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## THE LONG TAIL OF INVESTMENT RESEARCH

*How Economic Forces are Reshaping the Research Industry*

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## Introduction

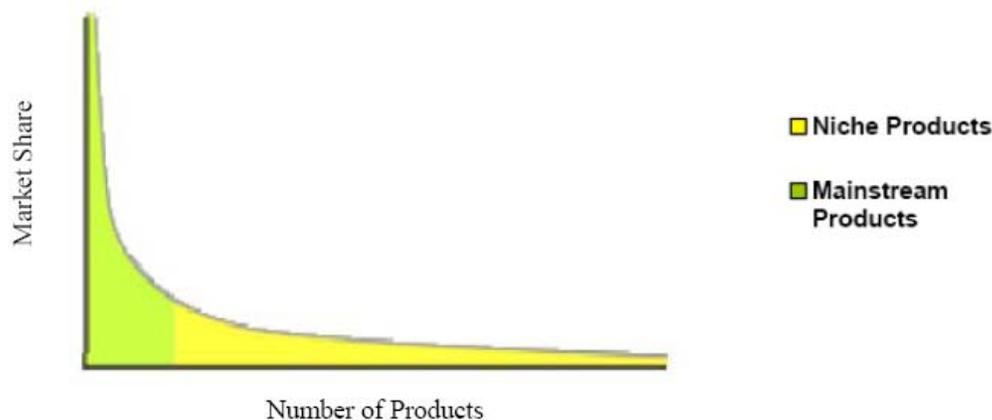
In 2004, Chris Anderson popularized a new theory about the nature of markets in the information age. According to Anderson, innovations in distribution, pricing and marketing are transforming many industries, shifting demand from mainstream products and services to smaller market niches. This theory, which came to be known as the "long tail," has widely been used to explain recent developments in content industries like music, books and movies.

In this paper, we look at the investment research industry through the lens of long-tail economics. Does the research industry follow the patterns of other long-tail industries? While there are many indications that the demand curve for research is shifting, the research industry still lacks several of the qualities of classic long-tail industries.

### ***Long Tail Economics—Revenge of the Nerds***

Published in 2006, Chris Anderson's *The Long Tail* posits a new economics which shifts demand—and consequently revenues and profits—from mainstream products and services to smaller market niches.

The chart below is a graphical representation of a typical long tail demand curve. While a small number of mainstream products have a large portion of overall market share, the long tail of niche products can be cumulatively as large a market presence as mainstream products—or larger.



In *The Long Tail*, Anderson argues that three forces are driving the long-tail phenomenon: democratized tools of production, improved distribution, and filters that make it easier to connect supply and demand. Democratized tools of production expand the number and diversity of producers. Democratized distribution makes it easier to access the proliferated supply. Filters connect supply and demand by giving recommendations and guidance.

#### *What is a Long Tail?*

*The long tail* is the colloquial name for a long-known feature of statistical distributions (Zipf, Power laws, Pareto distributions and/or general Lévy distributions ). The feature is also known as "heavy tails," "power-law tails," or "Pareto tails." In these distributions a high-frequency or high-amplitude population is followed by a low-frequency or low-amplitude population which gradually "tails off." In many cases the infrequent or low-amplitude events can *cumulatively* outnumber or outweigh the initial portion of the graph, such that in aggregate they comprise the majority.

Such distributions are surprisingly common. For example in standard English, the word "the" is the most common word and other short words such as "of," "is," and "have" are also quite common. These common words are vastly more common than most other words. For example, about 12% of all words in a given text are "the," while "barracks" occurs in less than 1 out of 60,000 words, but cumulatively, words roughly as rare as "barracks" make up about a third of all text. These rare words are the long tail in English vocabulary.

Critics of *The Long Tail* argue that Pareto's Law—the so-called 80/20 rule, i.e. 80% of products accounts for 20% of revenues—is alive and well. Anderson acknowledges that this rule can still be applied to most industries, but argues that the shape of the curve is flattening. Demand is moving away from mainstream products, especially in content industries. Companies like Amazon, eBay, Netflix, iTunes are facilitating (and capitalizing on) the long tail phenomenon. These companies are making it easier to find and purchase obscure products that previously would have required an obsessive amount of effort to hunt down.

