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Trends in the Global Capital Markets Industry 2013: Buy-Side Firms

Key emerging trends across buy-side firms and their implications for the global capital markets industry

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1. Highlights

The global economy grew at a lackluster pace in 2013 and barely registered any growth over the previous year. The global economy showed signs of recovery: a still-shaky but notable improvement in the Eurozone; an aggressive shift away from deflation in Japan, stable growth in China, and growing momentum in the U.S. and U.K. economies. However, risks continue to encompass the global economy.

Improving outlook, stabilized valuations, and positive sentiment led to strong performance of equity markets worldwide, with significant gains witnessed in the developed markets. Global equity market capitalization grew by 17.0% during 2013 to $59.8 trillion.[1] Rising bond yields and widening credit spreads due to Federal Reserve's decision to begin tapering resulted in highest interest in bonds. Commodities continued to perform poorly due to disappointing growth in the emerging markets, as well as a reduction in the demand-supply gap.

Collective assets under management (AUM) of the global buy-side industry[2] as at the end of 2012 stood at $64.0 trillion. AUM of pension funds and hedge funds rose by 8.2% and 0.4% to reach $29.8 trillion[3] and $2.25 trillion[4], respectively.

Against the backdrop of a tough operating environment, asset managers are increasingly focusing on client communication, interaction, and engagement for client acquisition and retention purposes. As a result, firms are increasing their presence on social media tools and investing in development of mobile applications as part of their marketing strategy to enhance brand awareness and deliver an enriching experience.

Regulatory initiatives such as the Dodd Frank and European Market Infrastructure Regulation (EMIR) mandate that over-the-counter (OTC) derivatives be cleared by central clearing counterparties (CCPs). This requires buy-side firms to post collateral of a high quality nature to CCPs and it is expected to result in a collateral burden for the buy-side industry. Consequently, firms are implementing advanced collateral management systems for efficient optimization in the use of collateral held worldwide.

1 World Federation of Exchanges

2 Market size for buy-side industry includes only the collective AUM of mutual funds, pension funds (for top 13 nations), sovereign funds and hedge funds for our analysis

3 Global Pension Assets Study 2012, Towers Watson

4 Hedge Fund Research, January 2013

2. Introduction

2.1. Global Capital Markets Players[5]

Global capital markets players can be broadly classified into three core categories:

- **Buy-Side Firms:** Private equity, mutual funds, hedge funds, pension funds, unit trusts, and proprietary trading firms
- **Sell-Side Firms:** Investment banks, brokerage houses, and independent analysts
- **Financial Intermediaries:** Stock exchanges, clearing houses, and custodian banks

This paper reviews and summarizes the key trends prevalent across buy-side firms and the implications for these firms and global capital markets.

2.2. Global Capital Markets Performance

2013 turned out to be a year marked by improved global financial conditions and reduced systemic risk on the back of new policy initiatives by the government and central banks. These steps helped in stabilizing the consumer, business, and investor confidence.

Equity markets were given a significant boost in 2013 as the Federal Reserve committed to keep interest rates closer to zero, while announcing its decision to start tapering its quantitative easing program effective January 2014. Equity markets rallied in 2012 due to attractive valuations, tamed global inflation and accommodative monetary policies by many central banks, and broadening recovery.

Global equity market capitalization grew by 17.0% in 2013 (January to December) to reach $59.8 trillion, beating the peak of $51.1 trillion attained in 2010 after the financial crisis of 2008.[6] The World Federation of Exchanges (WFE) also reported that the Americas was the best-performing region, witnessing a growth of 22.0% in market capitalization to $28.3 trillion in 2013 (January to December). This increase was driven by improved investor sentiment, and announcement of the tapering of quantitative easing by the Federal Reserve.

