Global Equities

European Equity Trading 2014: Part I

Get Set for Innovation

Rebecca Healey | V12:005 | January 2014 | www.tabbgroup.com

Top 10 for 2014

1. Nearly two-thirds of European buy side firms say research will eventually be paid from management fees.

2. The continued concentration by both the buy and sell side risks limiting small and mid-cap trading activity to an exclusive club of asset managers and investment managers which will have wider negative repercussions for Europe.

3. European commissions were up 9% in 2013 with average daily volumes for our sample set rising 16% year on year.

4. Traditional brokerage services are still valued by 68% of participants. The most critical services include access to capital, liquidity and in-depth knowledge.

5. While high-quality sales trading is valued, only 14% of participants increased flows to sales desks in 2013, while 52% decreased their allocation. Just 4% anticipate increasing sales trading flow in 2014.

6. Last year heralded the return of the block trade but only for a select few, as just 36% of respondents are benefiting.

7. Broker capital remains out of favour because it is seen as wasting valued commission dollars; only 35% are using it and 29% are reducing use.

8. The average number of executing brokers per buy side firm declined 10% in 2013, while 54% of firms anticipate a further reduction in 2014.

9. Sixty-one per cent of participants now have a local-regional specialist as one of their top-five brokers in commissions paid, as lack of coverage by the bulge brackets forces them to look elsewhere for specialist performance.

10. Seventy-eight per cent of participants now regularly trade emerging European stocks. Local brokers are retaking market share, with 47% of order flow, while 77% of participants are actively looking to trade local stock where possible.

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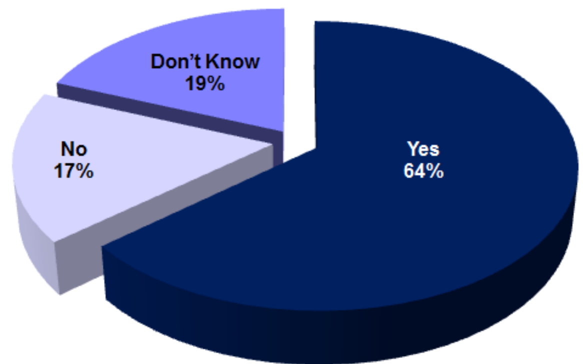
The Research Conundrum

2014 is set to usher in further change for the European financial industry, which will impact not only its 27 member states, but herald radical change set to ripple across global capital markets.

> "My PM is starting to behave as if the commission is coming out of her own back pocket, rather than the firm's money – and it is making her question what research she takes."
>
> (Large UK Asset Manager)

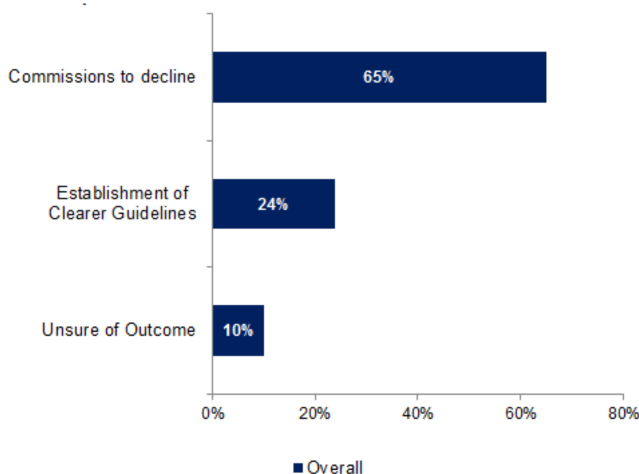
Exhibit 1
Will Commissions be Paid from Management Fees in the Future?

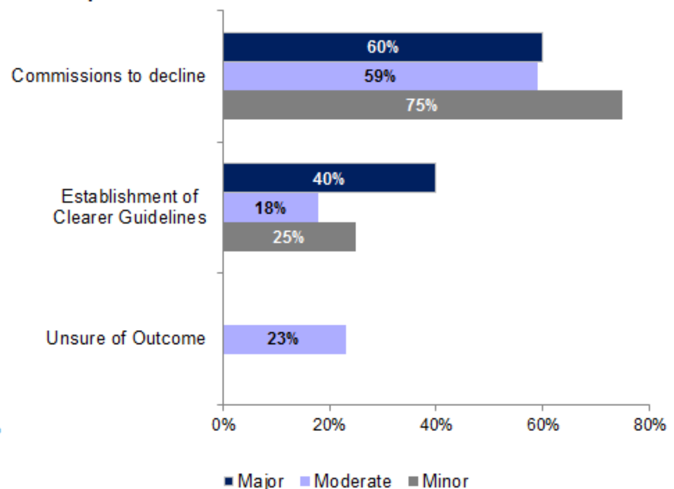


Source: TABB Group

As trilogue negotiations draw to a close, the MiFID II framework is finally emerging. However, it is the UK Financial Conduct Authority's (FCA's) intention to focus greater scrutiny on the commission process that will intensify the speed and magnitude of industry change, with participants right across Europe acknowledging the impact (see exhibits 1, 2 and 3). The glimmers of a European recovery and renewed enthusiasm for equity trading will not necessarily deliver respite to a besieged brokerage industry. Moreover, attempting to accurately cost research in an environment of declining commissions and conflicting interests will have wider ramifications. Not all participants are confident this will bode well for the industry as a whole in the immediate term (see exhibit 4).

Exhibits 2 and 3
What Will the Impact on the Industry be?





Source: TABB Group

Dealer commissions may be the immediate headline but greater transparency throughout the research process will finally break the relationship between turnover of assets under management and the generation of research, impacting not only the total

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commissions paid, but fundamentally altering how research is bought, accessed and consumed. Whether this translates into a reduction in the amount paid for research in absolute terms remains to be seen. TABB Group will be investigating this further throughout 2014.

Mid-Tier Missing Out

> "It's not difficult for us to get a meeting with a company. We can just pick up the phone and say, "We would like to meet you," so why are we paying brokers for this service?"
>
> (Large Nordic Asset Manager)

Some buy side participants are already pushing for the sell side to provide menu pricing for research. However, the more contentious issue regarding access to corporations remains a higher priority. While clearer guidelines are welcomed by all, there are a multitude of challenges that arise through this process, which is evident when answers are broken down according to commissions paid. Mid-tier asset managers whose portfolios are weighted towards small and mid-cap names look likely to bear the brunt of the significant changes.

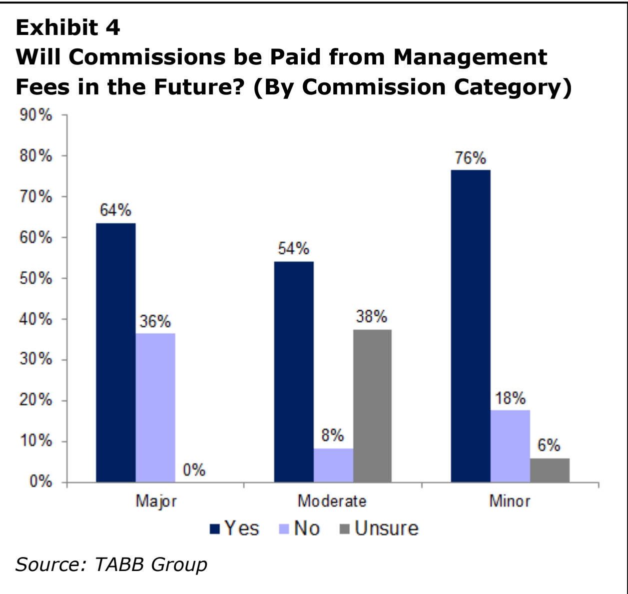

Exhibit 4
Will Commissions be Paid from Management Fees in the Future? (By Commission Category)

Source: TABB Group

Larger players have the resources behind them to be able to choose to operate independently rather than risk the ire of regulators. If you own 5% of a company, it may well be feasible to call direct to arrange a meeting, but as portfolio managers and funds stretch out across Europe or into new asset classes, their circle of influence declines. Here brokers are still able to provide valuable assistance that is not economical for asset managers to provide independently and the buy side are willing to pay for the services provided.

> "If I am paying 15bps split between research and execution, logically if the research is not paid by commission why would my execution commission be anything higher than 7.5bps?"
>
> (Large UK Asset Manager with Major Commission Spend)

Some fund managers still rank brokers according to access obtained, but now feel unable to reward brokers for this activity; if their trading moves to automation and execution-only commission fees, then the dealing desks are once again relying on turnover in order to pay for research. Others are trying to establish what constitutes a unit of 'value' for research, as opposed to what it's fundamentally worth. The learning curve is substantive, both internally and externally. If an investment firm pays a broker €10,000, some fund managers perceive that is 100% attributable to them, whereas often this is split 60/40 between research and execution.