The following sections will apply *Long Tail* insights to the research industry to see how well they fit. To what extent do the long-tail forces of democratized production, improved distribution, and filters apply to the research marketplace?

### ***Long Tail Production***

Democratized tools of production expand the number and diversity of producers. The best example is the personal computer, which has put everything from printing presses to music studios in the hands of anyone. Effectively, these tools lower the barriers to entry, lengthening the tail of available goods.

Does this apply to the equity research industry? Certainly, the barriers to entry have gotten lower over time. The PC makes it easier for analysts to produce investment research. Edgar and other online databases facilitate access to financial information. Reg FD levels the management access playing field. Quantitative research firms have lower costs to develop and maintain proprietary models. Outsourcing firms like Irevna or Amba have helped to reduce costs for firms at both the head and tail.

<b><i>Force</i></b>	<b><i>Business</i></b>	<b><i>General Examples</i></b>	<b><i>Research Examples</i></b>
<b><i>Democratize Production</i></b>	Long Tail Toolmakers, producers	Digital cameras, desktop music editing, blogging tools	Edgar, Desktop publishing, Outsourcing firms
<b><i>Democratize Distribution</i></b>	Long Tail Aggregators	Amazon, eBay, iTunes, Netflix	Soleil, Jaywalk, Instinet, Citigroup, Pulse Trading
<b><i>Connect Supply and Demand</i></b>	Long Tail Filters	Google, blogs, Rhapsody recommendations, Best seller lists	Investars, Starmine, Integrity Research

### ***Long Tail Distribution***

The second long-tail force is democratized distribution, which makes it easier to access the proliferated supply. The internet is the classic example of this force, having dramatically lowered the costs of reaching consumers. Examples of companies have successfully leveraged the internet to exploit long tail economics include Amazon, eBay, iTunes and Netflix.

In the research industry, the proliferation of research aggregation platforms in recent years has helped democratize distribution. Because equity research comes in many forms that are not easily deliverable over the web (analyst access, management access, etc), however, the internet is not as effective a distribution medium for equity research as it is for books or music. Nevertheless, distribution platforms like BNY Convergex's Jaywalk, Soleil (which is also a research provider in its own right), Instinet and

Citigroup are all developing different approaches to the distribution challenge, while new players like Pulse Trading are providing turnkey trading and access to sales traders.

The advent of new payment mechanisms—notably Commission Sharing Agreements, or CSAs—are also democratizing distribution in the research industry. CSAs, which separate the cost of research and trade execution services, provide investors with easy access a broad array of research products. As regulatory trends and market conditions create greater demand for commission unbundling, CSAs are likely to grow in popularity and further democratize research distribution.

### *The Fire Hose of Research*

Despite the development of innovative new research aggregation platforms, there is no equity research equivalent to Google or Amazon that can help find the research you want and purchase it. Wait a minute, you say. What about First Call (Thomson), Bloomberg, or Reuters? While all are strong distribution channels for research, they are currently being undermined by changes in the research marketplace.

Most existing distribution platforms were built to reflect the original “fire hose” distribution model of Wall Street research. In the days when research was heavily subsidized by investment banking, the major sell-side firms had an incentive to blast out as much research as possible. This model has changed since the Global Research Settlement, which decoupled investment banking and research operations and raised the cost-structure of sell-side research. Since the Settlement, Wall Street has been reevaluating how it distributes research. Sell-side research firms are now looking for ways to control who gets research and how.

The current research distribution systems—including First Call, Bloomberg and Reuters—are designed to broadcast research. These systems are well suited to the old Wall Street business model, but not to the emerging one. Making them work in an unbundled world will be a big re-engineering task, almost as difficult as asking TV stations to customize their content. The research industry still has a long way to go in terms of distribution democratization.

