European Equities Market

2013 State of the Industry

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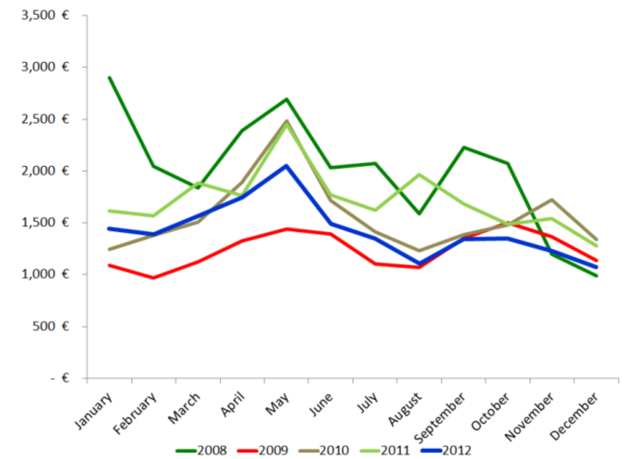
The Equity Resurgence

European equities bounced back onto the world stage in 2013. The Eurozone crisis may still be ongoing, but markets that were deemed "uninvestable" six months ago are regaining popularity. Yet just as the market takes its first tentative steps towards recovery, the potential severity of market regulation alongside worsening economic data has the capacity to eradicate any optimism for a new era of European equity trading.

After the famous Draghi speech in July 2012, hedge fund and then long-only activity increased, redressing the slide in 2012 volumes to levels similar to those seen in 2009 (see Exhibit 1). Turnover levels at the start of 2013 were down just 1% year-on-year versus 11% in 2012.

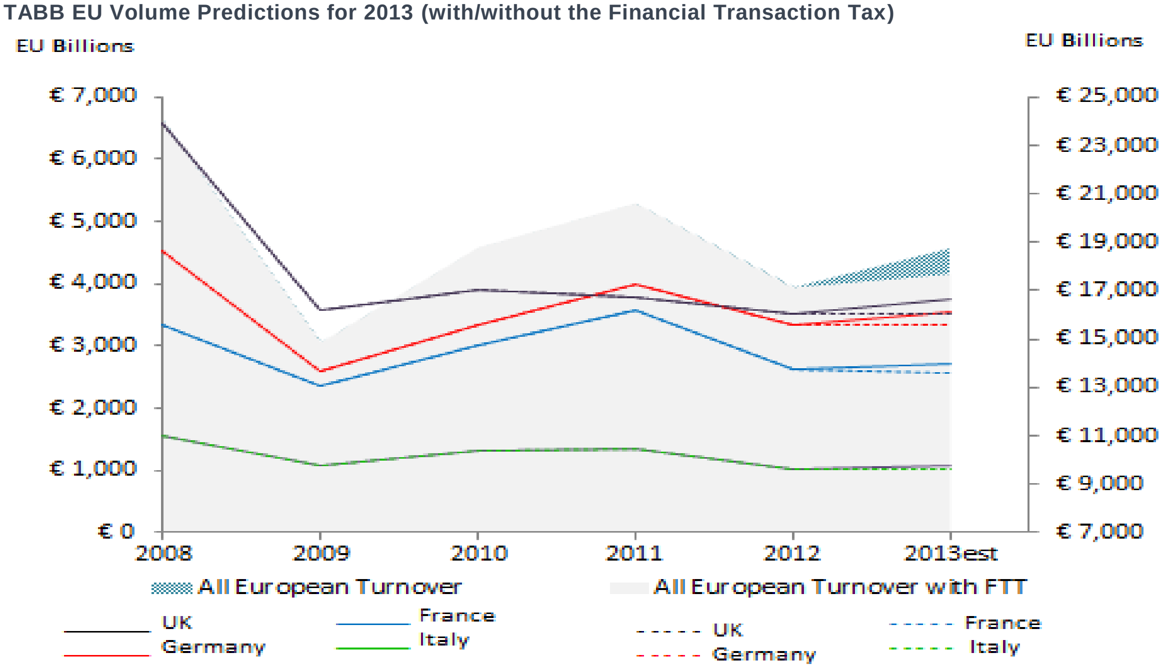
European Equity Turnover (Euros BN) 2008 – 2012



Source: Thomson Reuters/ TABB Group

As MiFID II nudges towards implementation, and participants readjust service expectations after prolonged austerity measures, the question remains whether the upturn in volumes will continue. The European Financial Transaction Tax will have a direct correlation on volumes and market participant concentration, accentuating a further dramatic restructuring of European liquidity. While the impact on individual countries may be minimal, the combination of France and Italy implementing a tax will slow the return to recovery (see exhibit). The inclusion of the other nine countries by 2014 would only accentuate this.

TABB EU Volume Predictions for 2013 (with/without the Financial Transaction Tax)



Source: TABB Group

French equity turnover declined 26% in 2012. Prior to the introduction of the tax, French turnover as a percentage of European turnover increased from 13.84% in 2008 to 17.3% in 2011. Post-August, the French market share of European trading was diluted to its lowest level since 2008, reaching just 11.88% by January 2013. This may be a question of underlying economic conditions rather than the burden of any additional tax. However by contrast, the UK increased its market share to 21%, yet Germany's overall share of European market volumes declined slightly, from 20% to a current market share of 19% despite more positive economic data.

The results of the Italian election the weekend of 24th February looks likely to herald the introduction of the Italian Financial Transaction Tax, currently scheduled for March 1. An additional tax to that of France will have a far greater effect on overall European volumes in 2013 crippling model driven strategies, thereby impacting the recent return to volumes.

It would appear the intention of the European regulators is to reduce trading to the bare minimum. The inclusion of pension funds in the proposals aims to encourage low-risk investment strategies in buying shares at issuance and holding them until maturity. By effectively penalising pension funds that trade actively, the argument is that the management fees of those funds could be substantially reduced. What is not acknowledged is that if funds are saddled with underperforming positions, returns will also be impacted.

Execution has already been fundamentally redefined due to depleted margins, bank deleveraging, and increased regulation – reducing the ability of market participants to interact. With implicit market costs more important than explicit costs, flexibility to access liquidity wherever it is available is reshaping the traditional linkage between portfolio management and execution. As institutional traders are forced to automate order flow to limit signaling risk, some managers have chosen to reduce order flow rather than manoeuvre their way around fragmented liquidity. Without natural orders to ease the flow of liquidity, we risk returning to volatile markets, which will further deter investors.

During 2012, model-driven funds continued to dominate broker order flow at the expense of the stock-picker. In 2013, the return of the fundamental investor will offer a valuable glimmer of hope for brokers to address the commission slide of 2012. Squeezed volumes have put pressure on a sell side seeking to operate a sustainable business model with sub-15bps secondary market commissions and an evaporated primary business. However, if regulation targets model-driven trading, any upturn in commissions will be muted and will be too little, too late for some. Further consolidation amongst the European brokerages is inevitable.

European equities have the potential to face a brighter future in 2013; however, much depends on the extended implementation of the Financial Transaction Tax. We urge caution to avoid irreparable damage to the fragile ecosystem of European Capital Markets and the wider economy as a whole.