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Greater Clarity

"Nothing will happen immediately, but within five years' time, yes – there is too much that has to change within the system."
(Large Continental Asset Manager)

Some participants perceive the long-standing pressure to 'pay the street' as somewhat of a misnomer; the buy side now pay what they choose to pay and it is up to brokers to establish what services they are able to provide according to what they believe their research is worth. Changes in regulation would ensure that there was greater clarity around the process and eliminate any slack in the system – both in terms of number of brokers, but more importantly, in the quality and quantity of the research consumed. The challenge is that in conducting the exercise, some on the buy side saw their number of research providers increase rather than decline.

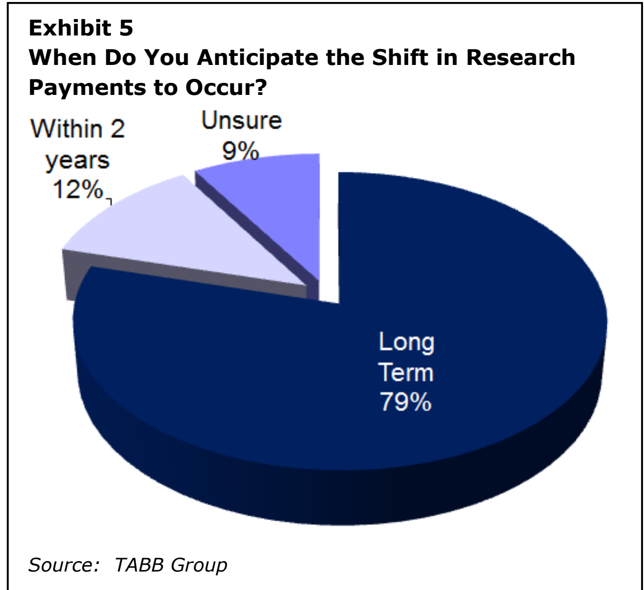
Loss of Commissions – and Leverage

Undoubtedly this will impact European commission pools at the very time few brokers can sustain further significant losses. That said, few participants expected radical change in the next few years (see exhibit 5). The challenge is more who can survive in the interim, and this will impact the buy side as well as sell side.

"There is no pressure on our PMs to churn the funds just for the hell of it. We trade when we need to trade."
(Large UK Asset Manager)

With commission wallets depleted and PMs under pressure to perform –encouraging them to place safer bets rather than risk stock-picking decisions – small and mid-cap names will continue to move down the liquidity curve. Aggressive commission compression has also shifted investment banks towards more liquid closet index activity, and with high-frequency trading less active in small cap names due to the increased risk, illiquid names are becoming even more illiquid. As a consequence, the investment model for new pension fund and insurance mandates continues to demand a shift in strategy to more model-driven turnover with an increasing global focus able to move to the next opportunity in larger-cap global names based on idea generation rather than limited by geography.

Exhibit 5
When Do You Anticipate the Shift in Research Payments to Occur?



Source: TABB Group

"In our optimisation process, we utilise cost curve estimates. So naturally we are eliminating some of the smaller liquid positions simply because they are too expensive to trade."
(Medium-sized US Asset Manager)

Capital markets are in danger of being limited to only the most liquid names for the majority. With European politicians wedded to the expectation of SMEs driving a European recovery, limiting small and mid-cap trading activity to an exclusive club of asset managers and investment managers will have wider negative repercussions.

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Not Just the UK

For those breathing a sigh of relief that their own regulators are not forcing them to follow suit, market participants across Europe commented on the underlying fiduciary push, which is likely to follow to ensure they meet best execution requirements. While the UK's FCA is leading the charge, regulators and market participants from around the globe are watching. Regulation is radically changing the landscape for both the buy and the sell side and this will change the interaction, the players and the future shape of the industry in its entirety.

"The only way we can meet best execution is by separating execution and research. One way or another eventually we are all going to get there."
(Large Continental Asset Manager)

The shift to automation for the full cycle of the investment process as well as the execution process is not solely dependent on action by any individual regulator: this is the new economic reality for many. The continued concentration of the industry – sell side to buy side to the underlying investments – has focussed on a one size fits all approach which will no longer suffice.

A new era of European specialisation is emerging which places European equity trading desks in a unique position; previous experience from MiFID I will provide the valuable opportunity to capitalise. Dealing desks have already been dramatically redefined – with both positive and negative results – providing a framework to build a sustainable future for a new era of execution. With research and payment models now set to undergo a similar evolution across the asset classes, further innovation will emerge. The prognosis for continuing decline in turnover volumes and commission wallets will continue to push the need for immediate action on outdated business models. The status quo is finally being overthrown.

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Market Particpant Views On the UK FCA's Initiative

"We should be paying for research out of the bottom line."
(Large UK Asset Manager)

"I think having this transparency is great. If you ask your client base how many calls they get back about Level 2 disclosure, if it's anything like us, the phone falls very silent. To bring it to the fore is the right thing to do."
(Large UK Asset Manager)

"It's getting the PMs to think it's their clients' money that they're spending. If you're paying for it out of your back pocket, would you actually buy this piece of research?"
(Large UK Asset Manager)

"I'm not sure that the asset management company has the ability to really evaluate why they pay XYZ to the vendor, so it's important that they are asking the right questions."
(Large Continental Asset Manager)

"I can't really see it changing – our local brokers have not even implemented CSA's yet and a large proportion of our equities trading is in local stocks."
(Small Nordic Asset Manager)

"We probably read 20% of the research that's sent us. There's a lot of noise in the system, but let's be careful not to overregulate it. A lot of what's going to happen is what's happened in trading, market fragmentation and liquidity suffers. You might have the same in research."
(Medium-sized UK Asset Manager)

"Once you start paying hard dollar for research the whole industry will suffer – where do you draw the line? We made money on that piece of research therefore we will pay you – if we lose money, does the broker cover the loss?"
(Medium-sized UK Asset Manager)

"This will never happen in my lifetime. There's not enough in management fees to actually pay for this."
(Large UK Asset Manager)

"If we are restricted in what we were paying, would the FCA scrutinise the hedge funds in the same way? If they don't, it makes it a very uncompetitive market. You can't just do it with the big guys just because they're easy to monitor."
(Large UK Asset Manager)

"This really requires the brokers to come up with a firm split between how your commissions are allocated within the bank. But they don't do that. If they do, it's an estimate. If they themselves don't know what the exact split is, then how are we to know? The brokers need to find a solution."
(Large UK Asset Manager)

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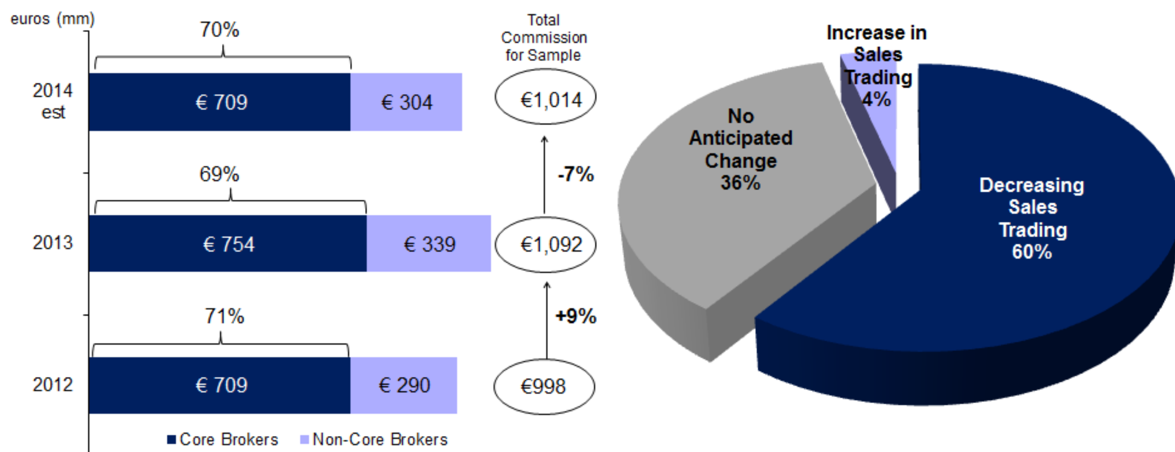
The European Resurgence

"The amount going to non-core has reduced dramatically and soon will affect our core. We are in the process of addressing this but haven't done so yet."
(Large Continental Asset Manager)

Optimism about the future of Europe has returned, with average daily volumes from our sample set increasing 16% year on year, yet the changing execution environment will scupper any possible upsurge in revenues from increased activity. Commissions for our sample set may have risen by 9% in 2013 after 2012's dramatic decline of 27% (see exhibit 6), but the reality is that any upturn is unlikely to continue.

Several participants spoke of the increase in activity this year being due to fund rationalisation on the back of poor activity in 2012, requiring one-off portfolio adjustments rather than any sustainable rise in trading. Even for those whose activity is increasing and execution spend is higher, total commissions paid are likely to lower unless there is a significant increase in emerging market activity, which typically charges higher commission fees. The latest furore regarding commission payments in the UK and the anticipated increase in use of automation by 96% of market participants (see exhibit 7), illustrate that the industry will remain forced to consolidate further to remain economically viable.