### *Microchunking Research*

As the buy side gets increasingly frustrated with sipping from the fire hose, many companies have been developing innovative new solutions to the challenge of sifting through research offerings. In recent years, a host of companies have developed Research Management Systems, which are designed to help manage the fire hose. Tamale, Code Red, First Coverage and Starmine's new StarBox product all try to bring order to the research flowing into inboxes and voicemails. Marshall Wace's TOPS system tracks the performance of the trading ideas coming across the transom. FactSet's AlphaMetrics and Bloomberg offer similar capabilities for tracking the performance of best ideas.

The advent of Research Management Systems is an example of what Anderson calls “microchunking”. The trend is to separate content into its component parts (“microchunks”) so that customers can use it the way they want, or mix it with other content to create something new. As the various RMS approaches tag and categorize the various research microchunks, the opportunity arises to create new aggregation platforms for research similar to what Rhapsody is trying to do for music.

### ***Filters: Connecting Supply and Demand on the Long Tail***

The final long-tail force connects supply and demand by giving recommendations and guidance. Chris Anderson uses the term filter for the technologies and services that sift through vast array of choices to present you with the ones that are most right for you. Examples would be Google's “wisdom-of-crowds” search methodology and Amazon recommendations, along with “word of mouth” sources like blogs and customer reviews. There are many varieties of filters:

- ◆ multi-level taxonomies (classification systems)
- ◆ pattern matching ("other people who bought this also bought that")
- ◆ bestseller lists and editor recommendations
- ◆ collaborative filtering (other people's play lists or tagging)
- ◆ sampling

In the research market, there still are not many effective filters to help connect supply with demand on the long tail. The dynamics of the research market don't easily support a "wisdom of crowds" approach. Institutional investors have neither the time nor the incentives to share their insights and opinions. However, there are some filters out there, such as the II and WSJ rankings, our colleagues at Investars, Starmine, or Integrity Research itself.

Currently, sampling is the most commonly used filtering mechanism in the research market. Research providers typically set up investors with limited trial periods or participate in the broker vote process. Unfortunately, sampling is an inefficient way to find new research. For investors, it is hit or miss, much like the child's game of battleships—many frustrating misses before getting a hit.

*What do you mean by good?*

Part of the reason why there are few effective filters in the research industry is that there is no standard definition of "good" research. One person's good can be another person's bad.

<b>"High Quality"</b>	<b>"Low Quality"</b>
<b>Relevant to my specialty</b>	Not relevant
<b>Actionable</b>	Not actionable
<b>Fresh</b>	I know that already
<b>Insightful</b>	Noise
<b>Makes me more productive</b>	Wastes my time
<b>Limited distribution/unique</b>	Widely disseminated
<b>Generates profitable trade</b>	Generates unprofitable trade

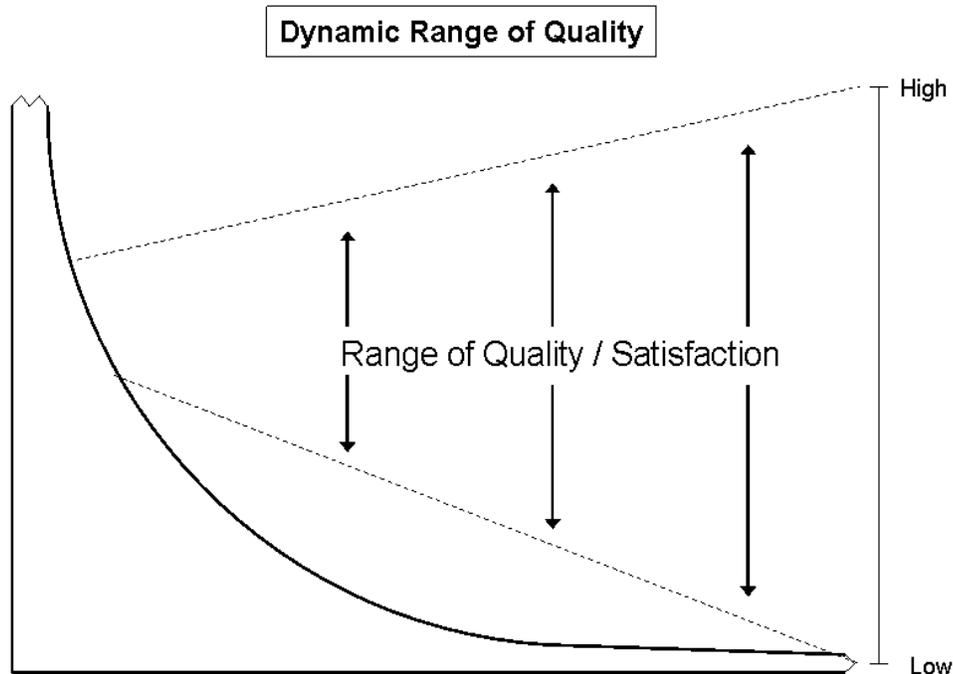
As Lisa Shallett of Sanford Bernstein points out, the quality of research depends in large part on what the user already knows. It also depends on what type of investor the user is, their investment style and approach, their job function, how they are compensated, and so on. In other words, defining good research as an absolute measure is difficult if not impossible since it varies dramatically by the investor using it.

