EMEA Equities: the resilience of 'low-touch'

- We see no evidence of European investors shifting away from low- to high-touch equity trading, even in times of elevated volatility.
- We expect low-touch will gain market share in the coming years, albeit at slower pace and only as a part of the wider trading package. This will be driven by new products …
- … and inherent cost advantages over the voice-brokered model. At one extreme, 'our' banks which derive at least 55% of their cash equity revenue in Europe from electronic trading achieve cost/income ratio of 65%, or better.

Background

In 2011, the US institutional investors shifted some of their US equity trading flows away from 'low-touch' (where we include off- and dark-order books) and into 'traditional'/voice-brokered execution; not surprisingly, this translated into brokers allocating a greater share of commissions to sales/trading and research departments. The shift prompted many learned commentators to forecast a decline in the relative importance of low-touch trading in the US equity markets.

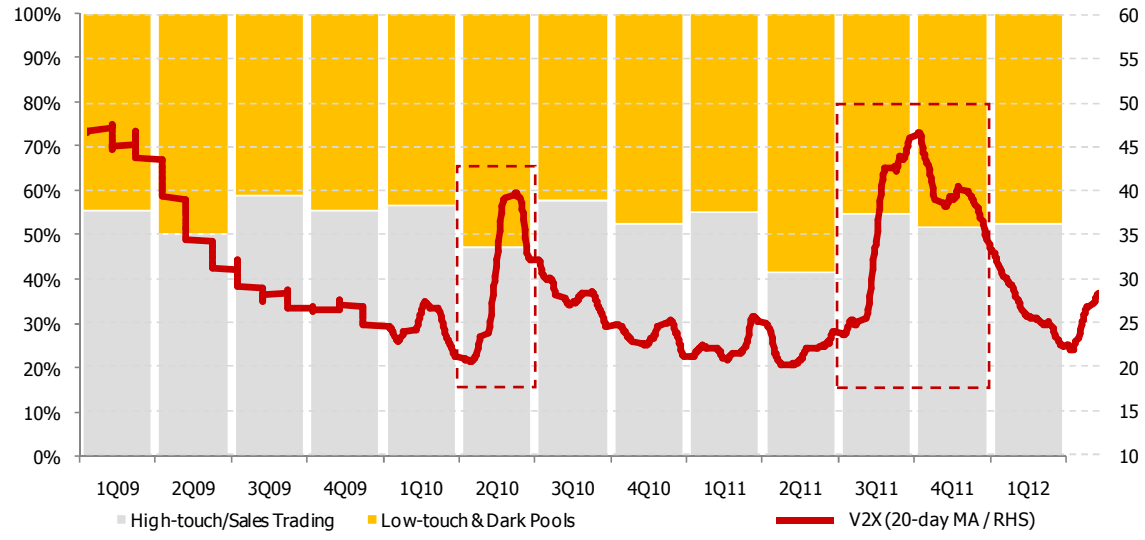
The coverage of this topic in Europe has been comparably muted. This note, summarising a larger study we conducted in 1Q12, focuses on European high-/low-touch trading patterns, and the top investment banks European units' underlying cost/income efficiency during 1Q09-1Q12.

Low- vs High-Touch

In periods of elevated volatility, investors could be reasonably expected to favour fundamental analysis over trend-based/computerised strategies (e.g. Black Box; see Appendix): the latter cannot, by definition, be of much help when share prices make significant moves without apparent reason. We have, however, found little evidence of such switch.

Our research - combining publicly available data and with active market participants' views – instead suggests that, in the main European markets, electronic/low-touch and traditional/high-touch equity traded volumes are generally balanced, with high-touch trading volume slightly ahead. Volatility spikes in 2Q10 and 2H11 (as measured by Dow Jones V2Xindex – see below) had no appreciable impact.

Equity low- vs high-touch trading turnover& V2X volatility (Europe excluding MEA)*



Notes: (1) V2X = Dow Jones EURO STOXX 50 volatility index; (2) 'Europe excluding MEA': includes Western and Central/Eastern Europe, Russia & CIS, and Turkey; excludes the Middle East, and Africa. Source: Tricumen, Dow Jones.