Exhibits 6 and 7
Commission Spend (2012–2014e) / Change in Order Allocation Estimates for 2014



Source: TABB Group

"I have not been expecting the same out of brokers, but they have been delivering, even though they would not be getting paid. But now the brokers are breathing down my neck, waiting for the money."
(Medium-sized Continental Asset Manager)

Buy side participants are currently responding to the changes using the following options:

- Continuing to concentrate externally; reducing the number of core brokers to concentrate the research vote
- Concentrating internally by reducing the number of touch points in a firm
- Simplification of services taken, by boiling down to written research rather than ad hoc conference calls, management visits, email exchanges or data requests
- Moving services in-house where possible

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- Changing investment strategy to focus on large caps rather than smaller mid-cap stocks that require specialist local providers

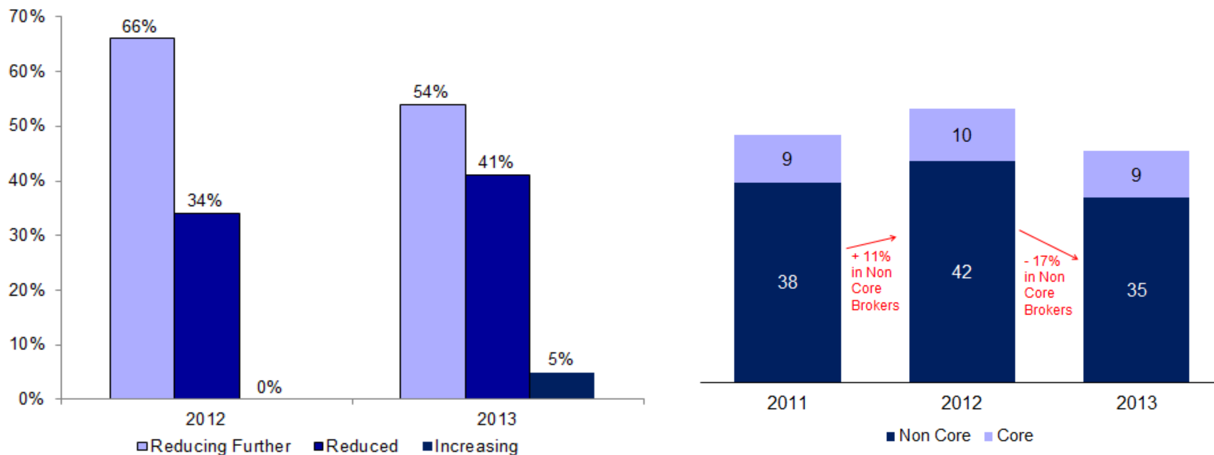
"Where I have had to slim my list down, I have had to prioritise on globals. I can't afford to pay someone who only covers Europe."
(Medium-sized UK Asset Manager)

The last option illustrates the depth of impact that the concentration of brokerage coverage will have on the industry and how the underlying size and might of individual asset managers will dictate the outcome. Larger asset managers will be able to fund internal expertise but the risk remains that mid-tier asset managers will be pushed to indexing or diminished portfolios as the consolidation of the research process evolves.

Playing for Time

The continued uncertainty around regulation has ensured market participants have been delaying the inevitable: broker lists continued to be trimmed in 2013, with a decline of 10% in the overall number of brokers used versus 2012. Although the reduction in total brokers is slowing, it is not over yet; 54% of participants anticipate reducing their broker list further in 2014 (see exhibit 8).

Exhibits 8 and 9
Reduction in Brokers (2012–2013) / Average Number of Core / Non-Core Brokers (2011–2013)



Source: TABB Group

"Half our brokers are now the niche players who provide the coverage we can no longer get with the bulge brackets – but if we switched them off, it's only 10% of my overall wallet – it would make no difference to the globals."
(Medium-sized Continental Asset Manager)

Compared with 2011, the average number of brokers – and of these, the number of core brokers – changed only slightly in 2013, reversing the increase seen in 2012 (see exhibit 9). Last year saw research payments switch to independents due to the perceived declining quality of research from the bulge brackets. This concern appears to have now been addressed, or else surpassed, by a greater need to remain relevant with their global core brokers. Specialists will either need to expand or partner in order to cover the full breadth of activity if they wish to appeal to a maximum number on the buy side; the reduced commission wallet will continue to be leveraged carefully to wring out every possible service.

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For those who have already tightened the execution list in order to limit counterparty risk, the ideal scenario for some would be a consolidation in the number of research providers. With the heavy cost burden of Financial Information eXchange (FIX®) Protocollines, some of the smaller firms perceive it is not worth their while to be linked to multiple providers. Yet equally, a large tail of brokers doesn't pay.

"We are now down to a core of two plus locals which changes according to what we are trading – the whole payment process now has to be more targeted."
(Large UK Asset Manager)

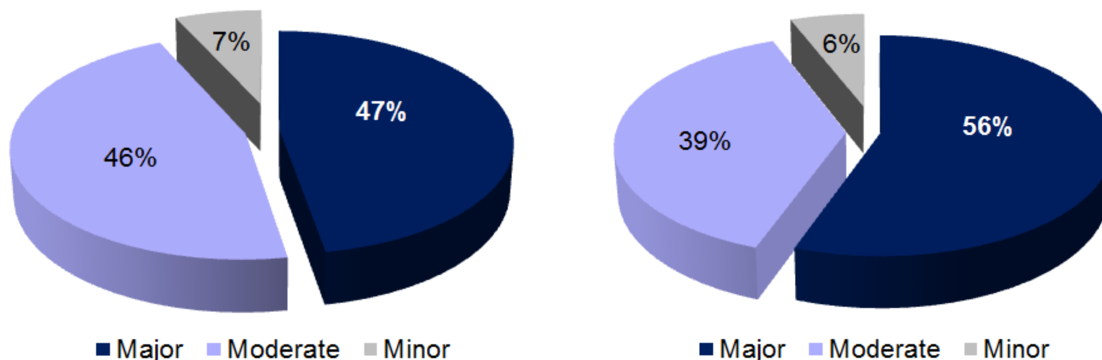
Options are slim; dealing desks can double the money for a global, but this will not necessarily impact their service levels. Alternatively, if they double commissions for a smaller house, they may see improved service but cover a reduced number of stocks and fail to leverage valuable commission dollars holistically.

Some asset managers can afford to whittle broker lists down to a handful of providers, but for European funds where the portfolio is diverse across country and sector, participants are struggling to reduce broker lists further, particularly if they trade a high percentage of small and mid-cap stocks. As such some asset managers anticipate increasing rather than decreasing the overall number of brokers in 2014.

Premier League

The concentration of buy side flow is occurring twofold: once between each buy side firm's list of brokers and again as the buy side itself consolidates. Major commission payers will continue to dominate, with just 6% of available commissions in the hands of minor commission payers and moderate commission payers beginning to lose their impact (see exhibits 10 and 11).

Exhibits 10 and 11
Commission Breakdown between Major (>$50 million), Moderate (<$50 million to >$10 million) and Minor (<$10 million) Payers (2012 and 2013)



Source: TABB Group

The allocation of resources, particularly one-on-one meetings and IPOs versus commissions paid, will remain a contentious issue for

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the foreseeable future. Global investment banks creating a firm-wide relationship still appear to expect to be paid in every area by certain firms. For instance, large flows in Asia do not appear to pay for UK activity as yet unless a major commission payer is involved. Thus, so far, many mid-tier fund managers have avoided impact. This could all be about to change. Increasingly, asset managers are finding their broker lists shrinking not of their own volition, but as brokers are forced to retrench. With the sell side taking a holistic approach to execution and research commissions in aggregate – combined with their ability to monitor which clients to focus their limited resources on – the mid-tier will increasingly be forced to whittle down their requirements, change their behaviour or look elsewhere.