*Dynamic range of quality*

Filters are especially important in the research industry because there is a wide dynamic range of quality on the long tail. The further out the tail you go, the more likely you are to find narrowly targeted goods that fit your exact needs—as well as narrowly targeted goods that are not at all appropriate for your purposes. In the *Long Tail*, Anderson provides a concise explanation for this characteristic of the long tail:

*"If a producer creates something to be absolutely right for one audience it will, by definition, be wrong for another. The compromises necessary to make something appeal to everyone mean that it will almost certainly not appeal perfectly to anyone—that's why they call it the lowest common denominator."*

The chart below provides a graphical representation of how the dynamic range of quality can widen as you move further out along the tail:



Source: Chris Anderson, *The Long Tail*

Long Tails have a wide dynamic range of quality: awful to great. By contrast, the average store shelf has a relatively narrow dynamic range of quality: mostly average to good. Tails have a wide dynamic range and heads have a narrow dynamic range. Can the same be said for research? Probably. Street research is good quality, but generally you had to look in the tail to find the people who called Enron or WorldCom. Research has the added dimension of scarcity value—that is, an insight that is not widely disseminated is valued more highly than if it were broadly disseminated.

### ***Research Economics: Down the Rabbit Hole***

The previous sections have shown that the long tail in the research industry is expanding. New production mechanisms, distribution platforms and filters are allowing boutique research providers to find markets for their products and services. However, these new capabilities are not the only forces at work in the research marketplace. Changing market conditions are also having a powerful impact on the shape of the demand curve in the research industry.

The most significant force currently affecting the research marketplace is the trend towards unbundling. In recent years, regulators in both the UK and the US have been developing incentives for traditional soft dollar brokers to offer more explicit research pricing. Now, many of the major bulge firms are aggressively promoting unbundled research services like Commission Sharing Agreements (CSAs), which allow investors to direct soft dollar commissions to a wider range of research providers than ever before. As payment mechanisms like CSAs make research pricing more explicit, investors are asking themselves how to value that research.