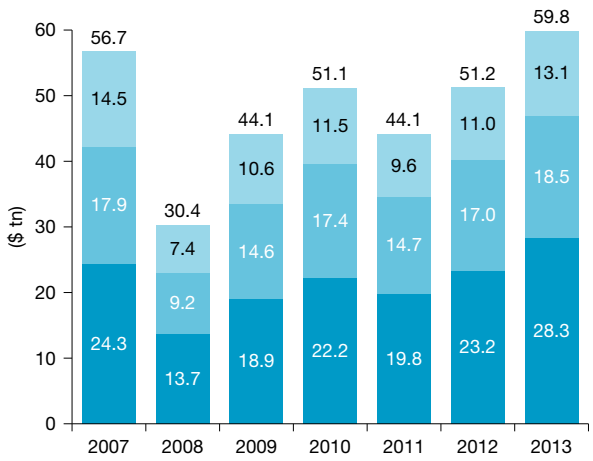
Europe, the Middle East, and Africa (EMEA) was the next best performing region in 2013, according to the WFE, with market capitalization growing by 19.0% to $13.1 trillion. European equity markets rose on account of lower valuations of European stocks compared to U.S. stocks, the control of inflation, and supportive monetary policies by central banks.

Asia-Pacific's equity market capitalization growth was the least among all regions in 2013 (January to December) according to the WFE, growing at 8.8% to $18.5 trillion, which compares with a higher growth of 15.8% witnessed in 2012. Performance of equity markets was particularly stronger in Japan and Taiwan with market capitalization increasing by ~30%. Market capitalization of the emerging economies of Indonesia and India fell due to higher inflation and current account deficit, political instability, and the tapering of stimulus by the Federal Reserve.

5 Wealth management and private banking are covered in a separate paper within our *What You Need to Know series*

6 2013 WFE Market Highlights, World Federation of Exchanges, September 2013

Exhibit 1: Global Equity Market Capitalization ($ trillion), 2007–13



	CAGR 2007-'11	Growth 2011-'12	Growth 2012-'13
Total	**(6.1%)**	**16.0%**	**17.0%**
Europe Middle East & Africa (EMEA)	(9.7%)	14.0%	19.0%
Asia-Pacific	(4.9%)	15.8%	8.8%
Americas	(5.0%)	17.2%	22.0%

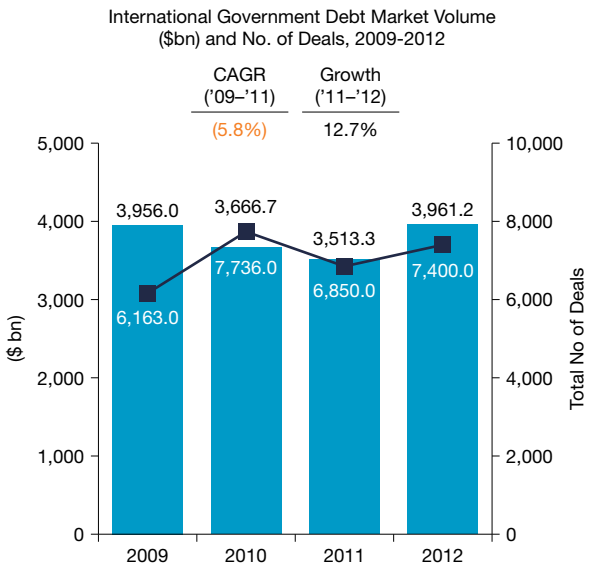
Source: World Federation of Exchanges, 2013