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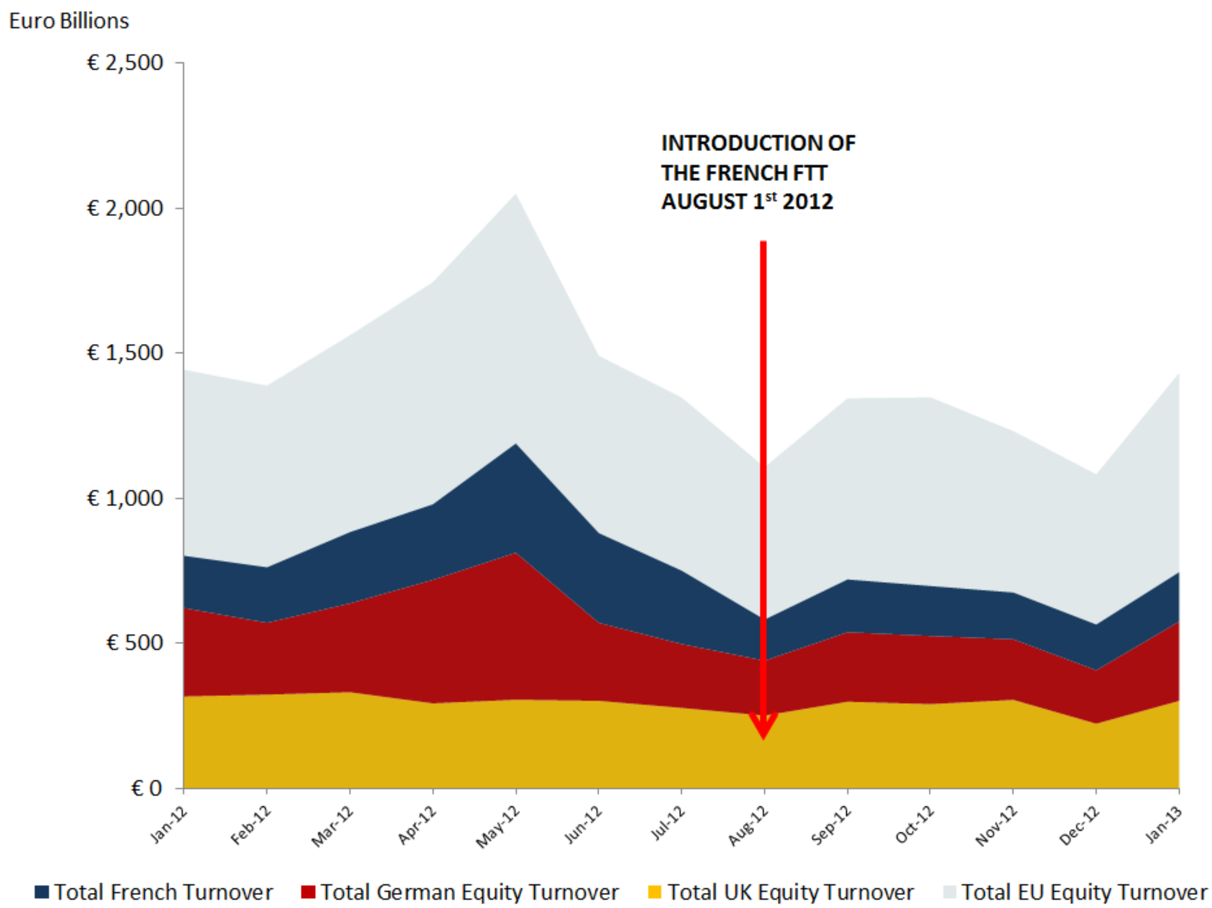
FTT hits France

French equity turnover fell 43% in August 2012 versus a fall across Europe of 17%

French market share of European turnover fell from 17% to 15% year-on-year, and to just 11.88% by the beginning of 2013

Developed Europe Turnover by France Relative to All EU Countries (Euros BN) 2008-2012



Source: Thomson Reuters/ TABB Group

Prior to the introduction of the tax, French equity turnover had been rising year-on-year. In 2011, the value of transactions settled by Euroclear France was €81.9 trillion, an increase of 9% over 2010, and volumes increased 18%. In contrast, year-on-year volumes in 2012 declined 26%. Projected revenues by the French Treasury have been estimated at €170 million in 2013, increasing to €500 million in 2014, an increase that would be questionable on declining volumes.

The introduction of the Italian FTT on March 1 is causing widespread concern. Whereas the French FTT accounts for a 0.2% tax on the purchase of shares in French firms with a market capitalisation of over €1 billion (US$1.3 billion), draft proposals of the Italian legislation indicate the tax will be applicable to all companies with a market capitalisation of €0.5 billion irrespective of where the trade occurs. At the time of this publication, the decree has yet to be confirmed, despite an imminent implementation date.

Other measures currently being proposed cover taxing OTC trades at 20bps (22bps in the first year) which would make broker crossing systems prohibitively expensive. Trades executed on primary or lit MTFs would be taxed 10bps (12bps in the first year). Long-only order flow is continuing to move to utilization of dark pools in order to limit signaling risk in low-volume markets. The exclusion of broker crossing systems will increase the cost of execution for many asset management firms.

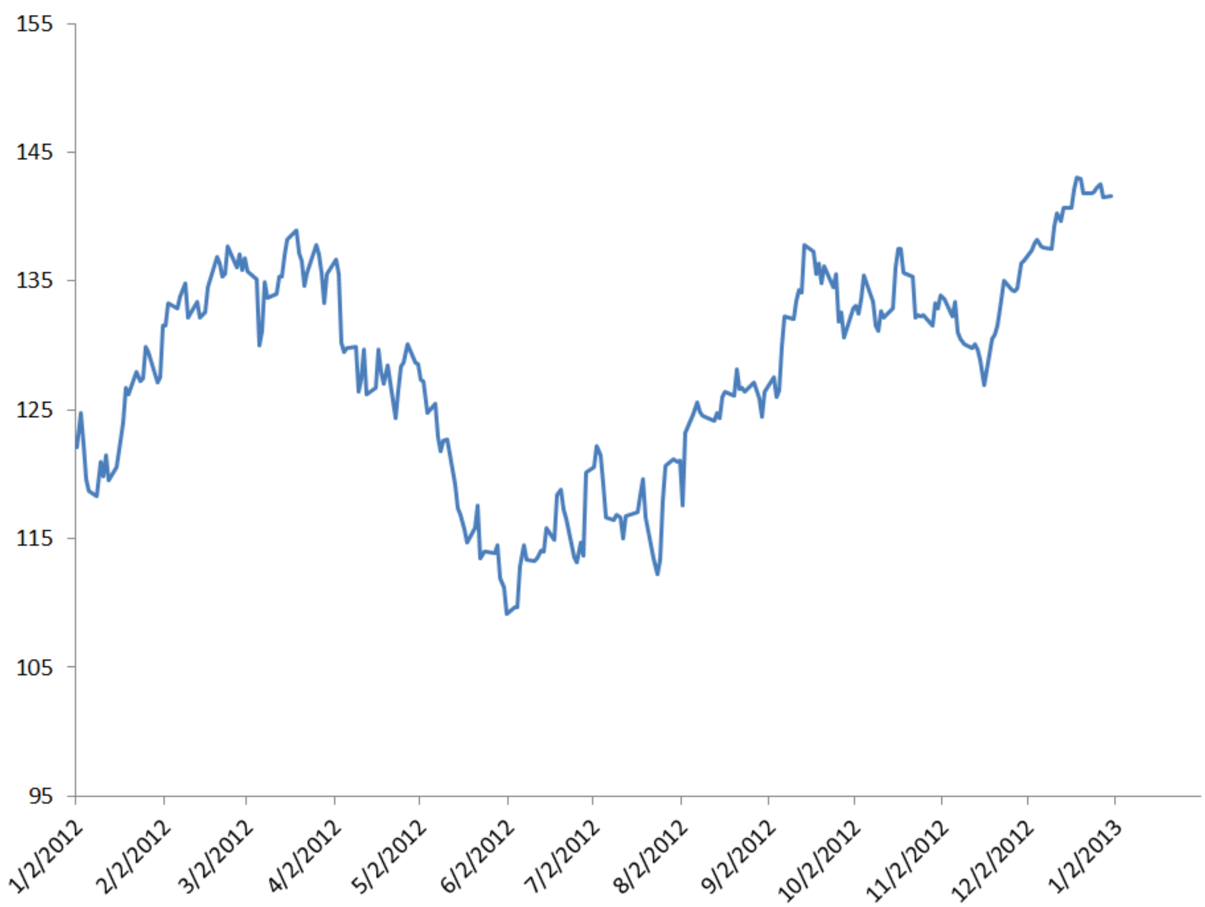
An additional 2bps is proposed for trades executed using high-frequency-trading (HFT) strategies, potentially having a cancellation rate of 60% or more over the day. Volume Weighted Average Price (VWAP) algorithmic strategies passively executed by long-only asset managers have the potential to fall into this category, particularly in more volatile markets. Buy-side conversations have indicated that this would force participants to throttle algorithmic strategies, lowering their execution performance capabilities.

The Draghi Effect

Post-July 2012, the ECB action delivered renewed market confidence in European equity markets.

The European Stock Index rose 39% from its lows of Summer 2012. It was all looking so promising.

