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WHAT YOU NEED TO KNOW
CAPITAL MARKETS

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

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

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Contents

1 Highlights

In 2010, recovery in global capital markets was supported by increases in equity market capitalization, government bonds outstanding, and foreign investments. Helped by these industry trends, buy-side firms' global assets under management (AUM) reached $56.4 trillion in 2010, surpassing 2007 levels[1].

However, the regional picture highlights some strong differences, as emerging markets in Latin America and Asia-Pacific were the major contributors for this growth. Though the global buy-side industry's profitability increased as firms kept operating costs low in 2010, the fear of economic slowdown in 2011 has resurfaced (especially in the Euro area) and equity market capitalizations have been extremely volatile. The on-going market volatility is therefore expected to have a significant negative impact on global buy-side firms in the short term, and potentially the medium term.

Despite strong market performance in 2009 and 2010, investors (both individual and institutional) remained wary of certain asset classes such as European equity products, and increased their demands for transparency and customized solutions. The overall product landscape continued to change, with focus shifting towards emerging market equity-based products and core government bonds. Also, with moderate or even poor growth prospects in developed markets, buy-side firms are focusing on expansion into high-growth emerging markets such as Asia-Pacific and Latin America.

Trading venues in Asia-Pacific (such as Singapore, Shanghai, and Hong Kong) have gained prominence in the global financial markets and are attracting more firms and capital to the region. With the emergence of new financial centers, connectivity issues with the new exchanges have made firms focus on new technology such as smart order routing.

Following the onset of the financial crisis, the role of regulation has also increased and put enhanced pressure on firms to raise minimum required capital, increase transparency, and manage risk more efficiently. As a result, buy-side firms are focusing on developing comprehensive enterprise-level risk management systems to comply with new regulatory reforms and increase their operational efficiency.

All the above factors, along with increase in competition and pricing pressures, are reshaping the buy-side industry. Firms will have to respond through a mix of innovation, consolidation, and operational efficiency drives.

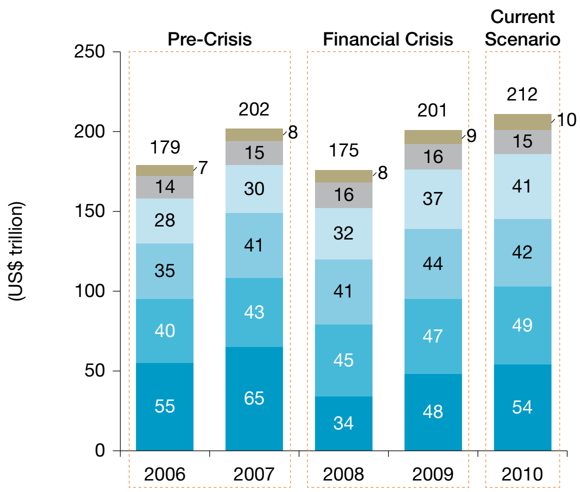
[1] Global AUM recovered further in 2010, Business & Economy, 04/08/2011

2 Introduction

2.1. Global Capital Markets Performance

After the severe financial crisis of 2008 and 2009, global capital markets have resumed growth. The global financial stock (debt and equity outstanding) grew by $11 trillion in 2010 to reach $212 trillion, which was above the 2007 peak level. The increase in the global financial stock was partly due to the recovery of global equity markets in 2009 and 2010, and largely due to growth in government debt securities (the latter is 14.6% above the 2007 levels while equities are still 17% below the level of 2007). Cross-border capital rose for the first time since the financial crisis in 2010, but still remains below the 2007 level.

Exhibit 1: Global Financial Stock (US$ trillion), 2006–2010



	CAGR 2006-'09	Growth 2009-'10
Total	**3.9%**	**5.6%**
Non-financial Corporate Bonds	8.7%	9.7%
Securitized Loans	4.6%	(5.6%)
Public Debt Securities	9.7%	11.9%
Financial Institution Bonds	7.9%	(3.3%)
Non-Securitized Loans	5.5%	5.9%
Equity Market Capitalization	(4.4%)	11.8%

Source: Capgemini analysis, 2011; Bank for International Settlements Statistics, 2006-2010

However, the recovery in global capital markets has been unevenly distributed across geographies. Developed markets such as North America, Western Europe, and Japan were the major absolute contributors to growth in the global financial stock with a market capitalization of $6.6 trillion. Growth in emerging markets (up 13.5%) was much faster than in mature markets (up only 3.9%), and speaks to a shift in the global capital markets.