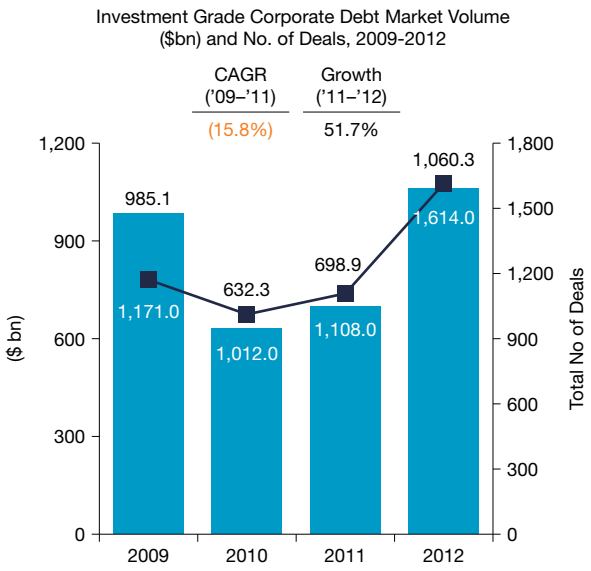
International debt market volumes grew by 12.7% to $3,961.2 billion from 2011 levels primarily due to the lower interest rates prevailing across major economies.[7] Euro-denominated central government debt market volume rose by 26.4% to $107.8 billion from 2011 levels. International debt market volume and Euro-denominated central government debt market volume for the first nine months of 2013 stood at $3,054.3 billion and $149.9 billion, respectively, according to the ICMA third quarter 2013 report. In Europe, the European Central Bank's promise to buy back bonds of troubled nations in the event of a default, the objective of shoring up the banking system, and the intention to address the large budget deficits were some of the reasons for the increase in debt volumes.

The ICMA third quarter 2013 market report also revealed that the volume of high-yield corporate bonds grew 28.7% during 2012 to $355.3 billion from 2011 levels and volumes of investment grade corporate bonds increased by 51.7% to $1,060.3 billion during the same period. International corporate high-yield debt volume and international investment grade corporate bond volume for the first nine months of 2013 stood at $322.4 billion and $812.4 billion, respectively, as per the ICMA report. With the availability of bank financing shrinking due to ongoing deleveraging efforts and tightened regulatory requirements, companies are tapping debt markets for their needs. Increased investor interest for higher yields in the light of a lower interest rate environment and stronger corporate balance sheets has also resulted in higher volumes.

7 International Capital Market Association: Market Data third quarter 2013, International Capital Market Association

Exhibit 2: International Debt and Investment Grade Corporate Debt, Market Volume ($ billion) and Number of Deals, 2009–2012





Source: Market Data 3rd Quarter 2013, International Capital Market Association

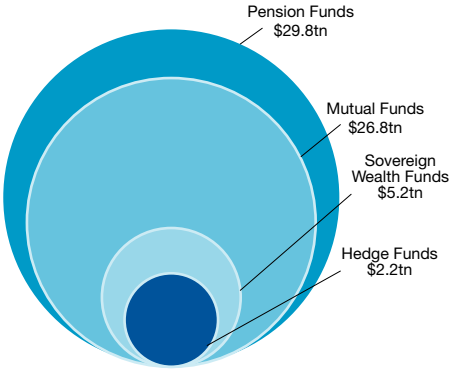
Commodity prices strengthened in early 2013 due to improved global economic outlook, but retreated later, going below 2012 levels due to improved supply conditions. Oil prices, after hovering around $105 in Q1 2013 (marked by geopolitical tensions in the Middle East), dropped below $100 in Q2 2013 due to improvement in supply and easing of tension in the Euro region. Metals, which witnessed a price decline in 2012, continued their downfall in 2013 due to an increase in supply and the slowing down of the real estate sector in China. Compared to 2011, commodities fared better in 2012, but continued to struggle due to fluctuating demand from emerging economies.

3. Emerging Trends in Global Capital Markets: Buy-Side

While world gross domestic product (GDP) decelerated further in 2012, albeit at a slower rate, due to continued economic challenges emanating from the Eurozone, global economy stabilized driven by lower financial volatility, accommodating monetary policies by major central banks, and gradual recovery in Europe.

In addition to improving economic fundamentals and reduced global risk, strong earnings announcements by corporations and cheap valuations also had a positive impact on the buy-side industry in terms of higher market performance and new inflows. The market size of the global buy-side industry stood at $64.0 trillion as of December 2012, an increase of ~10% from 2011 levels.[8]

Exhibit 3: Buy-Side Market Analysis – Major Participants as of December 2012



Source: Capgemini Analysis, 2013

The pension fund industry witnessed an increased growth rate during 2012, with collective pension assets of the 13 largest pension markets increasing by 8.9% to reach $29.8 trillion (compared to 3.9% growth in 2011).[9] The U.S. continued to remain the largest pension fund market with pension assets totaling $16.1 trillion (roughly 107% of its 2012 GDP), according to the Towers Watson Global Pension Assets Study 2012.