Thomson Reuters European Stock Index 2012-2013 – Closing Prices



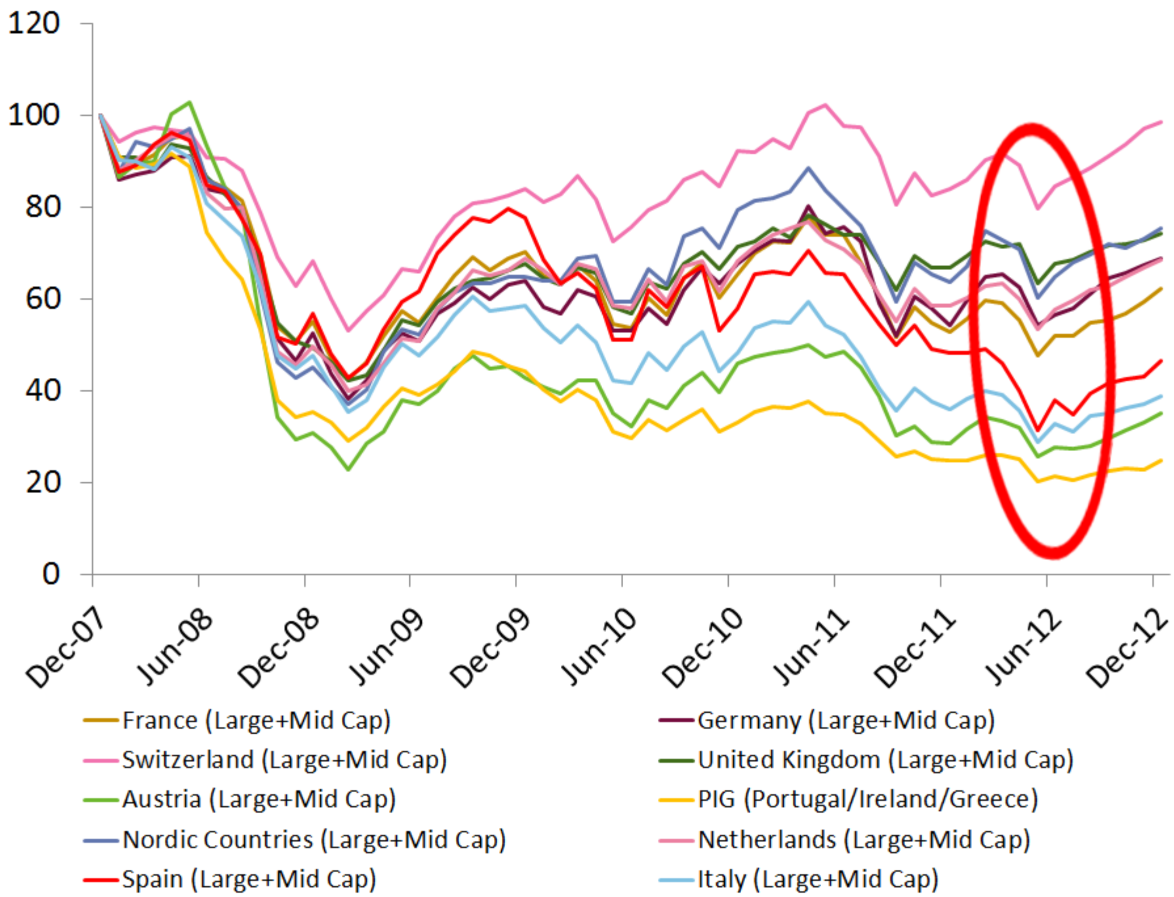
Source: Thomson Reuters/ TABB Group

Crisis Over?

MSCI EMU returned 18.34% in 2012 vs World Index at 13%

Of the top 10 performing global broad market indexes last year, five were in Europe.

MSCI Performance Ratings for Developed Europe (2007-2012)



Source: MSCI/ TABB Group

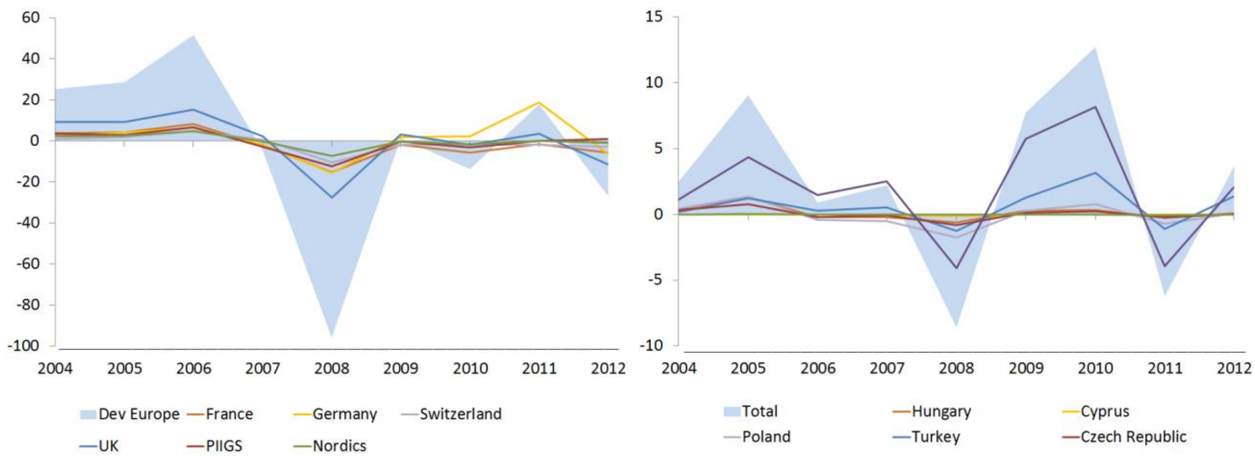
European MSCI performance ratings had a sharp upturn in mid-2012 after the ECB policy change offered investors greater confidence in the future of Europe.

Turning the Corner

Developed Europe Equity funds had outflows of (€20.1bn) in 2012

Emerging Europe in 2012 was the beneficiary of €21.7bn of inflows. By mid February 2013, Developed Europe saw €7.46bn of inflows versus €2.17 for Emerging Europe

Total Fund Flows – Developed vs. Emerging Europe (USD BN), 2004-12



Source: EPFR Global/TABB Group

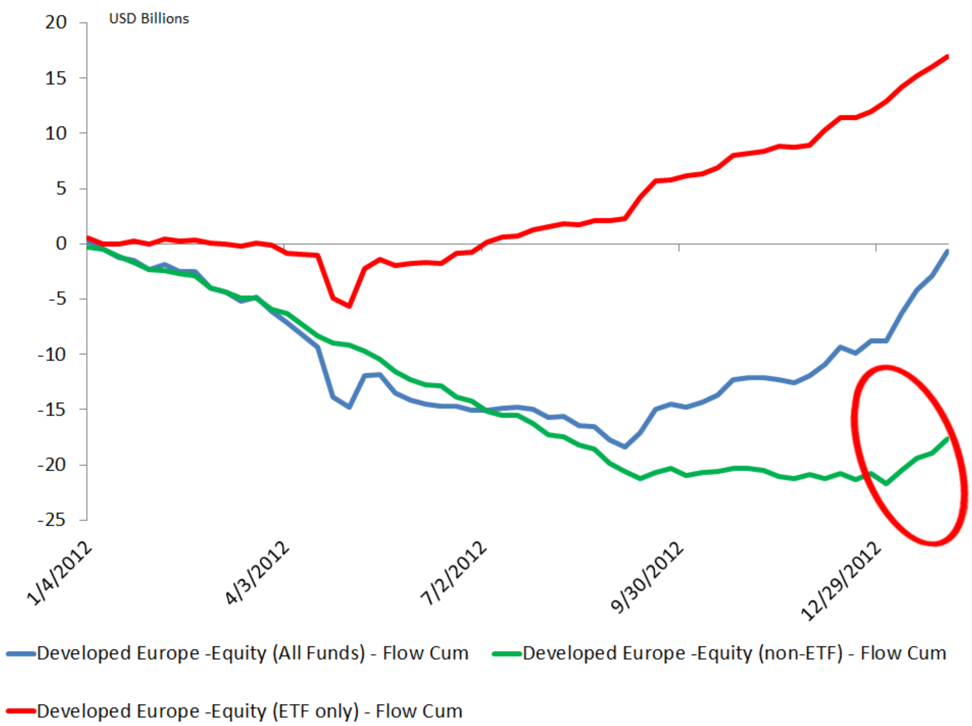
Fund flows remained firmly fixed on emerging European opportunities in 2012, buoyed by Turkish enthusiasm, with EPFR Global-tracked GEM Equity Funds at a two-year high coming into 2013. While 2012 was negative for Developed Europe, the policy shift by the European Central Bank in 2012 was a defining moment towards the resolution of the Eurozone crisis, effectively shutting the door on contagion risk. Fund flows have switched from Emerging Europe inflows to Developed Europe in 2013.