At the local market level, China contributed $2.1 trillion to the growth of the emerging market financial stock which was up $4.4 trillion in 2010[2], mainly due to an increase in equity valuations and lending. Global debt outstanding grew by approximately $5 trillion in 2010, with government bonds rising by $4 trillion. While corporate bonds grew, bonds issued by financial institutions declined in 2010 mainly due to low investor confidence.

[2] Bank for International Settlements Statistics, 2010

Globally, investors continued to diversify their portfolios geographically, with global foreign investments increasing to an all-time high of $96 trillion in 2010. Increased cross-border lending, debt issuance, and foreign reserves fuelled the growth in foreign investments; with foreign direct investments also attaining a new high of $21 trillion in 2010[3].

With the focus of investors and investment firms shifting to high growth emerging markets, global imbalances have increased further. For example, most developed economies are now net debtors, with their debt funded by emerging markets. Emerging markets, with high growth potential and rising income levels, have become the new centers for raising capital.

Going forward, the growth in the capital markets of emerging countries will likely remain strong as their long-term fundamentals look solid. However, global uncertainty and volatility have the potential to affect all markets and are key risk factors for the industry over the next few years.

2.2. Global Capital Markets Players[4]

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

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

This paper explores key trends prevalent across buy-side firms and their implications on these firms and the global capital markets industry.

[3] International Monetary Fund Statistics, 2010
[4] Wealth management and private banking are covered in a separate paper within our *What You Need to Know* series

3 Emerging Trends in Global Capital Markets: Buy-Side

With improvements in economic and market conditions, buy-side firms' assets under management increased from $52.4 trillion in 2009 to $56.4 trillion in 2010[5]. Operating margins of buy-side firms improved for the first time after recession as operating costs decreased in 2010. However, changing investor demands, increasing competition, stagnating demand in developed markets, and a toughening regulatory environment have posed a new set of challenges for buy-side firms.

Investor preferences have evolved (largely driven by extreme market volatility) and investors are skeptical about investing in certain asset classes such as mutual funds. The regulatory landscape has strengthened significantly, with government in many markets at various stages of implementing much more stringent rules—such as minimum capital requirements—putting pressure on firms to raise capital. In addition, the current environment of low mature market interest rates, high inflation levels, and increased global market volatility is expected to put extra pressure on the overall performance of buy-side firms.

These changes have led to the emergence of the following key trends for buy-side firms globally[6]:

1. The landscape of investment products is evolving due to increasing pressure from shareholders and changing investor demands.
2. Buy-side firms continue to focus on developing internal Enterprise Risk Management (ERM) systems.
3. An increased focus on operational efficiencies is driving investments in automating trading platforms, reducing latency, and enhancing data analytics capabilities.
4. Buy-side firms are expanding their operations in high-growth emerging markets.

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[5] Global AUM recovered further in 2010, Business & Economy, 04/08/2011
[6] Trends shown are not necessarily comprehensive, but have been highlighted due to their relevance and potential impact on the industry

4 Trend 1: Landscape of Investment Products is Evolving Due to Increased Pressure from Shareholders and Changing Investor Demands

4.1. Background and Key Drivers

The financial crisis led investors to more closely analyze how their investments are managed and understand their asset managers' investment philosophy, as well as to more actively seek transparency in their investment products and solutions. Investors are now questioning the wisdom of investing in many traditional products, which some believe may not achieve desired results in the current macroeconomic environment.

With non-traditional products often outperforming traditional products in the current volatile markets, investors' product preferences continue to shift. Non-traditional products such as exchange traded funds (ETFs) and liability-driven investments (LDI) have become attractive to investors due to their relatively stronger performance in the current uncertain economic scenario.

New regulations are also making certain product classes unattractive for investors. For example, in Europe, Solvency II legislation has proposed a 39% capital charge on equity investments and 29% on real estate investments, but no charge on government bonds.