8 Based on an aggregate of AUMs held by pension funds, mutual funds, sovereign wealth funds, and hedge funds (Other buy-side participants like private equity and VC funds are excluded for this analysis)

9 Global Pension Assets Study 2012, Towers Watson

The U.S. pension funds have been increasing their allocations to alternative investments, mainly driven by a shortfall in returns due to the continuing lower level of interest rates. Public pension funds in the U.S. have been steadily increasing their exposure to hedge funds in order to increase their portfolio returns, meet actuarial return assumptions, and reduce unfunded liability.

With the rate of deceleration slowing down and hopes of widespread recovery gaining traction, global mutual funds increased by 12.4% in 2012 to $26.8 trillion compared to a drop in 2011.[10] The Investment Company Institute's Worldwide Mutual Fund Data, Third Quarter 2013 report also indicated that mutual fund assets at the end of Q3 2013 stood at $28.9 trillion, and the U.S. market remained the most important constituent of the global mutual fund industry with an AUM of more than $14.0 trillion.

Sovereign wealth funds assets stood at $5.2 trillion as of the end of December 2012 and are expected to reach $5.6 trillion by the end of 2013, driven by increased foreign exchange reserves and commodity demand owing to a recovery in the global economy and growth in demand from emerging markets.[11] The hedge fund industry increased from $2.25 trillion in 2012[12] to reach $2.51 trillion at the end of September 2013 on the back of performance-based gains and new inflows.[13]

The emerging trends in the buy-side industry globally include:

1. Increasing adoption of mobile apps by buy-side firms to enhance brand awareness and client experience.
2. Increased initial margin requirement due to new regulations leading to collateral optimization strategies by buy-side firms.

10 Worldwide Mutual Fund Data, Third Quarter 2013, Investment Company Institute

11 Sovereign Wealth Funds, TheCityUK

12 Asia hedge fund capital growth accelerates as Abenomics creates opportunity, Hedge Fund Research, October 2013

13 Hedge Fund Research, January 2013

4. Trend 1: Increasing Adoption of Mobile Apps and Social Media by Buy-Side Firms

4.1. Background and Key Drivers

Against the backdrop of volatile markets, asset management firms are witnessing increased competition, heightened regulatory scrutiny, and growing customer demands for more information and greater transparency. Client communication, interaction, and engagement have become critical to all asset managers for client acquisition and retention. As a result, over the past couple of years, firms are increasing their presence on social media (Twitter and Facebook), and investing in the development of mobile applications to improve consistency and quality of information access, reporting, presentation, and communication.

The key drivers for increasing presence of buy-side firms on social media and usage of mobile applications are:

- According to Celent, "Financial services firms are also seeing increased demand for internal apps from their employees. After cutting back on firm-supplied device programs, many financial firms have launched Bring Your Own Device (BYOD) programs that enable their employees to access corporate systems through their personal devices".
- Increasing usage of digital tools can also be primarily attributed to the strong and increasing growth in smartphone and tablet usage numbers and the preference of customers to communicate via these channels.
- Firms are increasing their presence on social media and developing customized mobile applications to deliver a rich and dynamic experience to clients.
- Increasing preference for real-time tracking/monitoring of portfolios, transactions, news, and events by investors and fund managers is resulting in increased development of mobile applications.
- Firms are increasing their presence on social media tools to enhance brand awareness and protect brand reputation.
- Skyrocketing adoption rates of smartphones and tablets, increasing presence of clients on social media platforms, and the advancement in technology on a day-to-day basis makes it imperative for firms to be actively present on social media platforms and continuously invest in development of robust applications. Worldwide shipments of tablets and smartphones are estimated to grow at a CAGR of 44.4% and 26.0% during the period 2012 – 2014 to reach 117 million and 1,120 million, respectively.[14]
- Firms are also adopting and investing in mobile applications for retention of existing clients, prospecting new clients, and providing increased engagement.