The Rise of the ETF

2012 saw €8.9bn invested in European ETFs

Since the start of 2013, Developed Europe has seen €7.46bn in fund flows, €3.4 bn of which has been invested in cash funds, suggesting the tide may be slowing for ETF growth

Fund flows across Developed Europe – All funds, ETFs and Cash Funds



Source: EPFR Global/TABB Group

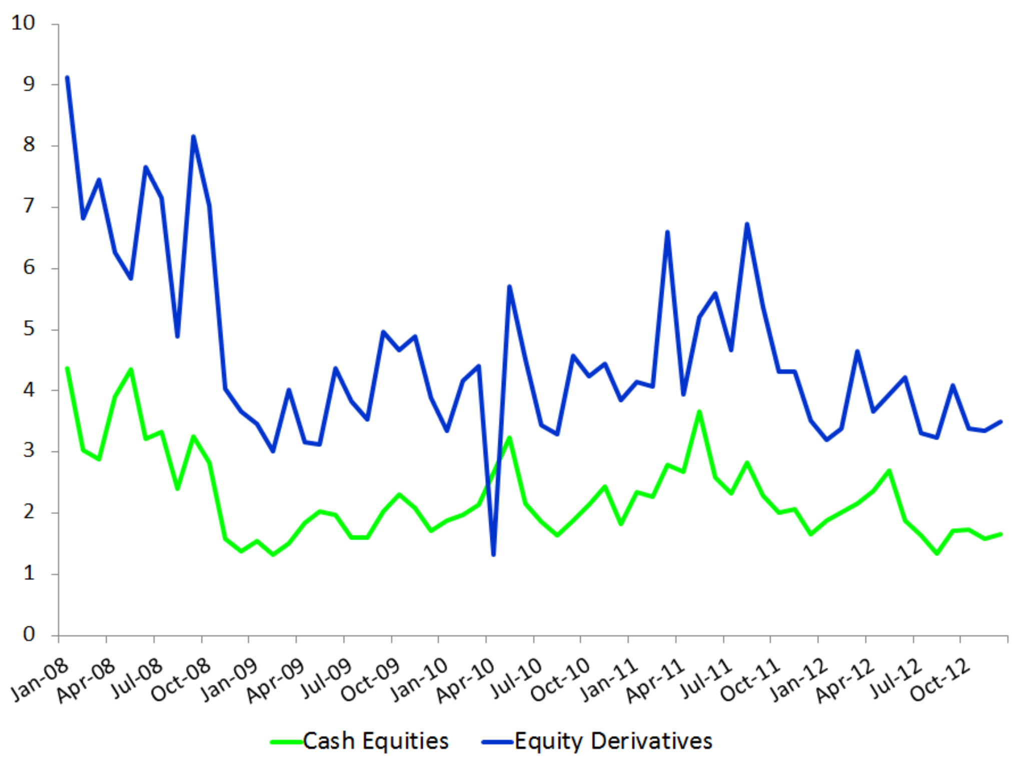
Despite the recent growth of ETF funds, the increased appetite for Cross-Border Funds in Europe, estimated to reach 43% of all European funds in 2013, will impact future growth. Moving exchange traded funds from one country to another in Europe can be both challenging and expensive in the fragmented European market as there is no single settlement system. As liquidity issues become more prevalent in Europe, we expect to see further rationalization with the number of ETF's offered.

Equity Linked

Equity derivative volumes down 38% since 2008

European equity derivatives continue to remain range-bound with the underlying equity, as continued low interest rates and an overall decrease of volatility reduced hedging needs

European Equity and Equity Derivatives Notional Turnover (USD T) 2008-2012



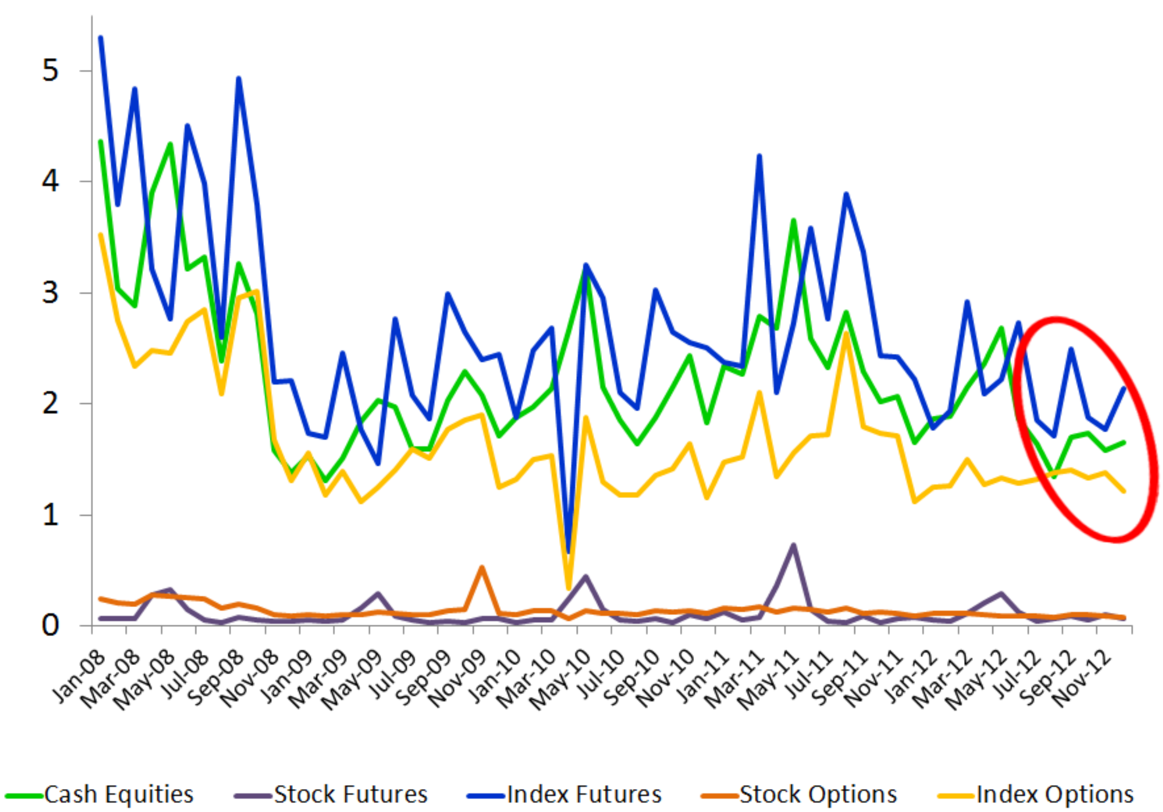
Source: WFE/TABB Group

A Future in Futures

Although down 40% from industry highs in 2008, renewed interest in Index futures at end of 2012

Post Q3 2012 there has been a slight divergence in Equity futures trading leading to speculation over the shift from cash equity to certain equity-linked products