The key drivers supporting the evolving changes across the product landscape are:

- Institutional investors are now seeking customized solutions and quality research. They are also questioning the performance benchmarks for traditional products such as fixed income in the current economic scenario.
- Private investors are looking for an effective balance of risk and rewards in their investment solutions as the market environment remains uncertain and volatile.
- Many investors experienced significant wealth erosion during the financial crisis, and still lack trust and confidence in traditional products such as mutual funds.
- Investors' objectives are also changing with new regulatory changes and the current low interest rate environment (especially in mature markets) which makes it difficult to realize desired returns if they continue to invest in traditional investment asset classes.
- Investors are also influenced by the relatively strong performance of non-traditional products such as ETFs, which are gaining popularity over traditional products.

4.2. Analysis

A shift in product preferences began even before the crisis started, with the financial crisis acting as a catalyst for the changes in investor preferences. Actively managed products such as equity and fixed income generally account for the majority of total global AUM and are expected to remain so for over the short-to-medium term, but their share has been slowly declining.

Investments in passively managed products (such as ETFs) and alternative products (such as hedge funds, REITs, and private equity) are slowly gaining ground and are expected to grow at a higher rate than traditional actively managed products.

Around actively managed products, the focus has been shifting towards fixed-income and emerging market products. Both in the U.S. and Europe, growth has been strong in government bonds, emerging-market equity funds, and target-date funds. It is apparent from the current situation that the shift is towards customized solutions which take factors such as linkage with macroeconomic trends into consideration and have specific time frames. Even during the worst of the financial crisis, target-date funds[7] grew by 13% annually during 2007-2010 in the U.S.[8]. The UK government is also planning to make target-date funds the default investment option for the National Employment Savings Trust[9] pension scheme.

With investors raising doubt on the ability of active managers to outperform the market, passive investments have been gaining popularity due to strong performance even during the financial crisis (at least relative to other investment options). Passively managed products, such as ETFs, have shown strong growth in the US and Europe, with 2010 AUM growth at 26% and 25% in the two markets respectively[10]. It is expected ETFs will continue to grow in the future, especially as investors face persistent uncertainty.

Despite their poor performance during the financial crisis, alternative investments continue to interest investors, especially institutional investors—though concerns have been raised around their transparency and risk management. Despite these investor concerns, AUM under hedge funds surpassed the 2007 (~$1.9 trillion) level in 2010 (~$2 trillion), primarily because investors still believed that hedge funds present the most effective means to outperform the market.

4.3. Implications

Shifts in investor preferences around focus markets, products, and risk appetite will have significant implications on buy-side firms.

Investors now desire solutions which are specifically designed and customized according to their needs, putting extra pressure on asset managers to devise with solutions which have clearly defined outcomes based on the ever-changing macroeconomic scenario.

Pricing pressure is also expected to increase due to investor shifts. As passively managed and alternative products gain market share, it will automatically put more pressure on actively managed products to respond, either through showing an ability to achieve above-average returns or, more likely, reduce fees and prices. Leading buy-side players will probably be able to sustain this pressure, but small players will likely struggle due to their lack of scale.

Overall, shifts in investor preferences may lead to consolidation in the industry, with large buy-side firms looking to acquire niche players in order to gain scale and new capabilities.

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[7] A mutual fund in the hybrid category that automatically resets the asset mix (stocks, bonds, cash equivalents) in its portfolio according to a selected time frame that is appropriate for a particular investor
[8] Target-date fund popularity grows, PSCA says; Pensions & Investments, 11/10/2011
[9] It is a pension system for all workers in the United Kingdom that do not have access to a company pension provided by their employer
[10] ETF Landscape: Industry Review Year End 2010, Blackrock

5 Trend 2: Continued Focus on Developing Internal Enterprise Risk Management (ERM) Systems

Along with improving their risk management systems, buy-side firms should also focus on improving their data management systems to ensure data accuracy while calculating their risk exposure.

5.1. Background and Key Drivers

Buy-side firms have long had their own risk management systems, but most of these systems have not been as comprehensive or accurate as required. Many of these systems calculated risk based on a single parameter (such as value at risk[11]) and were overly rigid in their approach as most did not consider current macroeconomic conditions for analyzing the true risk levels. Another major concern with these systems was around using inaccurate data to underpin risk calculations.