14 North American SnAppshot 2013, Celent, April 2013

4.2. Analysis

Asset management firms globally have been facing a tough operating environment after the financial crisis in terms of generating returns, increasing regulations, tarnished reputation, slowdown in revenues, and higher operational costs. Driven by disappointing returns, there has been intense pressure from investors to reduce management fees. Price wars were witnessed in the last two years between firms to boost market share. Considering the tough times ahead, it is imperative for asset managers to increase their AUM and enhance client servicing in parallel to remain competitive in the market. As a result, firms are increasing their presence on social media tools as a part of their marketing strategy and investing in development of applications to enhance brand awareness, retain existing clients, and attract new ones.

Investment managers are using social media to promote and protect brand reputation, and communicate with existing and potential clients. Asset managers use social media to provide a range of information, including videos from portfolio experts, product and service offerings, and new product launches. This also correlates with the objective of clients and prospects to receive information to self-educate themselves about investing and markets. For example, Fidelity Personal Investing, which launched its presence on Google+ and LinkedIn recently, shares information on markets, investment perspectives, charitable events it sponsors, and products via social media channels.

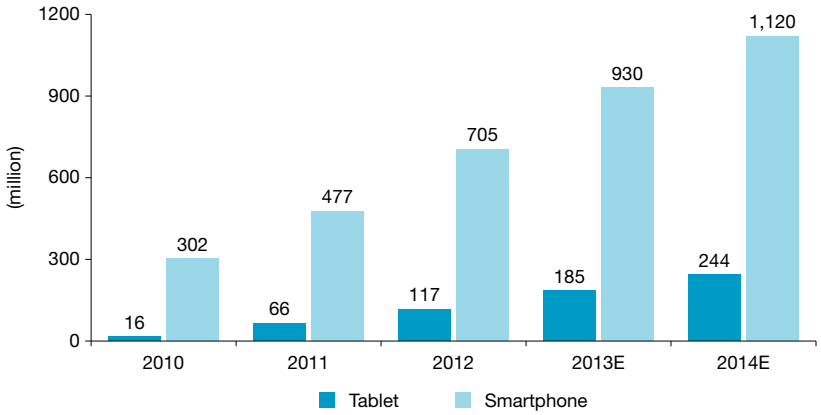
However, the usage of social media by asset management firms varies across regions. In a recent survey[15] among 90 asset managers, 50% of the firms in the U.S. cited that social media is a key element of marketing strategy compared to only 10% in the case of European asset managers. The survey also reveals that usage of social media by Asian managers was low, with 40% of those surveyed in Asia not being present on social media at all.

Firms are also turning to mobile and tablet applications to deliver a compelling experience to clients and employees. These applications are helping portfolio managers to track portfolios on a real-time basis. This tracking goes beyond profit and loss measurement, with some advanced applications allowing tracking portfolios across multiple dimensions, such as strategy, industry, country, and manager. For example, in October 2013, Northern Trust launched a new iPad application (complementing its mobile application Passport), which enables its institutional clients to access portfolio data, account exposure by country and asset class, market summaries, and video commentaries.

With the rapid proliferation of smartphone and tablet usage, tech-savvy investors are also expecting a richer and more dynamic experience through applications on their mobile devices. Investors are interested in accessing research on their applications in addition to tracking their portfolios on a real-time basis. Also, heightened uncertainty post-financial crisis has resulted in investors and fund managers to be updated on an anytime- anywhere basis.