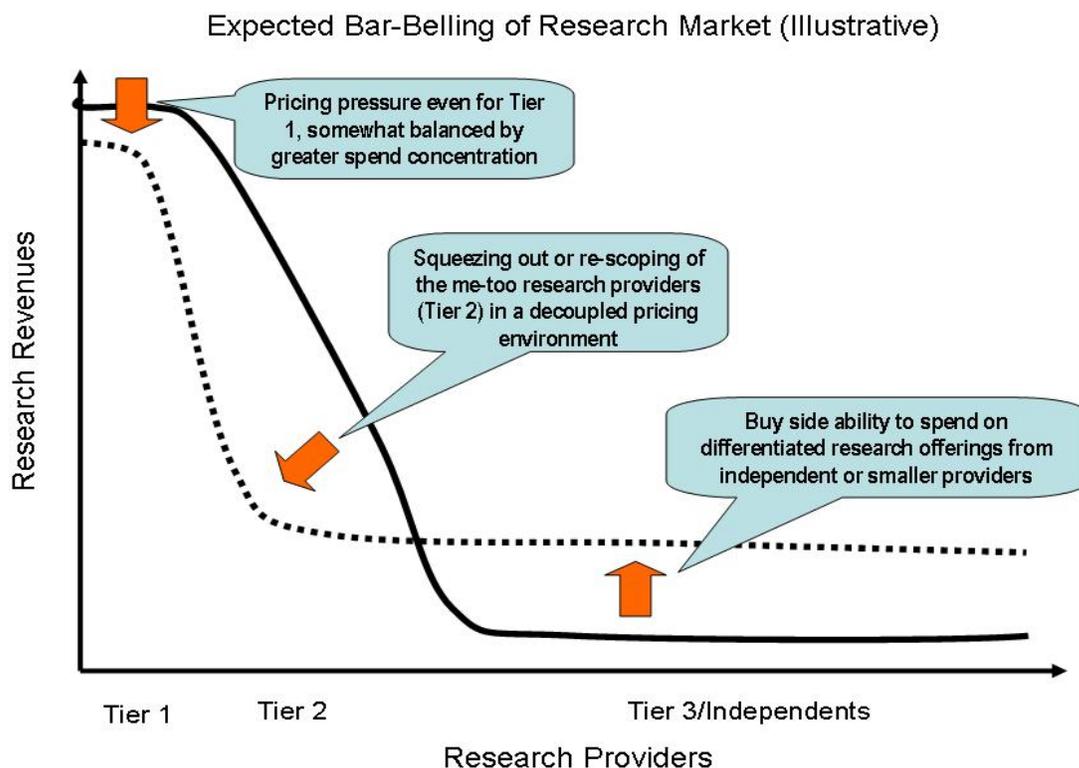
Many companies are developing services to help investors do so. Research Management Systems, such as First Coverage, Tamale, and Code Red are organizing and tagging research inputs, helping the buy side organize and value external research. Starmine's Starbox organizes and tracks research at the report level. Alpha networks, such as those offered by FactSet, Bloomberg and pioneered by Marshall

Wace, track and measure the performance of “best ideas” research. AQ Research is prototyping an auction process for valuing research. We at Integrity Research are busy cataloguing and data-basing research providers. Individual endeavors may not be successful, but collectively these, and additional efforts, will bring greater clarity to research market.

### Head, torso and tail

Although there are signs that the long tail is expanding, the 80/20 rule is still very much in force in the research market. The latest Greenwich Associates survey has 51% of U.S. equity commissions going to the top five brokers, and that concentration has been increasing. CSAs are also concentrating the trading relationships among the top 5 to 15 securities firms. So far, CSAs have not helped broaden research spend, especially for those that total over \$20 million (where three quarters of the spending stays with the broker to pay for execution and proprietary research). For the broader set of CSAs, the portion going to third party research is larger—46%—but still not large enough to lengthen significantly the long tail of research.

In the short run, CSAs will put the greatest strain on the “torso” of research—the 2<sup>nd</sup> and 3<sup>rd</sup> tier sell side firms who will now be paid through CSA agreements rather than direct trading relationships. The immediate blow is that they lose execution revenues, which under CSAs get diverted to the bulge firms that can execute trades more efficiently. Less immediate but ultimately more challenging, they lose contact with the buy side traders and must rely on the buy side analysts and PMs for their allocations. If they don’t have a strong research product, torso firms will see further revenue declines as analysts and PMs send their votes to stronger research providers. This is why Booz Allen anticipates a “bar-belling” of research:



Booz Allen Hamilton's recent study of the research market suggests that the research market will become more bar-belled in the future, as a decoupled pricing environment pressures second tier research providers while benefiting smaller “tail” providers.

### Headaches

What about the head? At the moment, momentum favors the bulge firms. They are gaining market share on the trading side. Will they also gain market share on the research side? CSAs give them advantages—control of the relationship, knowledge of the pricing for all the research being purchased through the CSA, relationships with the trading side.

However, bulge research has the most to lose. The increased transparency cuts both ways—it quantifies for bulge firms exactly what revenues are attributable to their proprietary research, or, more precisely, exactly how much money they are losing on proprietary research. It also quantifies for the first time the cost of bulge research for the buy side. Is bulge research two or three orders of magnitude better than non-bulge research? This is a question buy side firms will ask themselves. If and when the information gets out to the clients of the buy side firms, the questions get more urgent.