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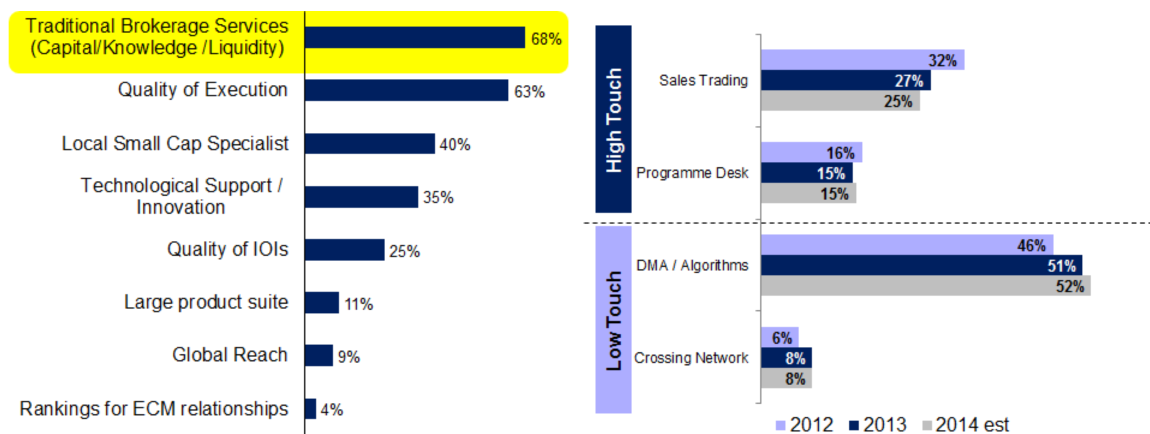
What the Buy Side Wants

"The problem with high touch is that it has become low touch – I don't need that. I can trade an algo myself."
(Small Continental Asset Manager)

Europe remains locked in the liquidity issue; 68% of participants view traditional brokerage services as having the greatest value (see exhibit 12). But if sales trading is not a dying art, it is becoming an ever more exclusive one; just 27% of overall commission was routed to sales trading. This is anticipated to fall to 25% in 2014 (see exhibit 13). Unless the buy side trader is getting the first call, market participants continue to complain of the stealth cutback in service.

Exhibits 12 and 13
Value of High Touch Services / Breakdown of Order Flow Allocation



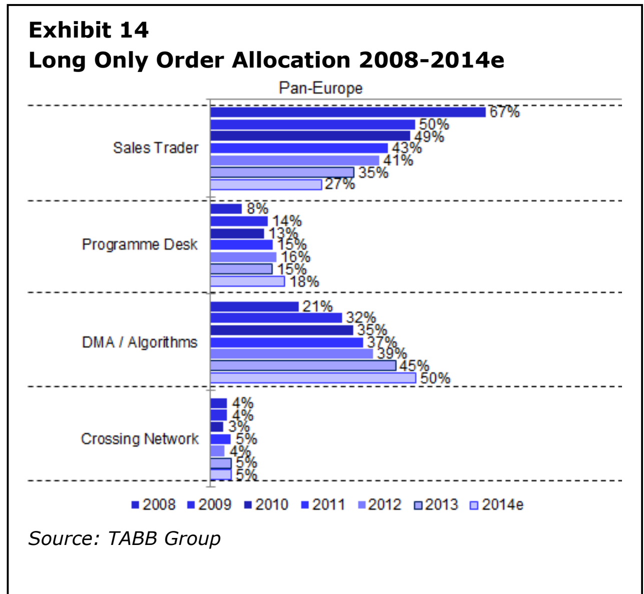
Source: TABB Group

Tale of Two Cities

"For someone to break into the top five will ultimately still be decided by their research."
(Medium-sized Nordic Asset Manager)

Despite the increase in automation, without true unbundling, brokers still need to offer both research and execution for the majority of European asset managers to maintain a core broker relationship. Yet even the traditional long only asset manager is being forced into behaviour change (see exhibit 14). As the split between research and execution intensifies, this will shift the requirement of services and this is already particularly evident in the UK versus mainland Europe.

Exhibit 14
Long Only Order Allocation 2008-2014e



Source: TABB Group

"For us it's all about who has the flow. High-touch coverage makes a difference, but not very much."
(Large UK Asset Manager)

It is in small and mid-cap European names where the differences are most stark. While UK asset managers have portfolios heavily weighted to small and mid-cap names and are able to depend on valued sales traders,

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"For us, getting blocks done in small to mid-cap names is absolutely crucial and smaller firms are definitely pushing to be the axe in certain names."
(Medium-sized UK Asset Manager)

European buy side managers describe their frustration at the retraction of sales trading services and how increasing regulation is handicapping a broker's ability to survive in an environment where commissions are still, in the main, wedded to research provision.

The subsequent 'juniorisaiton' of the sales trading service – the loss of the experienced sales trader who understands the client and their investment profile, exchanged for a junior on the desk – offers the opportunity for some brokerage firms to gain a foothold on competitors forced to cut back.

Currently, the greatest level of change anticipated in 2014 is expected to hit moderate commission payers on the buy side; if they are not receiving sufficient service, they perceive that they may as well trade directly themselves via an algorithm (see exhibit 15).

Exhibit 15
Change in Order Allocation Anticipated for 2014

Expected Change in 2014 Sales Trading Allocation (by Number of Firms)				
Commission Size	Size Categories	Increase Sales Trading	Flat	Decrease Sales Trading
Major	>$50mm	1	5	4
Moderate	$10mm-$50mm	0	6	21
Minor	<$10mm	1	10	10
Total		2	21	35

Source: TABB Group

Back to Blocks

However, accessing algorithms requires internal resources and a level of buy side knowledge that is still a work in progress for many. Hence, for tricky mid to small cap stocks, the benefits of accessing a valued sales trader retains a strong incentive.

"There is nothing a sales trader does for me now that I can't do myself."
(Medium-sized Continental Asset Manager)

There was a significant increase in 2013 of the percentage of participants trading between 10–20% of their flow as a block, but this was largely isolated to major commission players (see exhibits 16 and 17). In addition, the increase is not all traditional 'upstairs' trading. With the increase in automation, blocks in small and mid names are heading to crossing pools such as Liquidnet, which saw a sharp rise in activity during 2013.

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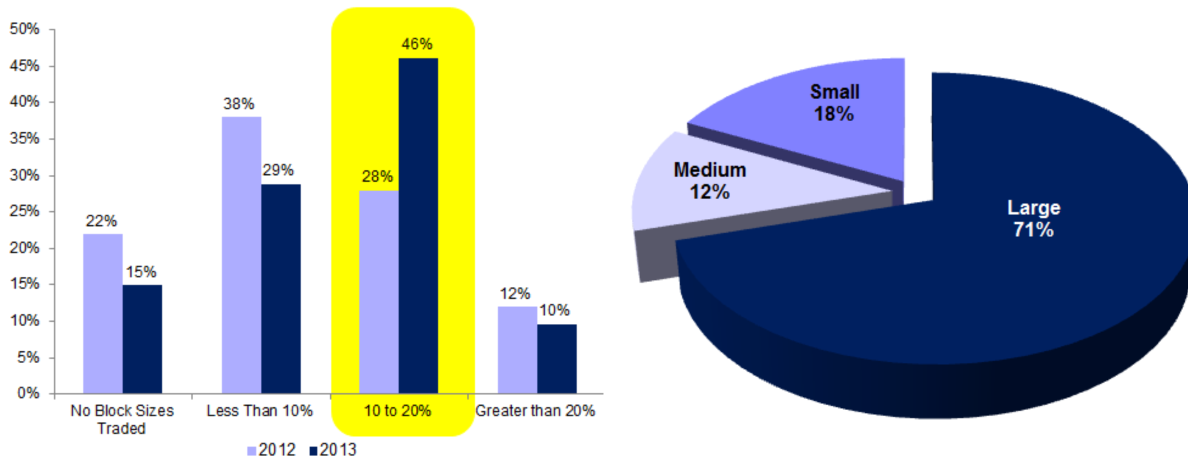
Exhibits 16 and 17
Return of the Block / AUM breakdown of Increased Block Activity in 2013



Source: TABB Group

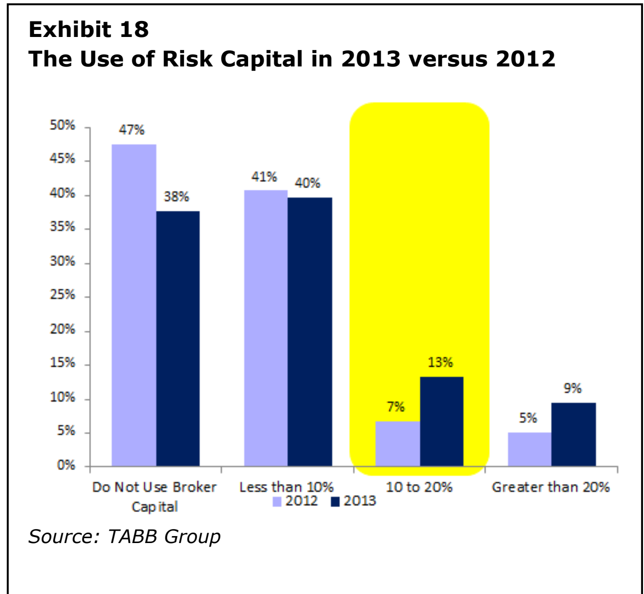
The Risk in Risk

Some brokers have opted for more aggressive capital commitment in 2013 and consequently 35% of participants saw an increase in their use of risk capital, with 22% of participants trading more than 10% of their order flow on risk versus just 12% last year (see exhibit 18). Again, this option was not available for all, and even then, not for the full size.

