is the new raw material from which information can be derived and information or data today is a product.

By collecting data, combining analysis techniques and programming machines to learn from interactions, machines can nowadays actually spot certain patterns better and sooner than humans, he argued. For example, early stage cancer developments can be found quicker using specific technologies. The analysis of big data can provide more insights than humans could ever generate alone. This brings us back to the question Mr. Cukier asked at the beginning.

Having pondered this in the context of our changing environment, the importance of big data has grown tremendously in the financial industry.

### AI IMPORTANCE GROWS BUT NOT EVERYTHING IS AI-ELIGIBLE

As an IRO, I am confronted with the importance of processing data every day. Processing big data to be able to provide the best price in financial products for trading is key to the business model of the company I work for. The competitive trading environment in which we operate, demands a state-of-the-art applications and algorithms to safeguard that this firm remains

at the forefront of liquidity provisioning in financial markets. The use of self-learning applications is growing rapidly there.

That trend has an impact on all parts of the financial industry. Brokers face regulatory pressure on commissions for their research and on commissions for their execution services, following the implementation of MiFID II. Asset managers at the same time can improve their abilities to interpret data, which leads to a better analysis of companies so that they can identify investment opportunities better than others. That means that for analysts, buy- and sell-side, there is a need to handle big data.

Bearing in mind this discussion, it is my opinion that not everything can be attained by an algorithm currently, such as the trust of an investor, belief in management and belief in the company. The fact that side-effects on the business (Nike launches new shoes – credit card transactions, weather-ice creams) suggests change in momentum, does not necessarily say something about the long term growth potential of a firm. Alignment between asset managers and the company depends on whether asset managers agree that the future growth strategies as presented, will add value to the business proposition. That part will not be replaced by technology as easily as it requires more interpretation to assure alignment. Interpretation that for now can only be given by interactions between specialists and management.

As asset managers cannot do everything themselves, there will always be a need for analysts with a qualitative assessment and judgment to support investors in constructing and maintaining a view on the market and on companies. Analysts are after all considered to be industry experts with good connections and an independent view.

### IMPORTANCE OF INTANGIBLES.... ESG

The importance of the impact of softer aspects also shows in the annual CEO letter, sent by BlackRock and State Street Global Investors to investors. Every year Mr. Fink of BlackRock and Mr. Taraporevala of State Street send a letter to investors in which they highlight their focus points and share their views on financial markets. This year, the letters reminded everybody about the importance of “intangibles”, specifically mentioning the importance of Environment, Sustainability and Governance (ESG). Interesting to note here that when one starts looking for a format in which ESG can be addressed and what it means, one will find out that currently there is no clear format or outlined framework to address ESG. According to market research (BlackRock, 2018) there are 37 (!) ESG initiatives within the EU, all aiming to become the industry standard on ESG. It is therefore fair to assume that it will still take some time before any standard is agreed upon – and hence expert interpretation will be of added value.

Whether ESG is something that should be seen as a new topic for companies to focus on or as “good business practice anyway” is a valid question here. The answer to that question seems to be

that ESG is not a goal, rather it is another way to increase engagement and understanding with those investors that seek further insight. The ESG principles force companies to stay critical about their purpose, their mission and their interaction with the outside world. For a company to avoid a low ESG-score, it needs to show what its contribution to society is and whether this is done in a sustainable way – and report about it! It is not a tick-the-box exercise.

This means that ESG is something corporates will have to respond to individually in the foreseeable future. IROs and analysts play an important role here. They align internal- and external views and exchange information in order to improve mutual understanding. Annual reports, ESG-related investment funds and indices, and integrated reporting are all examples that highlight the increasing impact of ESG standards.

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## THE INDUSTRY CANNOT GO WITHOUT DATA ANYMORE

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Of course this is just one example, but it underlines how the roles of Investor Relations and analysts are changing. IROs of public- and private companies are the first point-of-contact for asset managers and other external stakeholders with a corporate. As asset managers are now increasingly able to run their own models, they seek more direct interaction with companies through IROs, instead of through analysts. The interaction with analysts is not disappearing, but it less often the primary source of information for an increasing number of asset managers following the impact of MiFID II. Market data increasingly is. Market data enables asset managers to take a better view on the valuation of a company as it provides further information on trends and developments.

That development also affects the appetite of asset managers to see companies in roadshows or conferences. Asset managers have become much pickier when it relates to attending conferences and participating in roadshows – as these services now are charged separately. Due to the unbundling of research under MiFID II, investors need to pay for all services offered by the brokers. Those services are all no longer included in the commission paid for the execution of the orders. As a result, the direct outreach to companies has increased strongly (research Exane BNP Paribas (2018)) as investors seek more clarity on the interpretation of data and on market trend developments in their models through talking directly to the company instead of to the analyst.

### CHANGES IMPACT ANALYSTS ... AND IROS

Looking back at all that has been discussed, the thesis whether analysts can continue to add value in the future depends upon their ability to process more data as well as to widen their view. The market environment is changing fast and analysts need to

seek ways to use the available information in a better way. One of those changes is the frequency of interactions with IROs.

#### WHAT IS CHANGING FOR THE ANALYST:

As discussed before, it is important for analysts to understand the impact of “intangibles” on the valuation of the company to understand the investment cases. Analysts need to widen their view beyond the analysis of company results alone. Matters like social impact, sustainability, regulation, diversification, industry trends impact business principles within companies. Asset managers pay more attention to these subjects in their analysis now.

It would seem unlikely that recommendations from analysts on companies without human interaction (for example through AI only) will become the standard in the foreseeable future. Analysis through the use of AI has of course improved understanding with asset managers already, but currently it does not yet provide a complete explanation for all that affects the financial performance of the company. Analysts can fill in that gap and make sure they are well connected with the IRO to obtain this information.

That said, keep in mind that the rise of passive investing also weighs on the analyst community.

This suggests that the analyst of the future is an analyst that advises on investments through the use of a model for the hard data, adapted for the use of algorithms, combined with an impact analysis of the “intangibles” on valuation.

#### WHAT IS CHANGING FOR THE IRO:

The changing environment also has an impact on the way IROs operate. The IRO is becoming an increasingly visible contact point for asset managers, for analysts and internally for the Management Board to discuss the topics raised by shareholders and analysts. As asset managers reach out to companies more directly, IROs need to assure clear communication about the data and (market) trends.

When clear communication is missing, it may lead to less investor focus or an incorrect view on an investment case. That could mean a missed opportunity for asset managers and companies – asset managers may miss a great opportunity to invest in a value proposition and companies may miss an investor that supports them in the execution of their long term growth strategy. That underlines the importance of the way the role of the IRO is changing – also in the light of the role the analyst plays in this universe.

#### CONCLUSION

Analysts will continue to be of added value if they can adapt to the changing demands from asset managers and other stakeholders, fueled by the technological developments like AI. The ability to interpret alternative data is an important factor in that consideration. Analysts need to expand their focus and use more and “better” qualitative and quantitative data available about the company, the sector and related sectors and re-shape their models accordingly. The IRO can support this process of weighting the information as well as the quality of the data into the process qualitative development, by providing insights and explanations. So the interaction with companies may for analysts prove to be as important as the interaction with investors to ultimately have a strong view on the investment case. That may perhaps sound logical, but from my experience analysts still have got a long enough road ahead to achieve this.

#### Literature list

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