15 "Asset managers embrace #social media marketing", Financial News, June 2013

Exhibit 4: Worldwide Smartphone and Tablet Shipment Estimates, 2010–14E



Source: North American SnAppshot 2013; Capital Markets and Wealth Management, Bill Fearnley, Jr., 25 April 2013

4.3. Implications

The need for capital market firms to be active on social media tools and develop mobile applications for investors and employees has significant business and technological implications. With investors becoming increasingly tech savvy and smartphone shipments estimated to grow at a faster pace in future, asset managers need to be present on social media and have mobile apps to communicate and engage with their clients on these channels. Buy-side firms could take advantage of social media and mobile applications to gain competitive advantage and garner additional business.

On the technology front, firms need to develop robust applications that go beyond offering basic research and offer multimedia content, such as videos and podcasts. As specialized skills are required to develop these applications, firms may also need to engage external consultants for mobile application development projects.

Due to the existence of multiple operating systems, firms need to use mobile application development platforms. This will significantly help in the reduction of costs as they can be deployed over multiple operating systems and brands. Also, firms need to keep continuously investing in new technologies and release new applications or enhance existing ones to retain competitive advantage and meet the changing needs of the clients.

5. Trend 2: Initial Margin Requirement Due to New Regulations Leading to Collateral Optimization & Transformation Strategies by Buy-Side Firms

5.1. Background and Key Drivers

Managing counterparty risk has emerged as one of the top challenges for buy-side firms after the global financial crisis. While the crisis resulted in increased scrutiny of the financial services industry in general, the OTC derivatives market received the greatest focus. As a result, with an objective to reduce the systemic risk and implement transparency, regulators in the U.S. and Europe started a number of regulatory initiatives governing OTC derivatives in the last couple of years. Under the new regulations that are expected to be implemented in phases, first of which are likely to be in 2014, buy-side firms are likely to face increased initial margin requirements, forcing them to adopt collateral[16] optimization strategies.

The key drivers for implementation of collateral optimization strategies are:

- Regulations proposed by the U.S. and European regulatory authorities to reduce systemic risk, improve transparency in the movement of collateral, and protect funds of institutions and clients. For example, effective 2014, Dodd Frank and EMIR require that OTC derivatives be cleared by CCPs, and this would require firms to post collateral.
- Large buy-side firms with operations across multiple geographies and asset classes need to deal with multiple CCPs, thus requiring them to put the collateral at their disposal for optimal use.
- CCPs require high-quality collateral, which includes cash and government bonds, resulting in a high cost of collateral.
- Firms are also adopting collateral optimization strategies for effective deployment of collateral across CCPs/clearing brokers and to better manage counterparty risk during the process.

5.2. Analysis

Collateral management, which was once an ancillary function for buy-side firms, has entered the mainstream after the global financial crisis and is now being considered as a significant part of the regulatory compliance framework. This can be primarily attributed to regulations such as Dodd Frank and EMIR, which require standardized OTC derivatives to be cleared by CCPs and non-centrally cleared derivative contracts be subject to higher initial margin requirements. Under the new clearing requirements, firms need to post high-quality collateral to clearing agencies and this challenge could be further aggravated as the BASEL III norms kick in. According to various industry studies, collateral burden, as a result of the Dodd-Frank and EMIR regulations is likely to be between $500 billion and $6 trillion[17] globally, making the sourcing of collateral a high-priority issue for the industry. With high-grade collateral availability getting scarce and costlier in the current market, buy-side firms are engaging in collateral optimization strategies in order to make effective use of available collateral across the enterprise.

16 Collateral refers to liquid securities that are provided against the possibility of payment default by the opposing party in a trade

17 "FSOC downplays collateral shortfall fears", *Financial News*, April 2013

Historically, buy-side firms have been optimizing collateral manually using Excel spreadsheets or outdated legacy systems. However, due to trading across multiple asset classes and geographies and dealing with multiple CCPs, buy-side firms need to have an advanced solution. Consequently, buy-side firms are implementing advanced collateral management systems that allow building a firm-wide view of collateral balances, and thus help in identifying excess collateral placed with brokers/ clearing houses that could be pulled back appropriately. In addition, advanced collateral management systems also help in improving stress testing capabilities, so that the buy-side firm can predict the collateral requirements based on multiple scenarios, thereby enhancing their risk management capabilities.