Contrary to some observers, we do not subscribe to the view that the share of low-touch trading has peaked relative to high-touch:

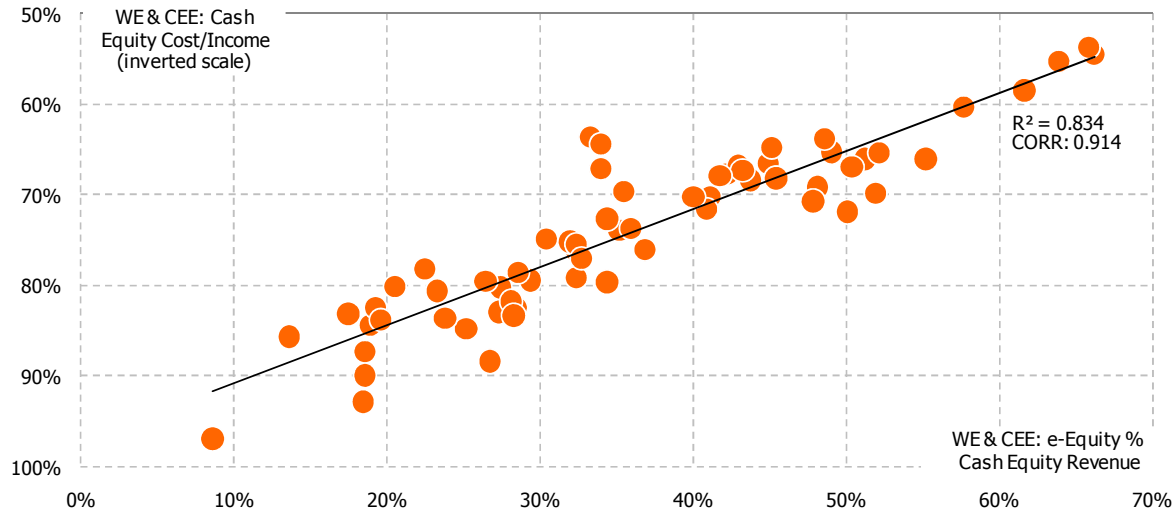
- According to specialised market commentators, algorithmic trading in 2011 held up better than other forms of computerised trading. Agency algo trading is designed to execute on terms most

advantageous to clients, and at reduced transaction costs: we cannot see why it would decline in importance. Further, a recovery in trading volumes (which remainssome 20% below pre-Crunch 2007/08 levels in key European and the US markets) should, if anything, benefit algo.

- Black Box trading and High-Frequency Trading (HFT – see Appendix) have retreated in recent years: Tabb Group estimated that HFT accounted for just over half of the overall US equity trading in 2010, noticeably below 61% in 2009; in Europe, these proportions were 35% in 2010 and 38% in 2009. Both Black Box and HFT are, however, dependent on observing and acting on market trends: a rather tall order in the extraordinarily volatile 2H11 markets. We expect that calmer markets - V2X fell from 35 to 25 in 1Q12 alone -will enable trending strategies to regain some of the ground lost in recent times.
- Dark pools are small. Depending on a definition, market commentators put the share of dark pool trading volume at 3-6% in Europe and about 12% in the USA as of early 2012. These volumes grew rapidly, however, boosted by continuous crossing and, more recently, HFT and algo traders entering dark pools that were setup and are owned by banks/brokers (which, in turn, are proactively monitoring the behaviour of the dark pools' participants). In our view, dark pools are, on the whole, beneficial to the wider market: e.g. they reduce the impact of large institutional orders. It is, however, difficult to predict what the future holds for them. Barring adverse regulation (not an unlikely prospect – e.g. perhaps enveloping all trading on ex-regulated markets?), we expect dark pools to attract a growing share of the electronic market.
- Development of new electronic products/solutions is accelerating: among the two of the more interesting ones, in our view, are Credit Suisse's 'meta-algorithm', launched in 2011, which chooses execution algorithms for specific trades; and UBS Direct Execution's (the unit co-led by Owain Self) 'UBS Swoop' (launched in Feb-12), an algo strategy dedicated to trading of illiquid securities, including small caps.

The above is, of course, subject to ever-shifting regulatory landscape (of which Europe's MiFID 2 is but one aspect). Meanwhile, the weakness of EMEA cash equity revenues in recent times highlights (yet again) the high fixed cost component of traditional/voice-brokered equity trading revenue; and, conversely, the cost advantage of a developed electronic capability. The chart below plots electronic equity revenue against the total cash equity cost/income ratio for five of the leading electronic providers in European equities which we cover on regular basis: 65 data points in total, covering the 1Q09-1Q12 period. Notwithstanding periods of accelerated/surged investment in fast-depreciating electronic systems, a very strong inverse link is evident: a developed electronic revenue stream is generally associated with low(er) cash equity cost/income ratio.