Equity and Equity Derivatives Volume by Instrument Type (USD T) 2008 – 2012



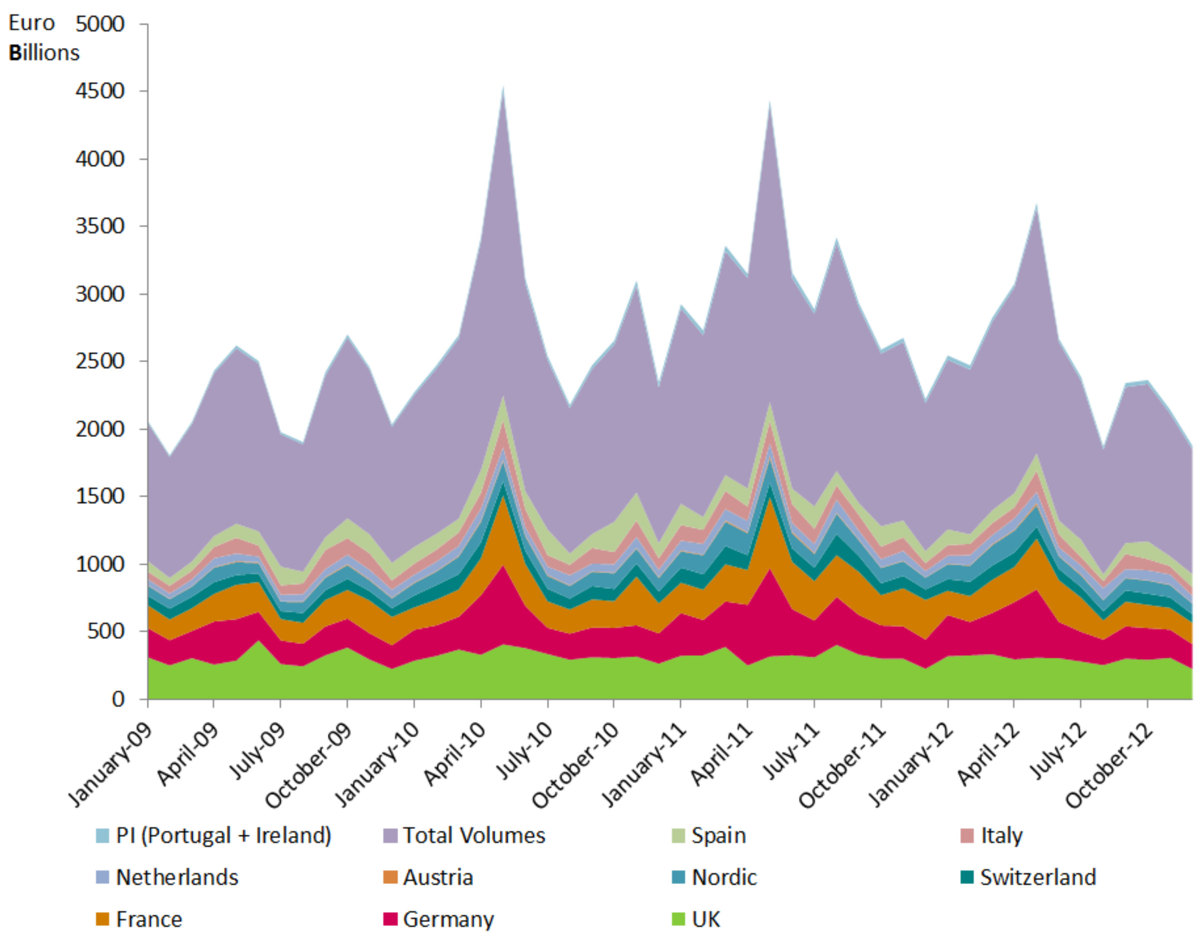
Source: WFE/ TABB Group

3 Countries = 52%

UK now accounts for 21% of European equity turnover, with Germany at 19% and France at 12%

As volumes decline there will be a concentration of tradable stocks which will increase issues finding liquidity, especially in small and mid cap stocks

Developed Europe Value Traded, by Country – Top 10 (EU Billions) 2008 – 2012

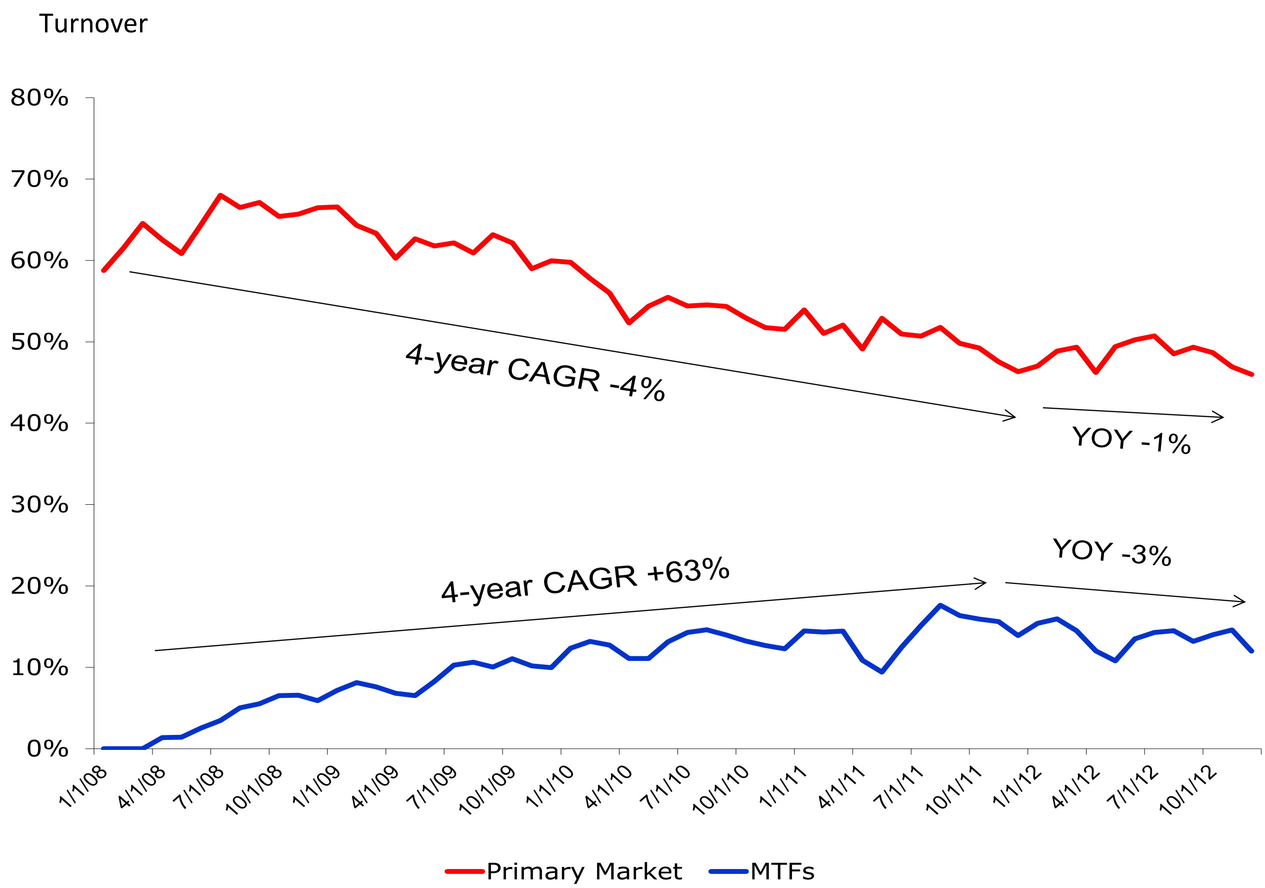


Source: Thomson Reuters/TABB

Not the End of the Primary

Market Share traded on Primaries fell from 65% in 2008 to 46% but stabilised in 2012

Volumes across Lit European Venues (Exchanges & MTFs)



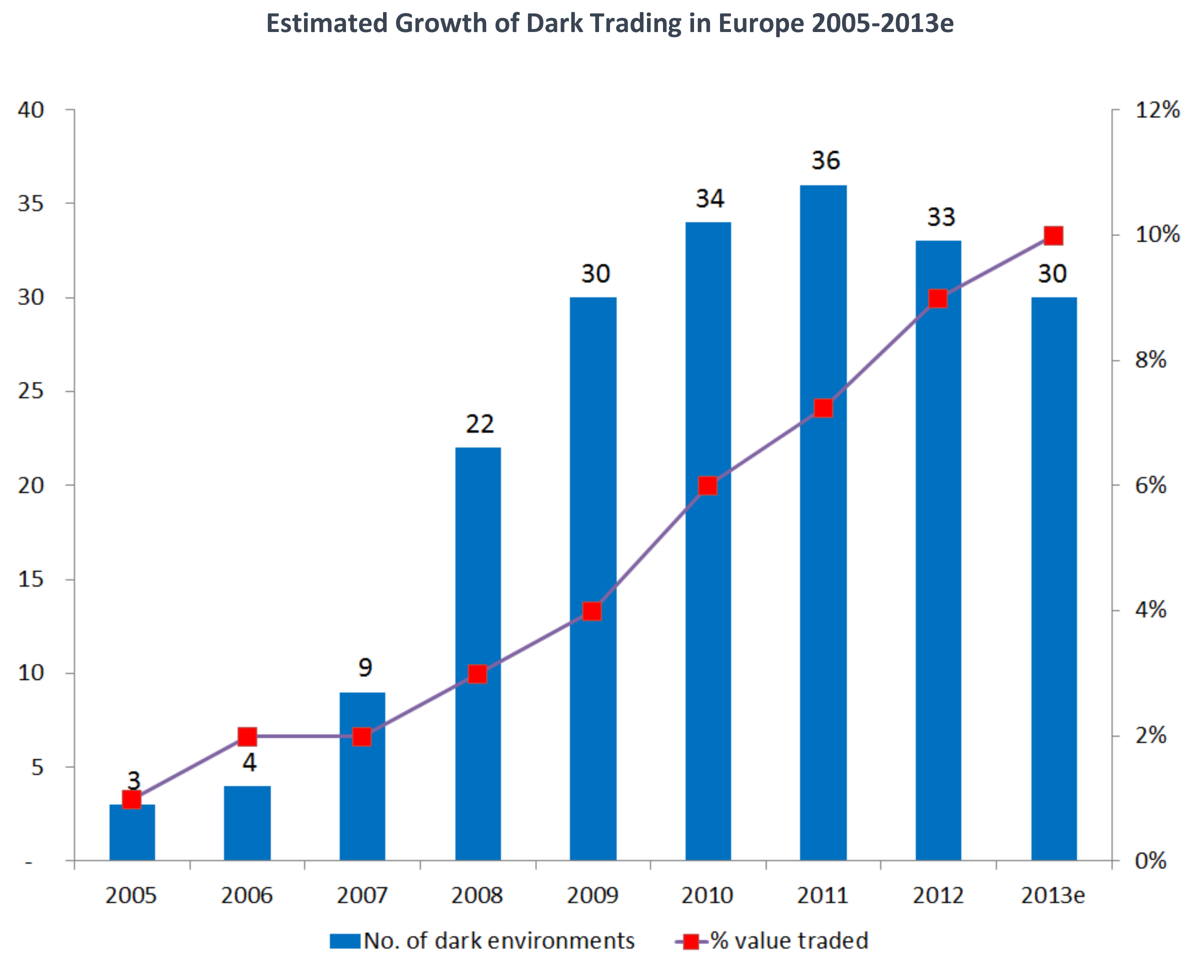
Source: Thomson Reuters/TABB Group

Turquoise and BATS Chi-X Europe reached 23.06% of equity volumes traded in January 2013, versus 42.12% traded on the four largest exchanges combined.