The key drivers behind this enhanced focus of buy-side firms on developing internal ERM systems are:

- Investors are demanding proper risk management controls as they do not want their exposure to exceed the desired limit.
- Regulators recognize that inaccurate risk management systems add significantly to the operational risk of a firm.
- Regulators are emphasizing the importance of maintaining data quality and accuracy, as this data is fed to risk management systems for calculating risk exposure.
- Financial industry associations working on global data and transportation standards are also asking their member firms to develop internal enterprise risk management systems.
- The need to have an enterprise-level risk management system has risen from the fact that previously, each division in an enterprise had their own risk systems and many times these individual divisions would (in total) exceed the risk exposure approved at the enterprise-level.
- Significant technological improvements enable firms to have more effective enterprise-level risk management system.

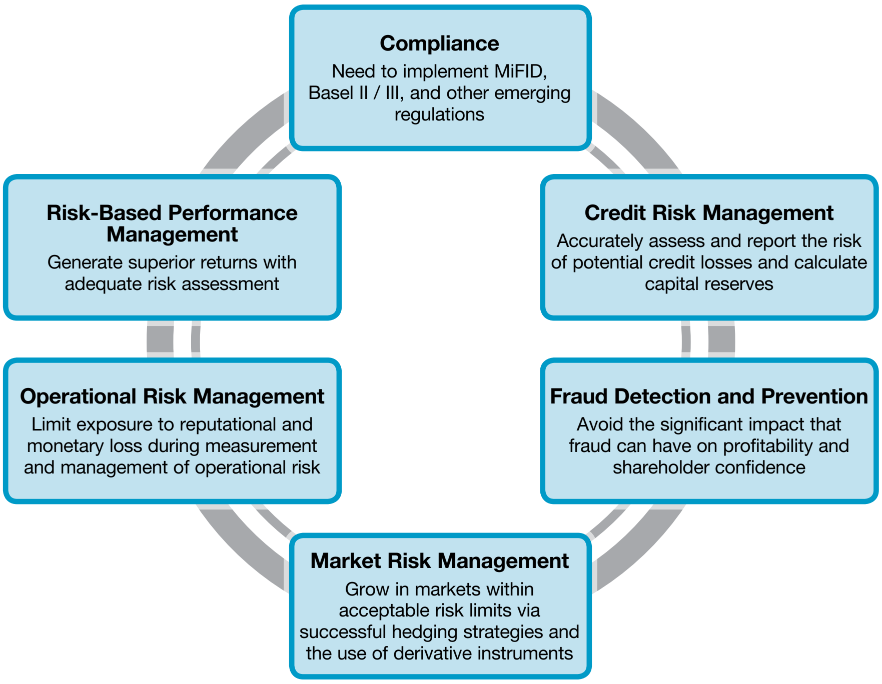
5.2. Analysis

After 2008, buy-side firms and regulators realized the importance of effective and comprehensive enterprise-level management of credit, market, and operational risks. Before the beginning of the financial crisis, buy-side firms focused on managing their credit and market risks in order to balance higher risk with the drive for higher returns, but these firms often saw no advantage for managing operational risks. Investors, for their part, permitted this behavior as long as they were receiving high returns on their investments.

However, the arrival and fall-out from the financial crisis highlighted the importance of also managing operational risks, as these risks not only pose a threat to individual firms but also to the entire global financial system. Regulators have pointed out that data quality problems are a major source of operational risk, recommending that firms maintain global data standards in order to identify and manage operational risks efficiently.

[11] A technique used to estimate the probability of portfolio losses based on the statistical analysis of historical price trends and volatilities

Exhibit 2: Enterprise Risk Management Framework



Source: Capgemini analysis, 2011; Enterprise Risk Management for Banking and Financial Services, SaaS, 2010

Firms have also realized the importance of managing risk, not only in each business unit but also at the enterprise-level. The view of risk management as only a compliance-driven activity as opposed to an active management tool is now changing, putting enterprise risk-management (ERM) at the forefront of most firms' agenda.

Enterprise risk management systems will not only help organizations understand various types of risks, but will also help management teams take better decisions based on proper data analysis.

5.3. Implications

For buy-side firms, the short-term implication of this focus on internal ERM systems will be an increase in technology spending at a time when capital requirements are being raised and margins are already constrained. However, in the long-term, buy-side firms who effectively implement these systems will be able to make more reliable business decisions, avoid dangerous risk, and demonstrate a competitive advantage to investors.

Firms will need to consider not only the building of overall risk systems, but also plans for upgrading and maintenance. In addition, risk management systems only go so far, so staff training and business process improvements that ensure risk management is firmly embedded in a firm's culture will also be critical.