"We have a budget that we want to keep to. I don't want to find out that at the end of the year I was supposed to pay broker XYZ a million dollars, but they ended up losing a quarter of a million dollars on bad trading that I have no control over."
(Large UK Hedge Fund)

The usual limitations in the use of risk still apply: the buy side trader does not want a partial fill on a risk trade to create competition for the remainder of the trade. Client facilitation as risk – more an extension of an indication of interest (IOI) marked as a book trade – is deemed as less controversial; participants can trade at the touch but are under no further obligation.

Exhibit 18
The Use of Risk Capital in 2013 versus 2012



Source: TABB Group

IOI Action

"Now with IOIs, what see is what I get. I hit the button, I am filled, no capital, no tears, job done."
(Large UK Hedge Fund)

The provision of good natural liquidity was on the wish list of most participants but the use of broker IOI remain somewhat of a hit and miss affair. While some have almost given up on a broker's accuracy in providing IOIs, the administrative headache for others is only intensifying, forcing harsher action in policing IOI activity. For

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"Brokers who view us holistically, including ECM, will be the winners for us."
(Large UK Asset Manager)

example, US rules on risk versus agency transactions for credit support annex (CSA) trades mean that if a buy side firm trades on a natural that isn't in fact a natural, and is incorrectly flagged accordingly in CSA aggregator, the resulting back-office mayhem will be enough for a broker to be relegated to the penalty box.

Some participants felt that brokers were finally beginning to understand the ramifications and the value of true IOIs, with the top global banks putting together more reliable automated systems. For others, IOIs remain merely an indication and it is up to the buy side dealing desk to pick up the phone and establish the true picture.

ECM: The New Wave of Blocks

"We need the broker who provides us feet on the ground in different places, with better contacts, better market knowledge than the average bulge bracket."
(Large UK Asset Manager)

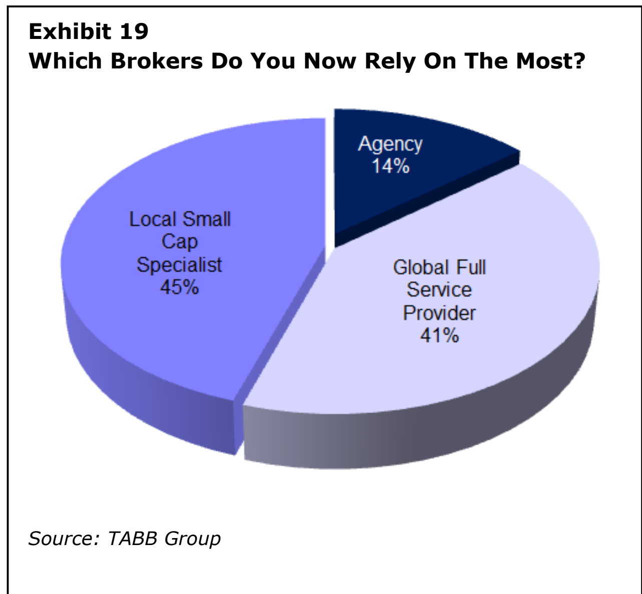
As the traditional blocks increase in their exclusivity, understanding the new make-up of block activity will enable alternatives to the traditional block and risk methods are emerging, such as an increase in equity capital market (ECM) activity. While smaller "blocks" will shift to crossing networks, holding multiple days' even weeks of volume in a single stock still creates significant execution challenges. The ability to directly negotiate with ECM departments to create a placement offers the ability to painlessly exit a large holding. As asset managers consolidate their underlying holdings, this activity is expected to increase.

The Local Last Stand

"I don't need as many of the bulge brackets. There's an overcapacity on the higher side. I am leaning more towards a smaller concentrated bulge with regional specialists."
(Medium-sized US Asset Manager)

For European asset managers who are struggling with depleted commissions to maintain their relevance to a resource-strapped sell side, the response has been to return to local brokers in their search for valuable quality coverage. Currently, 61% of participants have a local broker within their top-five high-touch providers and 45% rely most on their local small-cap specialist, leading to a continued tiering in clients, brokers, product and resources (see exhibit 19).

Exhibit 19
Which Brokers Do You Now Rely On The Most?



Source: TABB Group

For the larger asset managers who are focusing on global names at the expense of locals, there is a second tier that is switching back to country specialists in the search for ideas and valued coverage, specifically within the small-cap and emerging spaces. But again, the location, size and underlying investment strategy provoked a wide response to the value of a

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"The last thing you want is for a large chunk of one of your names to go through a broker who you just have no presence with."
(Medium-sized UK Asset Manager)

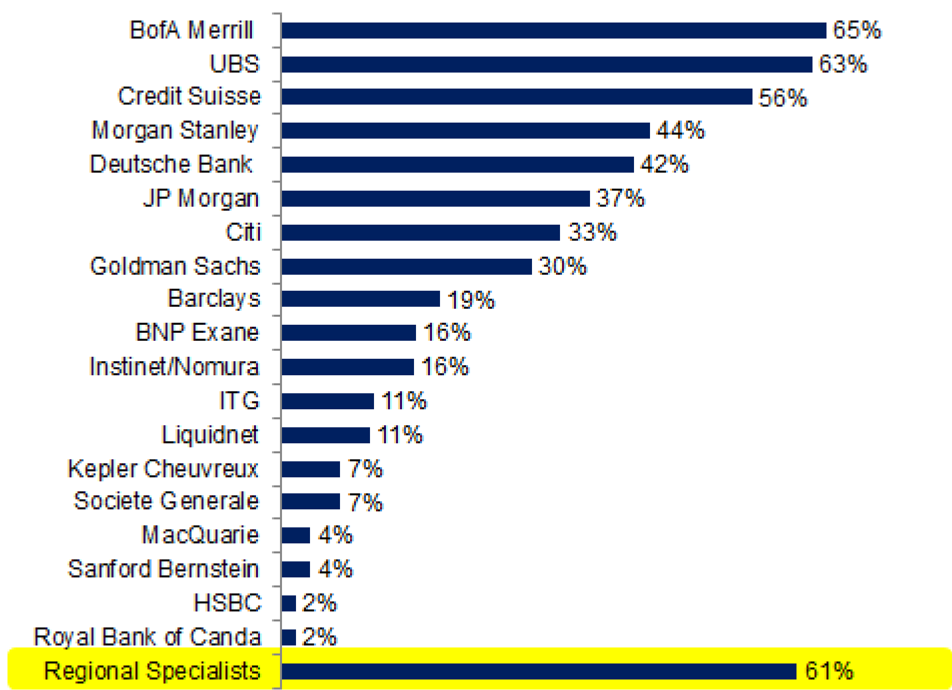
country specialist. If a fund trades Norwegian names once a year, it is not sufficient business to justify a local relationship. Whereas if the portfolio is broad, a buy side execution desk still has to make itself as widely available as it can in order to find the liquidity, when and where it becomes available.

At some point in the future this search for liquidity will be solved via technology, but in the interim, the European mid-tier still has a presence. The challenge then becomes how local brokers can continue to deliver what the buy side requires in the longer term to ensure their future viability.

Winners in 2013: Winners in 2014?

Coverage has changed as a result of economics and has impacted the top-five broker list, with many participants seeing significant change in their broker lists in the last year. The bulge bracket's one-stop shops can offer service across the board that regional specialists will struggle to do, simply in terms of scale and cost efficiency. But specialist service remains a strong focus for the buy side, with the use of regional specialists jumping from 38% to 61% in 2013 (see exhibit 20).

Exhibit 20
Top-Five Brokers 2013 (by Frequency of Mention)