### *Wagging the tail*

The tail of research has little to lose and much to gain. As the research market gets more transparent, as research develops a more coherent pricing mechanism, and as the buy side improves its research procurement process, tail providers are well positioned. These providers generally have low costs of production and more explicit pricing. The research tail is amazingly diverse, incorporating fundamental boutiques, expert networks, channel checkers, forensics and earnings quality, economics shops, even ex-CIA spooks. The research tail as a wide dynamic range of quality, and, importantly, can match any definition of “good research” you can devise.

The challenge is finding it. This is a challenge that many are taking on, including BNY Convergex’s Jaywalk, ResearchWave, and Integrity Research itself. More importantly, as research becomes a separate good, a distinct item which is no longer provided “free” as part of a larger equity relationship, the buy side will become more proactive. The shopping cart replaces the fire hose.

### *Profiting from the niches*

One of Anderson's key points is that the tail (niches) can be more profitable than the head (mainstream products). Relative to distributors of mainstream fare, distributors of long tail products have low inventory costs. Moreover, long tail products can have a high value, as they are narrowly targeted to fit perfectly the needs of their customer base.

In *The Long Tail*, Anderson cites the DVD industry as an example where long tail distribution can be highly profitable. In the DVD industry, the acquisition price charged by the studios varies over time. It is higher for new releases (between \$17 and \$19) than for DVDs which have been in circulation for over two years (\$6). The gross margin on the newest releases is very low, even negative for the first month, whereas the margin for older titles approaches 50%. Blockbuster, which has limited shelf space, focuses on the new releases, whereas Netflix allows users to access more esoteric fare. Approximately 90% of Blockbuster's in-store rentals are new releases, whereas 70% of Netflix's rentals are back catalog, giving Netflix a huge advantage in its cost of product acquisition.

As with the DVD industry, it is possible to profit highly from long tail distribution in the research industry. In recent years, expert networks and other primary research companies have been particularly successful in profiting off of niche products. Instead of offering widely usable products and services, many expert networks and other primary researchers have built a business model of providing narrowly targeted information on demand. And like Amazon’s Marketplace program, primary research providers have low production costs.

Given the profitability of distribution niche research, it is no surprise that bulge firms are trying to get in on the action. As commission sharing agreements (CSAs) become more widespread, bulge bracket firms are distributing more third party research than ever before. In many cases, it is more profitable for them to distribute the third party research than their own research because the marginal acquisition costs are zero.

## ***Conclusion: The Lengthening of the Tail***

So, do we have a long tail phenomenon going on in investment research? On the production side, we certainly have the long tail, at least in the U.S., and the tail is growing in Europe and Asia. Barriers to entry are low and have been getting lower. There are hundreds of research providers—Integrity Research tracks over 450 research firms but there are at least as many additional research providers out there. What we don't have are the strong distribution platforms necessary to shift demand towards the tail. We also don't have effective filtering mechanisms to connect supply with demand in the research industry.

There are many indications, however, that this is changing. CSAs, alpha networks, research management systems are providing the filters and distribution mechanisms necessary for making the long tail viable. It is only a matter of time before research pricing becomes more transparent and market mechanisms enhance the demand for niche research. These changes will have a profound impact on the research landscape, weeding out the weaker research offerings on all segments of the demand curve—head, torso and tail.

Equally important is the fact that research is being “microchunked” into component pieces, which are increasingly getting tagged and measured by research management systems and other long tail filters. Expert networks are leading this trend by bringing hundreds of thousands of industry experts into the investment research industry, effectively providing the buy side with highly specialized insights for highly specific purposes. Channel checkers and forensic researchers are doing much the same. So, while the *price* of sell side research getting unbundled, *the research itself* is also getting unbundled. And, as research breaks into its component pieces, the long tail gets even longer. Ultimately, the buy side will want only those micro-chunks that are relevant to them, and will filter out everything else. At that point we will have exactly what Chris Anderson describes.

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