Electronic % Total Cash Equity Revenue vsTotal Cash EquityOperating Cost*/Revenue
(Europe excluding MEA, 4Q09-1Q12)



Notes: (1) Operating costs: Comp & benefits (includes salary, bonus, amortized equity awards, other items e.g. severance costs; excludes one-offs e.g. UK bonus tax in 2010); Front office directs, incl. allocated legal costs; Tech & Ops; and corporate overhead. (2) Quarterly 4Q09-1Q12 data for Bank of America; Citi; Credit Suisse; Goldman Sachs; UBS. Source: Tricumen.

We expect our banks' high- and low-touch teams will converge: e.g. Citi, Credit Suisse in 1Q12. Our definition of high-touch has evolved over the recent years, but still essentially assumes that sell-side is there to source liquidity, up to and including ideas on algo trades and liaising between the buy-side and the risk team, especially on complex trades (e.g. multi-country program/basket trades). Liquidity, though, will likely remain the most important single factor: both in 'normal' markets characterised by the growing choice of execution methods, and when a significant shift in the wider market (the latest example being the Eurozone sovereign crisis) displaces individual stock picking. The service offered to the buy-side, in other words, will likely evolve in-step with changes in buy-side needs.

Appendix: Terminology

There remains considerable confusion over the terminology used to describe various computerised trading processes, types and strategies. The terminology we use for what we see as the key areas of computerised trading is described below, in alphabetical order.

The agencyAlgorithmic Tradingsimply automates the once all-human long/short trading process: it seeks to match a client's objective with the best execution methods. For example, before executing an order, an algorithm will consider liquidity in the market and various trading venues for execution, split a large order into smaller orders and wait for what it considers an optimal moment for execution. By default, algorithms are designed to seek the best execution terms for a client, which is entirely in keeping with regulations (e.g. RegNMS in the USA and MiFiD 2 in Europe), and especially relevant when dealing with multiple brokers.Not surprisingly, in 2011 algo trading held its ground much better than other forms of computerised trading listed here.

Black Box trading – blamed for all sorts of European market ills in the summer of 2011 – is a quant *strategy*(i.e. precedes execution) which refers to high-speed computers continually analysing market patterns and making buy/sell decisions, essentially trying to predict the market moves and/or arbitrage (including statistical) opportunities. Being trend-followers, black-box systems sometimes amplify substantial price moves in the market e.g. by triggering stop losses, or extending a price momentum; also, more often than not, a sharp move up or down is quickly followed by the price move in the opposite direction (e.g. 'flash crash' on 6-May-10 in the USA, when the main US share index dropped 8%, then recovered, all in the 15-minute interval).

> High-Frequency trading (HFT – also known as proprietary algorithms)is, in our view, a subset of Black Box trading. Theoretically, HFT aims to achieve a 'market-neutral' (i.e. neither long nor short) daily trading outcome; but is often said to profit from arbitrage, rather than directional calls.

Dark Pools have come to represent probably the most controversial aspect of the 'New Age' era in trading: in our view, this is largely due to the accusations that HFTs utilised dark pools to exploit differences between exchanges and dark pools. Dark pools enable brokers (by now, most of the banks we cover operate their own dark pools) to trade large blocks of shares without suffering from the fall in the share price of a given security in the wider market. Algo trading plays a role here, too.

Flash trading properly refers to a trade order sent to an exchange with the specific 'flash' instruction attached. If there are no immediate matches for that order, the order will be 'flashed' to market participants set up to receive such flashes; they, in turn, have a small time window during which they can offer a specific match for that specific order – and this offer may well be better than the one originally envisaged by the trader who first sent the 'flash' order in. At its core, flash trading, therefore, also seeks the most advantageous terms for client execution.

Program Trading and Electronic Trading are often used interchangeably by some commentators. We see program trading as, at its best, pure executionmethod for baskets of stocks above certain, usually high, minimum value. Electronic trading, by contrast,matches buy and sell orders, either in real-time or a predetermined time slot; and it is far more widespread, with most of the standardised securities traded in this way.

Notes & Caveats

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