Source: TABB Group

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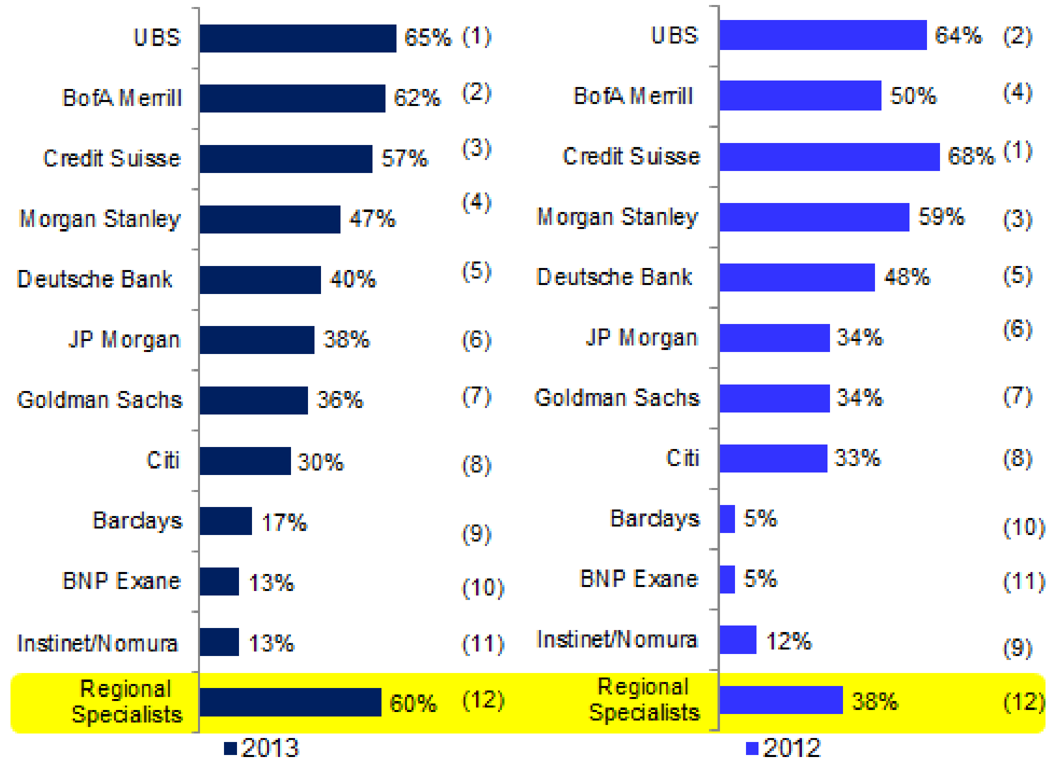
Some on the bulge bracket have attempted to replicate the specialist service within a global bank; Bank of America (BofA) Merrill Lynch was highlighted for this and moved to number-one position for the first time but the fight for the top slot is close with UBS dominating the Top 5 for year on year participants (see exhibit 21); the top 4 remain year on year from 2012, Credit Suisse, UBS, Morgan Stanley and BofA Merrill Lynch (see exhibit 22).

Exhibits 21 and 22
Top-Five Brokers 2013 Year on Year versus 2012 (by Frequency of Mention scoring more than 10%)



Source: TABB Group

The top six brokers – BofA Merrill Lynch, UBS, Credit Suisse, Morgan Stanley, Deutsche Bank and JP Morgan – were highlighted for creating a firm-wide relationship on multiple levels to ensure clients received maximum bang for their buck. BofA Merrill Lynch benefited from providing a consistent level of service, particularly in the small and mid-cap space, as well as the continued improvements to the algorithmic offering. Credit Suisse and UBS excel on all fronts, especially access to good liquidity, as well as reliable and consistent service, whereas Goldman was highlighted for the provision of good risk pricing. Morgan Stanley was highlighted for its innovation, liquidity and market structure support that clients valued. Citi was noted for its breadth of coverage and geographic spread of products. Credit Suisse was also singled out for the HOLT research service. Any negative comments focused on how reduced high-touch service impacts execution capabilities, but most made up with strong electronic offerings. Deutsche Bank in particular was highlighted for its dark electronic offering.

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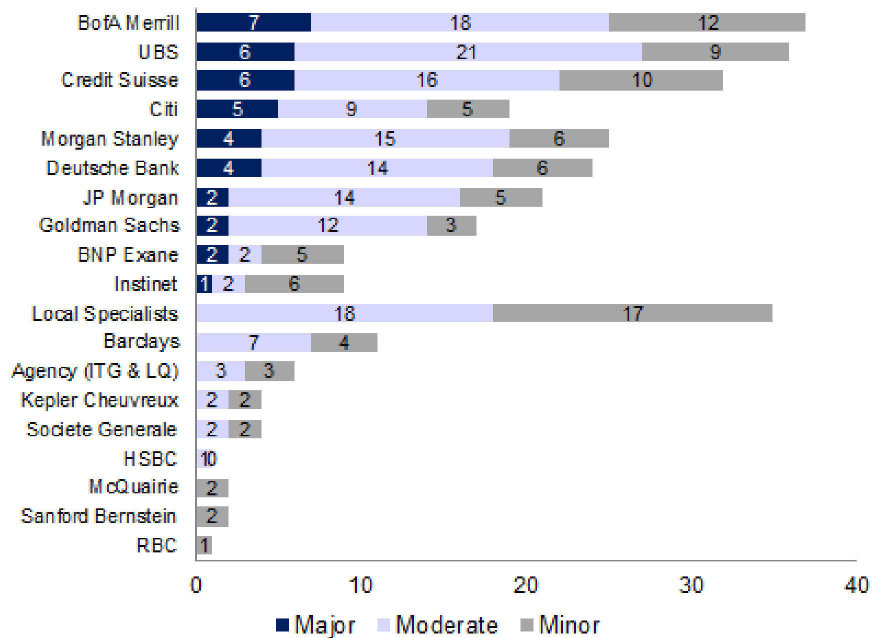
Exhibit 23
Top-Five Brokers in 2013 by Commission Breakdown



Source: TABB Group

When ranking the top-five brokers by commission wallet, the dominance of the top-three becomes further evident (see exhibit 23). The buy side firms with greater weighting among the major commission payers feature predominantly amongst the top-six brokers, with BofA Merrill Lynch, UBS and Credit Suisse, Citi, Morgan Stanley and Deutsche Bank. The geographic location also illustrates dominance in certain areas, with both Barclays and Exane BNP Paribas showing significant weighting on home territory (see exhibit 24).

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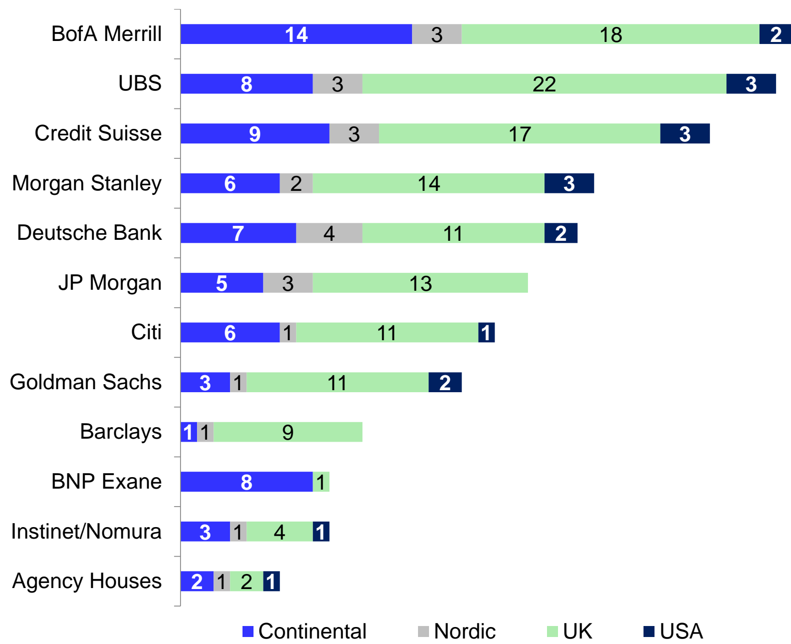
Exhibit 24
Top-Five Brokers in 2013 by Client Geographic Location



Source: TABB Group

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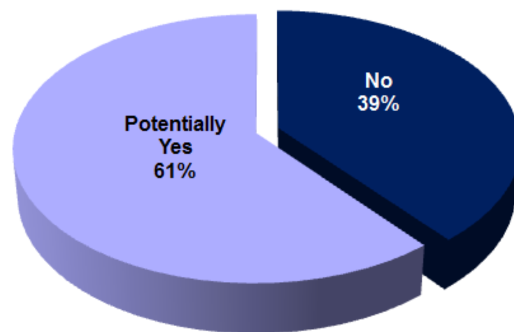
Ones to Watch for 2014

Although comments were made regarding the dilution of overall service, especially in relation to strained sales trading resources, others quoted the top five as delivering consistently strong trading and coverage relationships. However, because declining volumes and commissions will continue, the status quo is no longer viable in the current economic climate. As bulge brackets restrict their activity in certain business areas, a vacuum is opening that new challengers look set to fill, with more than half of the participants anticipating a new broker moving into their top five (see exhibit 25).