6 Trend 3: Increased Investments in Automating Trading Platforms, Reducing Latency, and Enhancing Data Analytics Capabilities

6.1. Background and Key Drivers

With the resilience and expansion of global capital markets in emerging economies such as Asia-Pacific and Latin America, trading venues in these markets are gaining importance. For example, exchanges in Singapore, Hong Kong, and Shanghai have now become global trading centers to rival those in the U.S. and U.K., and the dollar value of IPOs issued in emerging markets ($152 billion) surpassed that of developed markets ($129 billion)[12] in 2010. Buy-side firms who are looking to trade through these exchanges will need to invest in upgrading their trading systems to accommodate the increase in trading volumes and to be scalable to new products. Similarly, increasing adoption of algorithmic and high frequency trading[13] strategies by several buy-side firms has also put pressure on buy-side firms to invest in automation of their trading platforms.

There are many drivers leading to increased investments in upgrading trading systems and communications technology by buy-side firms:

- Buy-side firms are enhancing their data analytics capabilities in order to improve their trading decision-making.
- With increased competition and still-depressed investor confidence in asset managers, buy-side firms are looking to enhance their trading systems to differentiate themselves from other players.
- The emergence of new trading venues in emerging markets is driving buy-side firms to enhance their trading systems in order to accommodate the increase in trading volumes and products.
- Buy-side firms are looking to automate their trading platforms and reduce latency to support algorithmic and high frequency trading strategies.
- Buy-side firms are enhancing their quantitative models to capture and exploit market inefficiencies.
- Buy-side firms are enhancing their systems in order to capture the increase in trading volumes resulting from the regulatory move to have over-the-counter (OTC) derivatives trading take place on exchanges and cleared through central clearing houses.

[12] Sovereign debt boom fuels record global financial stock value; Financial News, 28/07/2011
[13] High Frequency Trading involves highly quantitative computerized algorithms to analyze incoming market data and implement proprietary trading strategies

6.2. Analysis

The global capital markets are expanding to new high-growth emerging markets, resulting in the emergence of new trading venues, especially in the Asia-Pacific region. These venues are now competing with global financial centers in developed markets such as New York and London.

As a result, buy-side firms have been increasingly expanding their footprint in emerging trading venues. In order to capture the growth opportunities that these emerging markets provide, buy-side firms have been investing heavily to expand and improve their trading platforms. A connection to more global exchanges will result in a growth in transaction volumes and pricing data, requiring firms to possess greater data processing capacity.

Regulators are also considering moving OTC derivatives trading to exchanges, notably through the Dodd-Frank Act in the U.S. but also through similar regulation in other regions. These developments will increase the need for firms to have systems to better accommodate and manage large volumes of data, as for example, global OTC derivatives average monthly volumes increased by 17% in 2010[14]. Buy-side firms are taking these new developments into consideration when enhancing their data processing capabilities.

High frequency trading volumes have been increasing in the U.S. as well as in Europe and Asia-Pacific as a result of a strong adoption rate, especially among hedge funds. For high frequency and algorithmic trading, buy-side firms require up-to-date technology to achieve minimum possible latency and the automation of their existing trading platforms.

An increase in trading volumes has not only affected firms' front-office operations, but also has had significant implications on back-office applications. Buy-side firms are hence focusing on improving the efficiency of their back-office systems, along with making them more scalable to higher levels of transaction volumes.

6.3. Implications

Buy-side firms, while investing in improving their trading platforms and data analytics capabilities, are expected to realize benefits such as improved trading decision-making, increased customer satisfaction, and higher revenues. Reduction in latency and enhanced quantitative models will help these firms to capture and profit from current market inefficiencies.

Buy-side firms need to develop trading systems which support various asset classes across geographies, have faster distribution and market data analysis capabilities, and be highly automated in order to take advantage of high frequency trading strategies.

[14] 2010 ISDA Operations Benchmarking Survey, International Swaps and Derivatives Association

7 Trend 4: Buy-Side Firms Are Expanding Their Operations in High-Growth Emerging Markets

Before expanding to newer markets, buy-side firms must have a clear understanding of their resources, capabilities, and the key challenges that they are likely to face in a particular market.

7.1. Background and Key Drivers

Developed markets in North America, Europe, Japan, and Australia are expected to grow at a modest rate in the near future, due to both current economic conditions as well as stagnating growth of certain asset classes and low investor confidence.