9% Dark

Consolidation of Dark Venues from 36 to 33 in 2012

Number of dark venues will continue to fall in 2013 as part of a wider industry consolidation and more sophisticated venue analysis



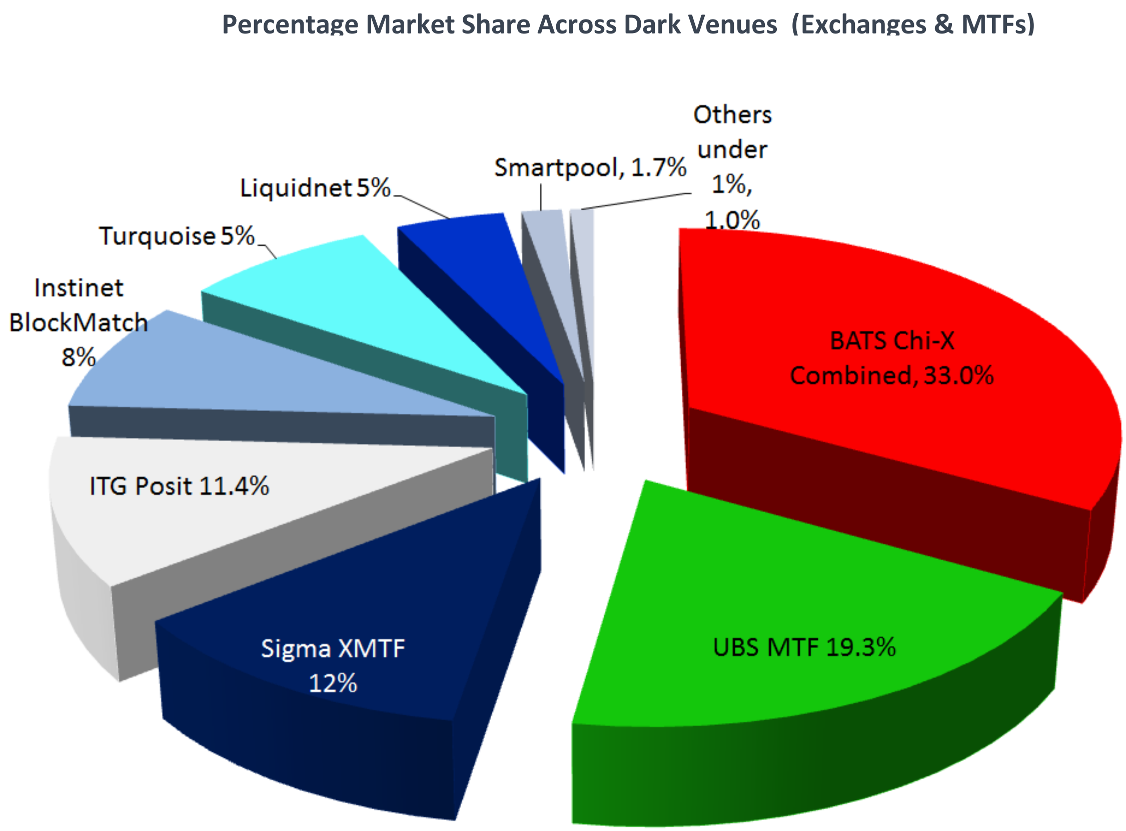
Source: TABB Group

Trading on dark venues continues to rise with a sharp increase in dark volumes executed across all venues in January 2013. The outcome of planned legislation in this area will impact end volumes so we remain cautious for our 2013 estimates overall in the short term.

Dark Fragmentation

Two main Dark MTFs now account for over 52% market share

Dark MTFs represented 5% of European trading volume in January 2013, but primarily in just two venues