"A couple of the big bulge brackets have dropped out of our core as a result of them diluting the service they offer. You don't have to go too far down our list to get to a regional specialist who offers differentiation. It will be challenging for them to maintain their position but they are now increasingly significant in our eyes."
(Large UK Asset Manager)

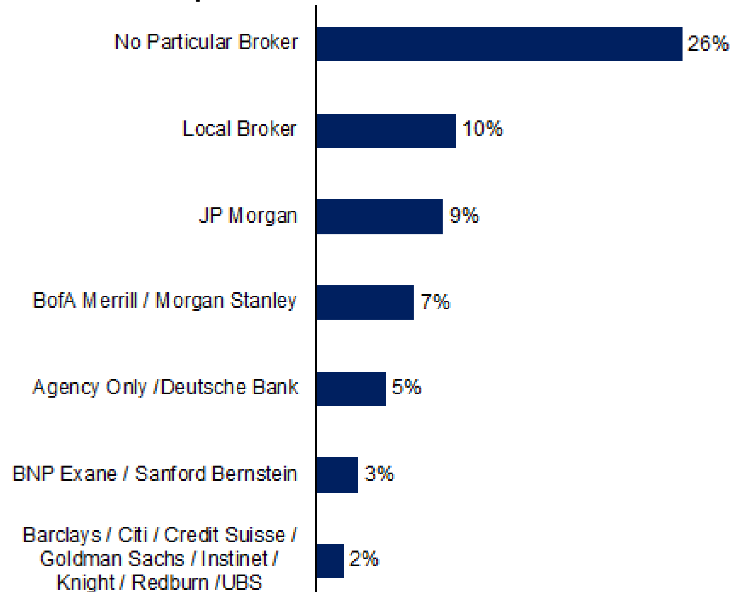
While the majority felt that no one particular broker currently stood out, the strongest bulge bracket contender was JP Morgan (see exhibit 26), which came up consistently as a firm firing on all cylinders for the majority of participants across a broad range of services, sectors and regions, from high touch to custody. Others that were mentioned were local brokers such as Exane BNP Paribas,

Exhibit 25
Potential for Top 10 Broker to Make Top Five in 2014?



Source: TABB Group

Exhibit 26
Broker Most Likely to Break into the Top Five in 2014



Source: TABB Group

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Berenberg, Goodbody, Invesco, Natexis, Oriel Securities and Redburn. However, this is subject to change, ultimately dependent on the European economy recovery versus renewed interest in certain European emerging markets, together with the ongoing decoupling of research from execution.

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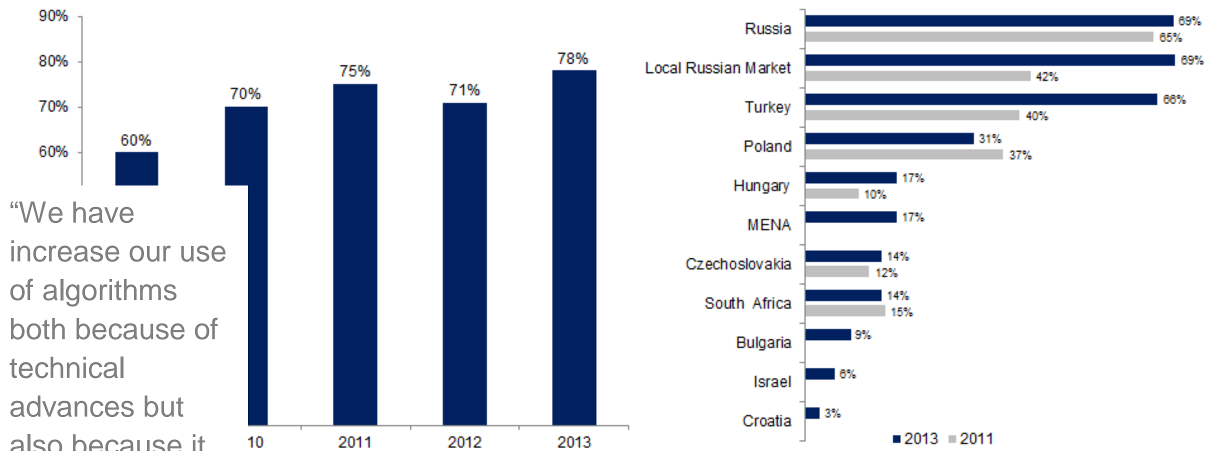
Looking East Once More

Seventy eight per cent of participants now trade emerging Europe stocks regularly, up from 71% in 2012, after a small decline from 2011 (see exhibit 27). Russia remains the prominent market, but the proportion of participants who actively trade within the Turkish marketplace has jumped by 26% in just two years (see exhibit 28).

Exhibits 27 and 28
Percentage of Participants Who Trade European Emerging Markets, 2009–2013 / Countries Traded



"We have increase our use of algorithms both because of technical advances but also because it suits a country offering – particularly SA or Turkey."
(Large UK Asset Manager)

Bar the dip in 2012, emerging European markets are continuing to gain in strength and breadth as a number of new markets become more accessible to a wider range of institutional investors. The recategorisation of Turkey to 'advanced emerging' on the FTSE index series has strengthened the ability of UK pension funds to invest and no doubt contributed to the increased levels of activity. In 2014 however investments will become localised on individual country performance, rather than the region as a whole. Those countries with relatively stable public finances in comparison with southern developed Europe will ensure emerging and even frontier Europe can be considered a more reliable source of alpha with favourable price/earnings ratios in the current climate. As the euro crisis continues its recovery, the balance between developed and emerging will continue to realign. While frontier markets retain their exclusivity, there is renewed impetus in accessing the Middle East and North Africa region, in particular Africa, from a broader range of participants.

The Rise of the Locals

Russia remains the most actively traded emerging market but the shift from the international order book to the local market has been reinforced by the merger of RTS and MICEX, and the introduction of favourable settlement and custody terms. The recategorisation of the Moscow Exchange Group's National Clearing Centre from depository status to central counterparty allowed US investors to access Russian stocks via MICEX for the first time. As a result of

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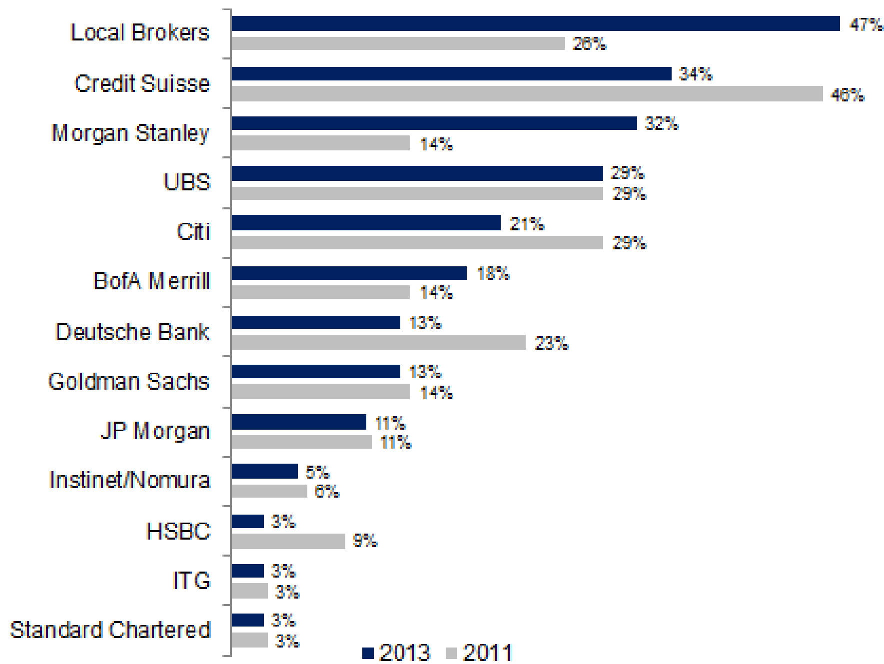
market structure changes, 77% of market participants are actively looking to trade local stock where possible, and local brokers are retaking market share with 47% of order flow (see exhibit 29).

Exhibit 29
Top Emerging Market Broker (2011 vs 2013)



Source: TABB Group

Relationships with local investing institutions may provide access to additional sources of liquidity, which remains a strong draw. However, local or regional expertise is only one component of counterparty selection; often it will be a question of the limitations of the underlying funds or custodian, or the improved counterparty risk associated with global depositary receipts, which will ensure bulge bracket relationships remain robust for the foreseeable future with Credit Suisse retaining the number one bulge bracket slot, but with Morgan Stanley's recent push into Emerging Markets being acknowledged by the buy side (see exhibit 29).

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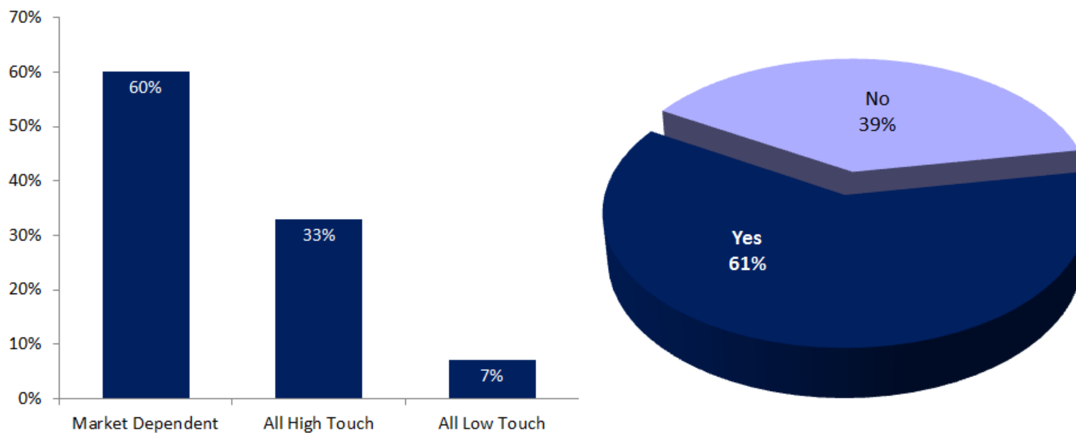
Exhibits 30 and 31
Order Routing Activity /Increasing Usage of Algorithms in Emerging Markets



Source: TABB Group

"Emerging Markets are our favourite topic of discussion – when will the taper kick in. I wouldn't be surprised if we continued increasing our flow for the first half of 14 but it will peak there."
(Large UK Asset Manager)

Pricing inefficiencies cause the greatest problems when dealing with emerging markets due to the technological constraints that are inevitable from a developing nation. As a result, many are increasingly using algorithms with 61% of participants now trading electronically; although for 60% it depends on the underlying market, with some emerging venues considered more electronic than developed venues as technological advances encroach further (see exhibits 30 and 31).