The situation is different in emerging markets, many of which have boomed due to growing economies, increasing income levels, and an expanding middle class. While global uncertainty and risk factors may also affect emerging markets such as Latin America and Asia-Pacific, these markets are likely to grow at a much faster pace than mature markets in the coming years.

The key drivers for buy-side firms to expand their base in emerging markets are:

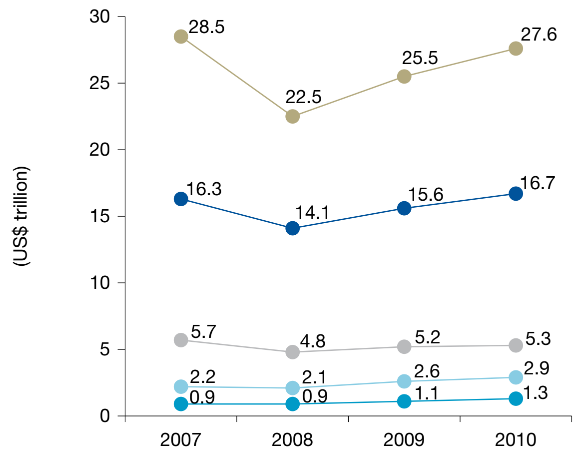
- Emerging markets are growing at a faster pace than developed markets, attracting global firms that want to capture future growth.
- A steadily-growing middle class in emerging markets provides significant opportunities for buy-side firms, especially in the mass market investments segment.
- Risk appetite of investors in emerging markets is on the rise as they are looking for different product options to invest their wealth, and have seen strong returns in markets such as real estate, even while mature markets have faltered.
- Capital markets in emerging countries are still not fully developed, with gaps existing around product types or investment strategies, providing global buy-side firms significant opportunities to fill the existing gaps.
- Financial centers such as Hong Kong, Singapore, and Shanghai are gaining prominence at the global level and buy-side firms are looking to increase their presence in these markets.

7.2. Analysis

In 2010, assets under management for buy-side firms increased across all geographies, but there were significant regional variations. Emerging markets posted higher growth rates in comparison with developed markets. For example, Latin America posted the strongest growth rate of 18.2%, followed by Asia-Pacific (excluding Japan and Australia) growing by 11.5% in 2010 (Exhibit 3). Brazil, Chile, China, India, Mexico, and South Africa posted the highest growth in their AUMs globally.

Assets under management for Asian emerging markets grew more slowly than their counterparts in Latin America, mainly due to a decrease of 6% in AUM in retail mutual funds due to volatile equity markets.

Exhibit 3: Assets under Management of Buy-Side Firms across Regions (US$ trillion), 2007–2010



	CAGR 2007-'09	Growth 2009-'10
North America	(3.4%)	7.6%
Europe	(2.2%)	7.1%
Japan and Australia	(4.5%)	1.9%
Asia (ex. Japan and Australia)	8.7%	11.5%
Latin America	10.6%	18.2%

Source: Capgemini analysis, 2011; European Fund and Asset Management Association, 2010

In 2010, emerging markets share of global assets under management was around 5% and if their strong growth continues, their share will reach 15% within the next decade. Ten western buy-side firms registered net sales of more than $5 billion from the Asia-Pacific in 2010 and a few of them posted net sales between $10 billion and $30 billion in the same year[15].

Emerging markets have become quite lucrative for many buy-side firms, but before foraying into these markets, firms should recognize the challenges that they may face. With many big players already present in emerging markets, the competition is intense and in many emerging markets, regulations are favorable for local players.

7.3. Implications

Many large buy-side firms have either expanded their operations or are focusing on having their footprint in the emerging markets. This has led to intense competition with a very high probability of over-capacity in many areas. This may lead to an increase in consolidation across the industry as many small players will not be able to handle pricing pressure. The industry is already witnessing heightened consolidation activity in emerging markets which is expected to increase in the future.

The increase in the number of merges and acquisitions will provide integration opportunities for professional services firms. Opportunities will likely arise in the areas of system or application integration and data integration.

[15] Global Asset Management-Boston Consulting Group, 2011

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About the Author

Rajendra Thakur is a Senior Consultant in Capgemini's Strategic Analysis Group within the Global Financial Services Market Intelligence team. He has four years of experience in the banking and capital markets industry with expertise in fixed income.

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