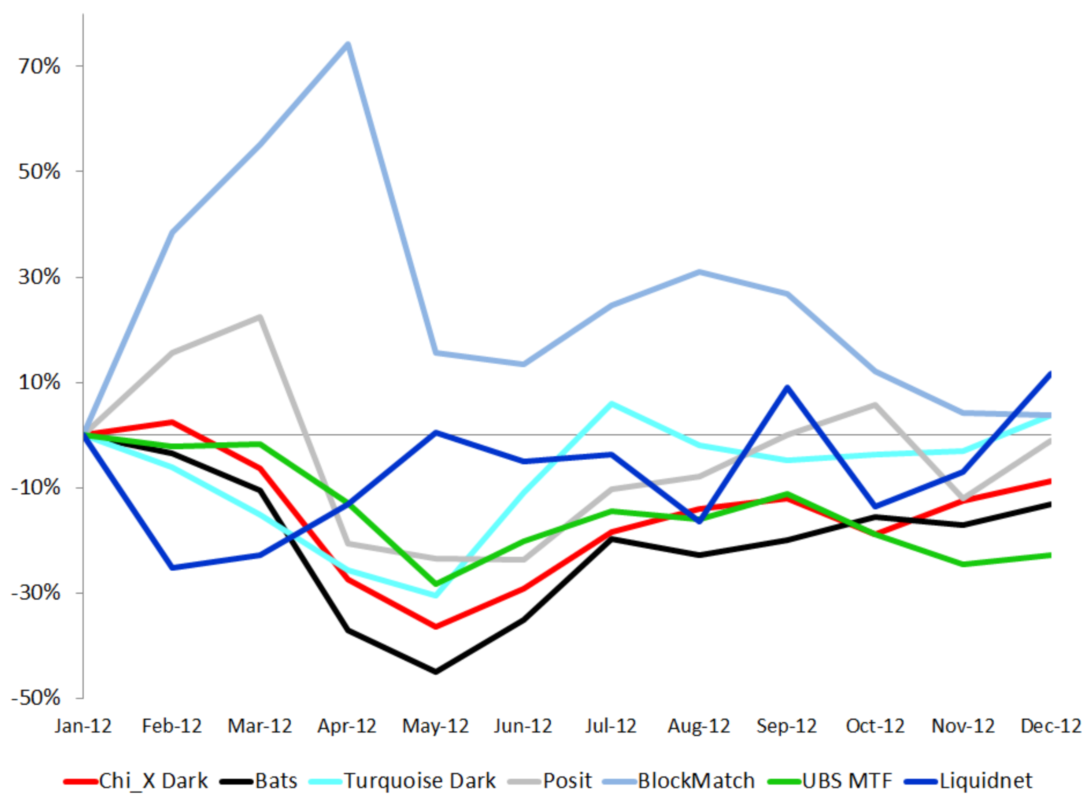
Source: Thomson Reuters/TABB Group

Decreasing Fill Size

Average trade sizes in the dark are declining

Order fills are now at similar levels seen on lit exchanges

Percent Change in Average Trade Size across Dark Venues in 2012



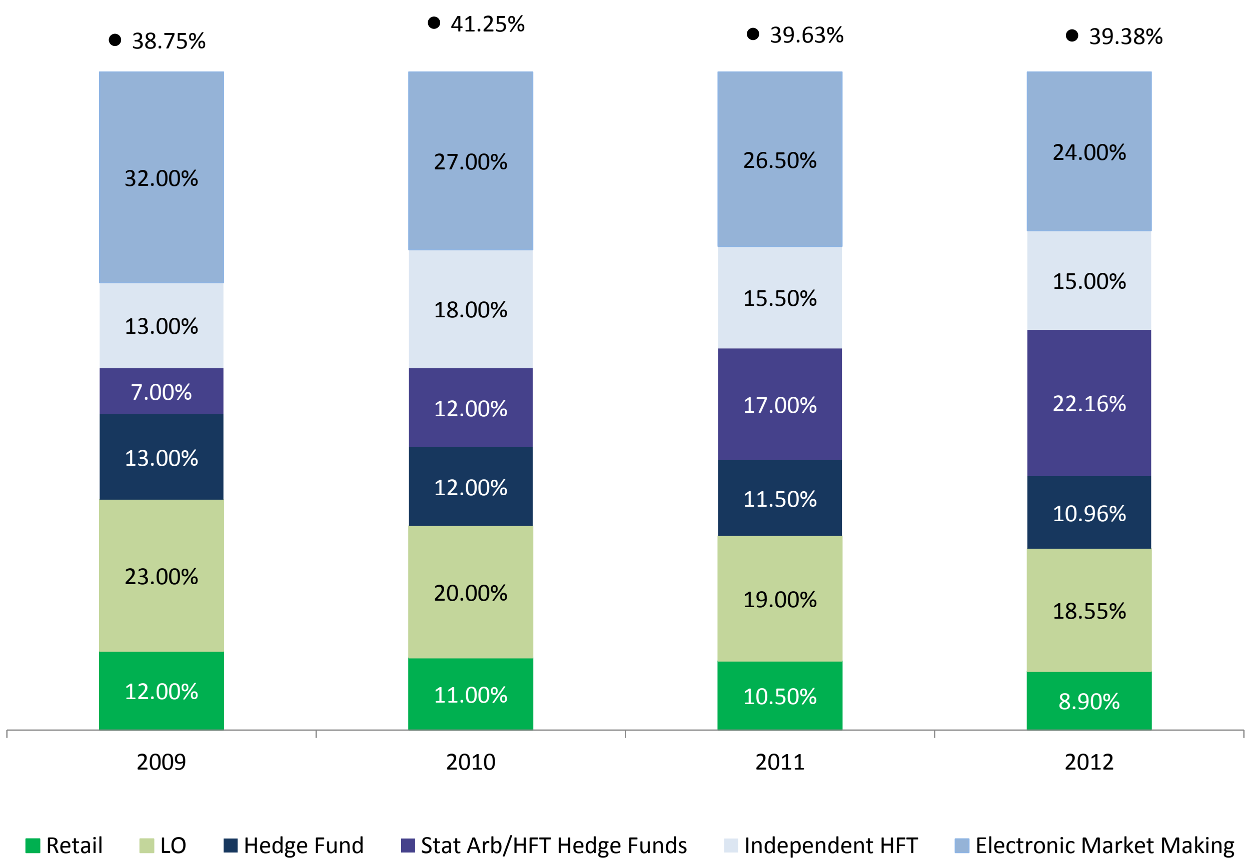
Source: LiquidMetrix/TABB Group

39% +

While HFT is stabilising, quantitative model-driven hedge funds now account for 21% of order flow

Attempts to target model-driven flow alongside HFT will have a drastic impact on liquidity formation in 2013

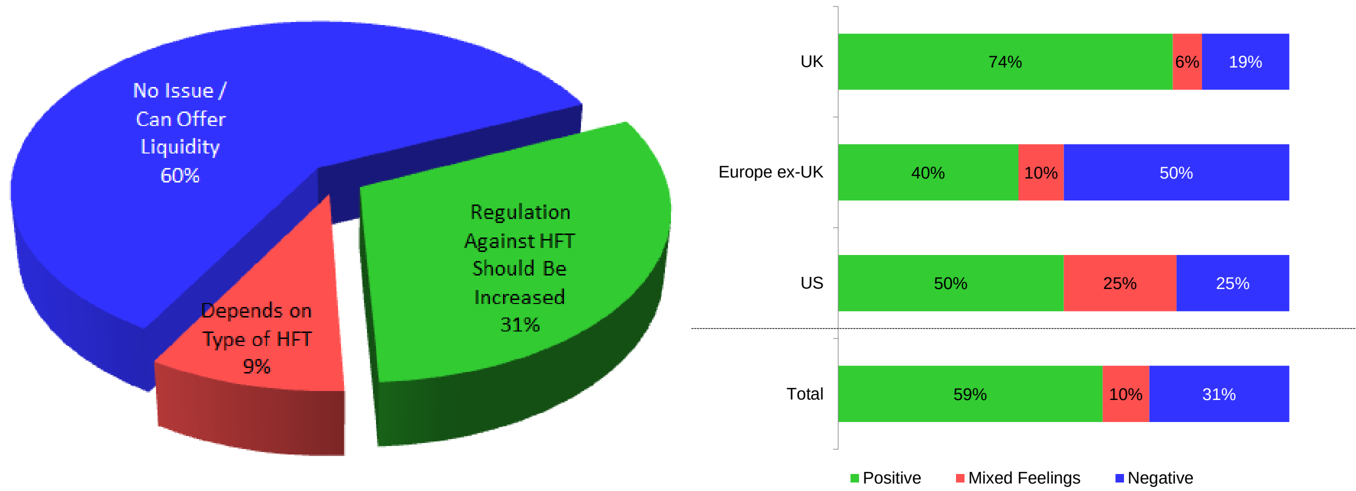
Annual Percentage Volume by Participant Type



Source: TABB Group

Lines in Europe are becoming increasingly blurred as to what regulators perceive as HFT flow. Attempts to target this flow with the introduction of the Italian Financial Transaction Tax in March will have a drastic impact on liquidity formation in 2013.

Changing Attitudes towards HFT - European Equity Trading 2012
Interviews with the Buy Side - Should there be further regulation of HFT?



Source: TABB Group

In 2012, there was a slight decrease in the proportion of automated trading that was purely latency-sensitive. HFT strategies have suffered from the drop in volatility and increased correlation, reducing levels of profitability. In addition, the risk of all risk positions being hit in parallel as brokers have become more adept at managing orders across a distributed market, means that pure HFT strategies cannot be leveraged to the same degree.

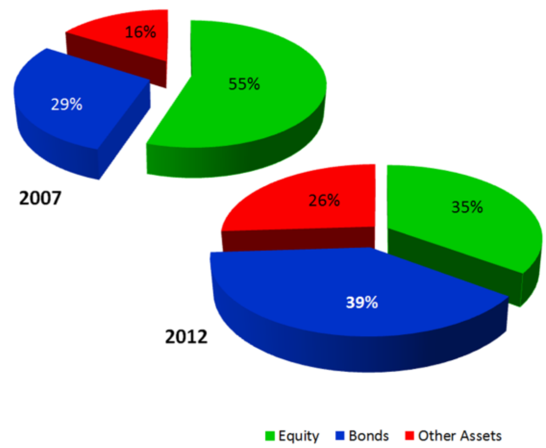
As a result, trading strategies are diversifying and challenging interpretations of what constitutes HFT flow. Whilst funds may have HFT strategies, their underlying models may now be more in tune with those of traditional long-only investment managers. The increased use of technology by the buy side to understand how order flow operates, and how they can benefit, has seen a growing level of comfort by some on the buy side to choose to access model-driven flow. This is particularly evident looking at the location of the buy-side trader.

As European regulation restricts traditional market-making flow, European capital markets are at a critical juncture. Unnecessarily heavy regulation will lead to distortions in the market structure that will damage an already fragile ecosystem. The irony is that if volatility increases in a smaller universe of stocks, correlation opportunities will also decrease, creating the very conditions that make HFT strategies profitable once again.

Passive to Active

2013 began with a bang. Despite widespread optimism, German Chancellor Merkel is facing potential election defeat in Germany, youth unemployment is at record levels and structural market imbalances remain; a successful resolution of the Eurozone crisis is still some way off. Yet the longer-term prognosis is that equities will recover from short-term setback and outperform bonds. There is a question of basic economics to answer which passive investing cannot deliver.

UK Pension Fund Assets 2007 versus 2012



Source: NAPF/ TABB Group

Pension assets now account for nearly 40% of total funds, with the remainder split between mutual and insurance funds.[1] In the UK alone, the second largest market globally, pension funds now hold more of their assets in bonds than in shares for the first time in 40 years but with a significant pension shortfall to address.

Across Europe, the management of pensions will become the next “crisis” -- the European Union’s working-age population starts falling in 2013, raising the old-age dependency ratio from 28% to 58% by 2060[2]. The industry will have to change its recent approach to investments, which will become harder to achieve with the introduction of a Europe-wide transaction tax that encourages long-term holdings from primary issuance, rather than an active investment strategy.

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[1] TheCityUK
[2] Eurostat

The Tide of Automation

The level to which automation is now ingrained in every aspect of fund management is illustrated in the proportion of automated trading for all European market participants, totaling 54% in 2012.

Automation no longer equals speed but efficiency, reliability and cost control. From portfolio managers analysing risk in the investment process, to greater compliance and risk analysis to meet fiduciary responsibilities, managing risk efficiently via automation throughout the whole investment process will continue to drive the rise in model-driven execution.

Model-driven trading in Europe between 2010 and 2011 saw an increase of 47% in execution-only commissions for hedge funds, whereas the fundamental funds continued to remain impacted throughout 2010 and 2012, falling by 12% (2011) and then 34% (2012). We estimate they will make the greatest gains in 2013 with commissions up by 17%. Hedge funds have already witnessed the strongest monthly return in 24 months, and the best January return in 7 years – up 2.32% in January 2013.