Heading Back Home

Ultimately, appetite for emerging markets in 2014 will come down to the available liquidity versus the alpha opportunities in the wider macro environment. The IMF has stated that Central and Eastern Europe is poised for a "tepid" recovery as countries with a large fiscal imbalances still risk market buffeting as the central banks in developed states unwind the previous loose monetary policy heightening the risk of inflation. The rise of southern Europe will also play a significant part as to how well emerging countries fare in 2014, with some southern states showing higher opportunities for alpha currently. Participants expected a swing back to Continental Europe was more likely in 2014 given the previous shift after the Eurozone Crisis. Ultimately Emerging Markets fate remains dependent on global investors searching for higher yielding assets which now they may well find closer to home.

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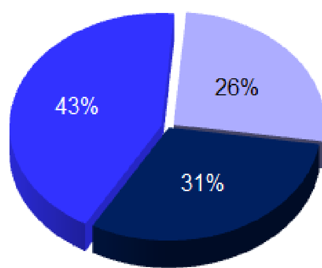
Methodology

We conducted interviews with 58 head traders of equity desks during September to November 2013. These firms comprise 49 long-only asset management firms and nine hedge funds, managing €14.6 trillion in assets under management (AUM) worldwide (see exhibit 51). As with prior years, we segment our participants according to size of AUM, as outlined in the table below.

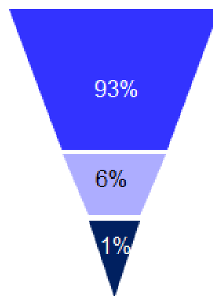
Firm Type	Large	Medium	Small
Asset managers	>€50B	€10B to €50B	<€10B
Hedge funds	>€2.35B	€380mm to €2.35mm	<€380mm

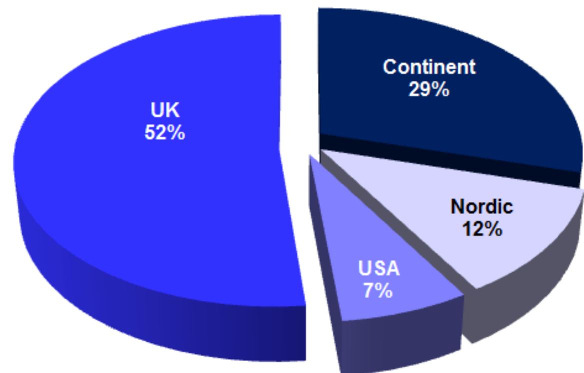
Exhibits 32 and 33
Participants Segmented by Assets under Management / Participants Segmented by Location

Population by ADV



€14.6 Trillion AUM





■ High ■ Medium ■ Low ADV

Source: TABB Group

Our participants are primarily located within Europe, but we also include firms located in the United States that trade the European markets directly (see exhibits 32 and 33). This year's report contains responses from 81% of the same firms who participated in 2012. We also segment our participants by size, based on average daily volume (ADV) to reflect the influence of their flow in the current environment.

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Conclusion

Renewed enthusiasm for trading European equities cannot guarantee respite to a besieged brokerage industry. Despite the huge transition the industry has undergone in a relatively short time frame, it is still a work in progress. The prognosis for continuing decline in turnover volumes and commission wallets will continue to push the need for immediate action on outdated business models. Much debated, but resistant to change until the last, the status quo is finally being overthrown.

Change is unavoidable. A tremendous opportunity now exists within financial services. Disruptive new business models, products and services – enabled by exponential improvements in technology and driven by the underlying European economics – will fundamentally challenge incumbent firms and market structures.

Slowing fund flows, reduced commissions, and a persistent shift away from developed markets dramatically changed the rules of engagement for many in 2013 to ensure their survival. Now Pandora's box has been prised open and a chain of events is unfolding which will ensure the emergence of a new European equity trading model.

The march of progress will continue to dictate that many business models will need to be "rightsized" to reflect the new market reality. Algorithmic trading has industrialised execution of capital equity markets and this will spread throughout the investment process. Full control over the dealing commissions by the buy side will deliver greater transparency throughout the research process and finally break the stranglehold between execution turnover and the generation of research. The results of this will impact not only total commissions paid but alter how research is bought, accessed and consumed. The challenge for European participants will be to ensure they are able to withstand the turmoil as the industry changes deep-rooted behaviours.

While the street is now doing a much better job of understanding the profitability of a firm and the buy side is improving their consumption of valuable resources, the reality is that the industry is slow to change unless it is forced to. The FCA's decision to create increased transparency of the commission process will intensify the speed and magnitude of industry change. But this is an economic reality for many not solely dependent on action by a regulator. While larger asset managers will be able to fund the shift lost brokerage services internally, mid-tier asset managers could be pushed to indexing or reducing breadth of their portfolios unless they can find an alternative. If not, the potential risk of limiting trading activity to an exclusive club of asset managers and investment managers covering only the most liquid of mainstream European stocks will have wider negative repercussions for the wider economy.

The shift to automation of the full cycle of the investment process rather than just the execution process will require seismic change. As the power of technology in the research process is grasped by the industry and undergoes full automation, significant change will emerge that will ultimately benefit the mid-tier. European equity trading desks are in a unique position; previous experience from MiFID I offers valuable opportunities to lead as other asset classes flounder in the regulatory barrage.

Experienced sales trading remains highly valued, and while technology has made traditional sales trading coverage somewhat redundant in recent years, it will be the amalgamation of both human and technological interaction that will provide the ultimate

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execution solution. To benefit from this fully, buy-side trading will need to be recognised for its true value. Overlooking or misunderstanding the potential alpha opportunity that a strong trading team can capture is a direct cost to clients' portfolios. This is already evident among a select few buy side firms, but this will need to become the core competency of all asset managers or they will find investors voting with their feet.

As short-term alpha becomes valued for its role in the investment cycle, further adjustments can be made to fund performance. Optimisation of the implementation process, greater tactical positioning around core portfolios and the creation of new opportunities as market dynamics change will alter the relationship once more between the buy and sell side.

The development of internal analytics and visualisation programmes to screen ideas against intraday activities as they occur will provide deeper aggregate market analysis on a pre-trade basis. By identifying anomalies in the market and better understanding the available liquidity and intraday momentum, buy side traders can drive interaction and dialogue to deliver better trading decisions. But it will be through valued partnerships with the sell side that they will maximise their value add to the investment process. The innovation in European equity trading has only just got started.

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About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of "first-person knowledge," TABB Group analyses and quantifies the investing value chain from the fiduciary, investment manager, broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their businesses. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, go to www.tabbgroup.com.

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Rebecca Healey

Rebecca joined TABB Group in March 2011, bringing more than 15 years' experience in e-trading and financial services. Rebecca has held various sales and trading positions with Bankers Trust, Goldman Sachs, and most recently Credit Suisse, where as Vice President she was instrumental in launching the successful AES product to hedge funds from its inception in 2002 until 2008. Prior to this she was the first electronic trader at Credit Suisse to be registered for all electronic European cash equity markets and covered sales trading into Asia and then Europe between 1997 and 2000. More recently, Rebecca was based in the Middle East from 2008 to 2010. There she was employed by the British Embassy in Bahrain, where she successfully launched the UK Government's financial services strategy and set up the Bahrain Financial Services Roundtable, which remains a key source of information for the UK Government today, especially in relation to Islamic finance. Rebecca holds a Bachelor of Arts degree in Spanish & Latin American History & Politics from the University of London. At TABB Group, Rebecca has authored *Dark Matters; One Touch, One World: The Future of Investment Banking; FX in Transition: Taking The Quantum Leap; MiFID II and Fixed-Income Price Transparency: Panacea or Problem?; Market Surveillance in Europe: Under Starter's Orders; European Equity Trading 2011/12: Looking for Allies in the Face of Adversity;* and *European Algorithms: The Evolution; and Trading in the Middle East: the Road to Mecca.*

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