5.3. Implications

As a result of the financial crisis and collapse of some big buy-side firms, the OTC landscape is going to evolve significantly, including the emergence of CCPs. This move toward central clearing is likely to result in a shortage of quality collateral and increase the demand for it. While larger buy-side firms may be able to navigate through these challenges easily, small and mid-scale firms are likely to face the real burden in terms of getting access to eligible collateral at reasonable levels. Therefore, buy-side firms need to move away from using manual methodologies and adopt technologies that enable effective and optimum allocation of collateral at a firm-wide level.

Though collateral management is primarily part of a cost center, its effective deployment can add to the bottom line of the firms, and this is especially true for small and mid-sized firms. Buy-side firms with smaller OTC volumes can consolidate their transactions with a single clearing house (which has an excellent credit rating) and thereby manage credit risk. This will help in getting the maximum netting benefits possible and decrease the effective cost of collateral. However, large buy-side firms, in order to strike a balance between netting benefits and counterparty risk diversification need to work with multiple clearing houses.

From a technology perspective, buy-side firms need to have collateral management systems that can be seamlessly integrated with other applications including order management systems, trading systems, risk management systems and multiple data vendor feeds. Buy-side firms that rely on securities financing (repo and securities lending) for their trading, could replace multiple legacy collateral management systems with a single, unified solution for the benefit of standardization. Buy-side firms also need to have collateral management systems that enable analytics, forecasting, inventory management, and stress testing on a real-time basis.

6. Additional Trends

In addition to the previous trends, those covered in Capgemini's *What You Need to Know: Capital Markets 2012* are still relevant as described below.

6.1. Demand for Low Latency is Driving Changes in the Data Center Architecture

Latency associated with the execution of a trade has cost implications for traders. Higher latency might result in the trade being executed at a less- than-optimal price, thereby resulting in the cost of execution going up. Therefore, there is a natural desire among firms for systems that can help them execute their orders with the lowest possible latency.

The current capital markets landscape is no longer dominated by monopolistic national stock exchanges where liquidity used to be concentrated earlier. A series of regulatory measures aimed at increasing competition among trading venues, most notably allowing Alternative Trading Systems in the U.S. and Multilateral Trading Facilities in Europe, have contributed to this. The fragmentation of liquidity, which resulted from the proliferation of trading venues has resulted in the evolution of market arbitrage strategies that in turn require infrastructure capable of carrying out real-time data analysis for identifying the venue where trades should be carried out to get the best price execution.

Traditionally, buy-side firms used to route their orders to their sell-side brokers, who in turn executed them on the exchanges on their behalf. However, this process was time consuming and did not provide the low latency that buy-side firms needed to exploit the arbitrage opportunities existing between different venues. Consequently, there has been an increased migration of buy-side firms to the direct-market access route, where they use their broker's membership for trading directly on the exchanges.

6.2. Product Design and Pricing of Order Management Systems Is Getting Overhauled Due to Changing Market Dynamics

Due to subdued growth opportunities in the mature markets of North America and Europe, many buy-side firms are expanding their operations through emerging financial centers in Asia-Pacific. The growing need for a global-level service offering by clients is driving Order Management System (OMS) solution vendors to build their capabilities within these emerging financial centers.

Additionally, firms that have been traditionally operating on a single-asset trading platform are demanding multi-asset platforms. The sluggish business environment, on the other hand, has also led to clients demanding an array of value-added services at lower costs due to budget constraints.

Post-financial crisis, the regulatory landscape around the world has evolved significantly with the objective of overcoming earlier shortcomings and preventing future crises. Complying with all the regulations and standards is expected to be even tougher as they keep getting updated on an ongoing basis. These developments have created a need for OMS enhancements.

The OMS vendor market has become increasingly competitive over the years with request for quotes by a potential client often attracting quotes from multiple vendors. The competitive nature of bidding and an increasingly demanding nature of the clientele have led to vendors coming out with comprehensive solution packages with multiple functionalities.

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