In comparison long-only bundled commissions fell by 10% in 2012 but execution only commissions fell by 29%.

The traditional role of the sales trader as order creator rather than order taker will resume, particularly in less-liquid European markets with small- and mid-cap names, which will positively impact European commissions in 2013. However, this will not dramatically alter the overall long-term trend in automation and the proportional increase in execution-only commissions from model-driven funds. Overall we see European commissions in 2013 increasing by just 3%.

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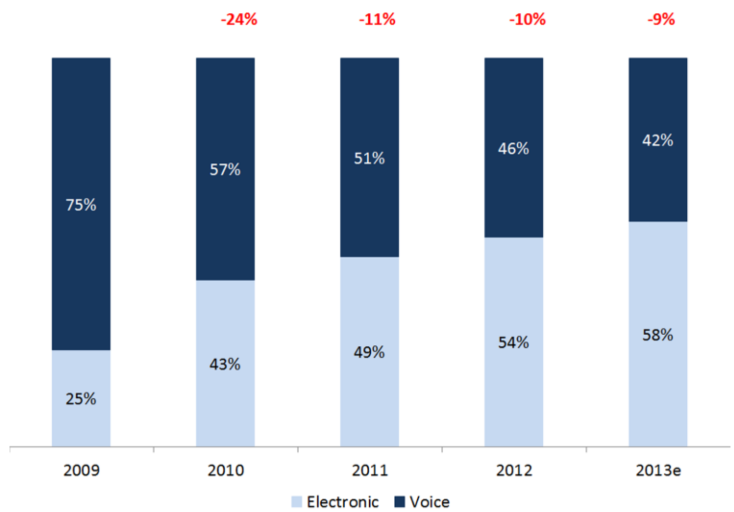
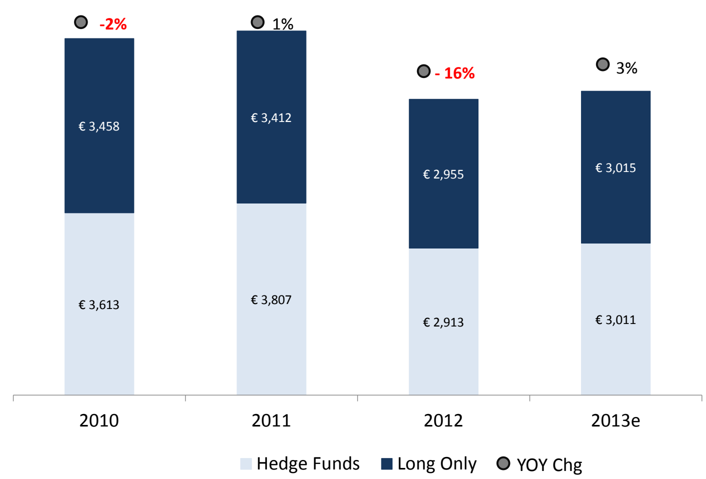
Institutional Turnover by Trading Channel (Voice vs Electronic) 2009-13e



Source: TABB Group

EU institutional equity brokerage commissions (in EU Bil)



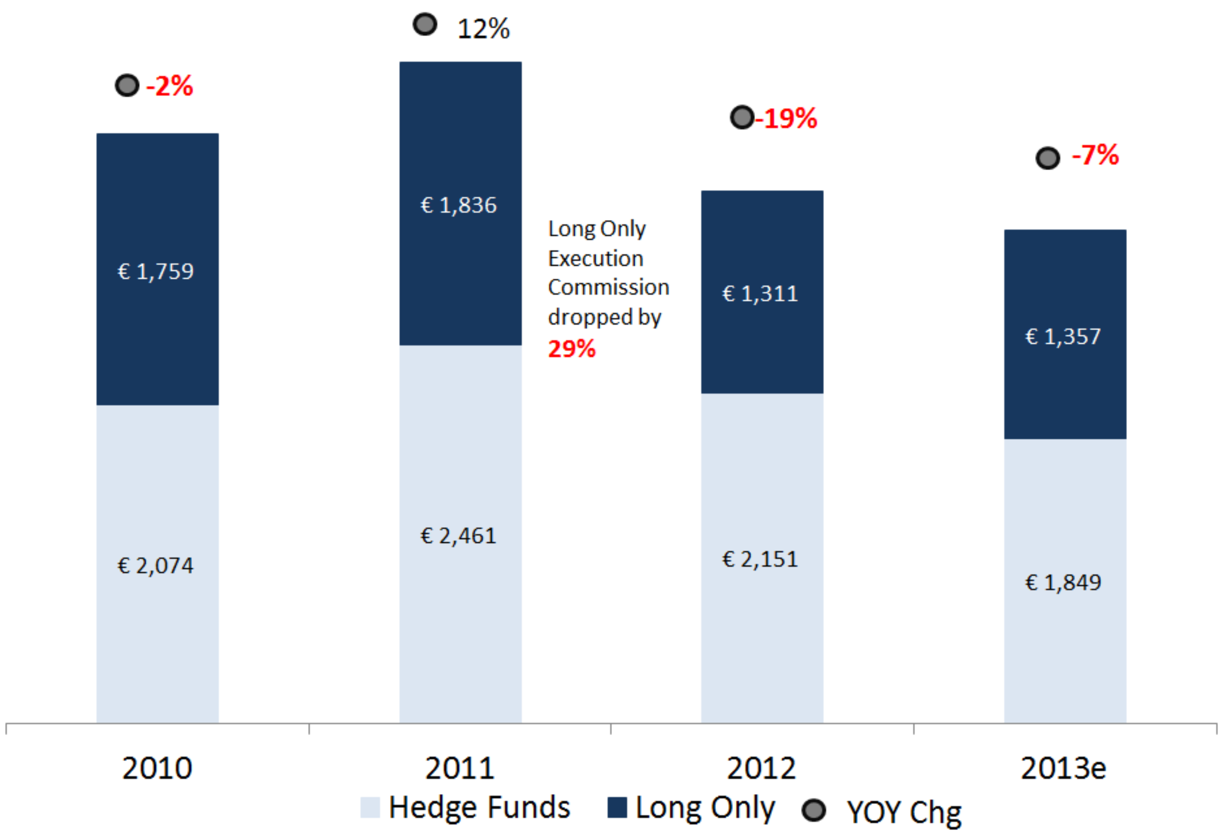
Source: TABB Group

€3.4trn to €3.2trn

2012 saw a 29% decline in Ex-Only Commissions for Long-Only Funds

Commissions will increase by 2% in 2013 for long-only funds, however model-driven funds will suppress any upturn with the increased use of the cost-plus model

European institutional execution-only brokerage commissions (in EU Bns)



Source: TABB Group

Final Remarks

Concerns over the ability of the politicians to address the Eurozone crisis have been replaced by greater concerns that increasing regulation will stifle any growth or innovation. Taxation appears to be the modus operandi of European leaders without any evidence that there will be any revenue to collect, and every indication that market liquidity will deteriorate in the process.

The age of the stock-picking investor may have returned, but only for a chosen few. The recent success of the fundamental hedge funds will address the slide towards model-driven automated trading – but it will only slow its path. While retail fund flows may have had their strongest start since 2006, cash equity fund flows are a third of ETF flows. The continued requirement for risk-averse investments by the majority will ensure that automation remains the mainstay of European trading DNA. As such, model-driven funds will maintain their dominance in Europe, slowly encroaching on the market share of the traditional long-only asset managers.

Lean commissions will dominate the available commission pool, and the cost base for brokers will continue to rise whilst income and the ability to generate it declines. In these austere times, brokers will need to weigh the costs and benefits of individual relationships and establish which coverage model will be a better fit for their business.

The increasing burden of conflicting regulation means that only a handful of global players will survive at the top. We anticipate further restructuring in the short to medium term, with firms focusing on core strengths. Second-tier firms will continue to struggle unless they can create a unique foothold in either research or execution.

The one great unknown will be the impact of the Financial Transaction Tax across Europe. Given that French equity volumes would appear to have stabilised, there will be politicians who see their course of action as justifiable. However, one country is not the whole story, and early indications are that the introduction of the Italian Financial Transaction Tax could have far-reaching consequences, potentially leading to structural changes in investment strategies as well as execution.

With the economic prognosis once again looking bleak, there is a real risk that Europe as a percentage of global trading will become increasingly irrelevant. Those in Brussels who perceive this as a coup against the finance industry may have a rude awakening at the wider implications of this policy.

It may well be a false dawn for the revival of European cash equities. The regulatory storm clouds are once again gathering on the horizon.

Is the Sun rising or setting on European Equities?

The future for European equities was looking optimistic for 2013. However, much now depends on the outcome of recent market legislation and its impact on the fragile European market structure.

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