IBM Global Business Services

IBM Institute for Business Value

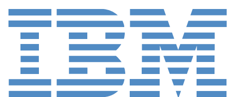
Financial Markets

The trader is dead, long live the trader!

A financial markets renaissance

IBM Institute for Business Value

IBM Global Business Services, through the IBM Institute for Business Value, develops fact-based strategic insights for senior business executives around critical industry-specific and cross-industry issues. This executive brief is based on an in-depth study by the Institute's research team. It is part of an ongoing commitment by IBM Global Business Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to iibv@us.ibm.com for more information.



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Executive summary

Financial markets firms have consistently earned more than the average company over the last decade. As one CEO told us, "I was lamenting to my board that my margins had decreased from 36 percent to 33 percent; one of my board members, the head of a grocery chain, stage whispered to his neighbor, 'Yeah, times are tough for me, too: mine went from two percent to a point and a half!'"[1] While sympathy from other industries may be hard to come by, financial markets leaders must nevertheless act to prepare themselves for the momentous changes they will face over the next decade.

In the face of commoditization and fierce competition, financial markets firms have continued to thrive by innovating and hustling, leading to an overall 15 percent return on equity (ROE) over the last decade, compared to 8.7 percent ROE for the average company.[2] Firms have long benefited from the edge provided by proprietary information access and market insight, but these advantages will come under significant pressure over the next decade as two inexorable trends accelerate: transparency and speed.

As these two forces approach their limits – transparency can't exceed the point at which everyone knows everything, and speed can't move beyond the instantaneous – many of today's profit engines will stall, while new value engines will begin firing on all cylinders. Firms must be able to succeed in an environment where *analysis*, not *knowledge*, is the value creator, and where it's not seconds that count, but milliseconds. Power will shift from the traders who have benefited from merely facilitating transactions to the buyers and sellers that take positions on either end of the trade, and the way that firms create value will likely experience a renaissance as transformational as anything the industry has ever witnessed.

To gain a clearer understanding of the future of the industry, the IBM Institute for Business Value, in cooperation with the Economist Intelligence Unit (EIU), conducted a global survey of more than 400 financial markets executives representing the buy side, the sell side and processors, as well as academics, plan sponsors, industry associations and regulatory bodies. The interviews and survey spanned 61 countries in the Americas, Asia and Europe. Nearly three-quarters of those surveyed believe that the industry will be significantly different in 2015, yet 46 percent rate themselves as only moderately able to respond to change.[3] This executive brief analyzes and synthesizes the study findings into a view of the evolving industry and a guide to what executives can do today to position their firms for tomorrow.

The fundamental task for firms will be to develop a clear perspective on risk. Value will be created in two ways: by effectively assuming and managing risk, or by mitigating risk, either by taking it out of the overall system, or by reducing it for their clients. Today, we characterize industry segments in terms of *buy side*, *sell side* and *processors* out of convenience. However, as value bifurcates on the risk dimension, this terminology may eventually become irrelevant.

"Everything is sweetened by risk."
– Alexander Smith[4]

Driven by transparency and speed, the industry will change substantially in the coming years. Excess agency profits will evaporate, the separation of Alpha and Beta will become complete, and the creation of alliances will be critical. In addition, demanding institutional and retail clients will drive a shift from a transaction perspective to one that is truly centered on the client. As a result, it will be vital for each firm to transform its business model

and optimize returns for the level of risk that it chooses to assume. To accomplish this most effectively, financial markets firms will be forced to change their supporting operating models in ways that make the changes of the last generation pale in comparison.

We recommend four basic steps to begin preparing for the future:

- Determine your optimal long-term relationship with risk
- Partner selectively to fully exploit your strategic, differentiating capabilities
- Optimize the profitability of each client
- Develop a purposeful, systematic culture of innovation.

And, once you've decided on the strategic direction for each of these four steps, then, of course, you must execute.

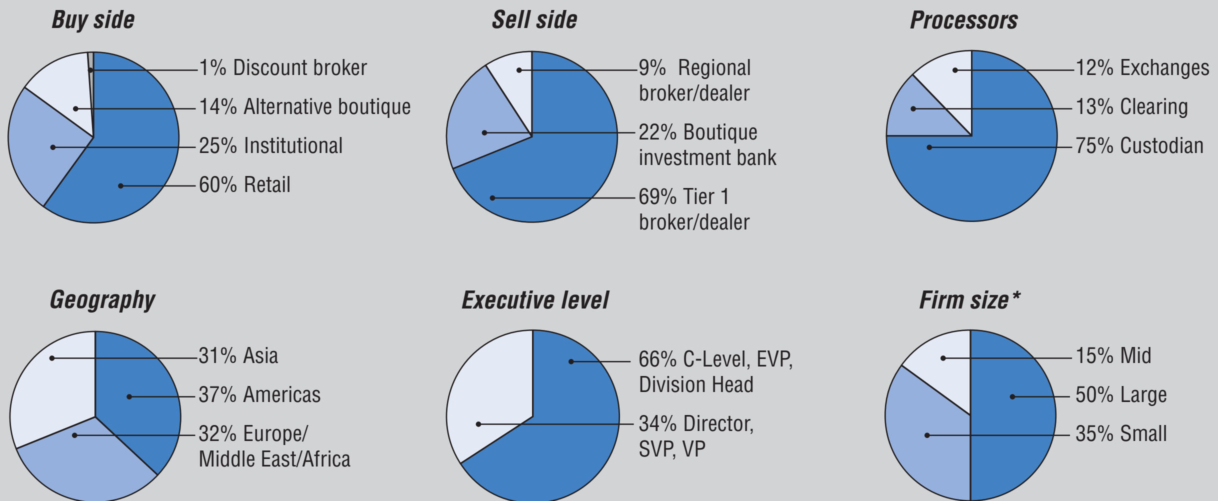
Study methodology

The IBM Institute for Business Value and the EIU obtained input from financial markets players in three geographies. Key questions underpinning the study include: How will value be created in the future? Which firms are positioned to succeed? What capabilities will be required? And, what steps must executives take now to prepare for the future?

We surveyed 402 business leaders from 296 financial markets firms in 61 countries (37 percent from the Americas, 32 percent from Europe and 31 percent from Asia):[5]

- Buy side: Institutional and retail asset management
- Sell side: Institutional sales and trading
- Processors: Asset servicing/custody, exchanges, alternative trading systems and clearing
- Academics, plan sponsors, industry associations, key regulatory bodies across Americas, Europe and Asia.

We conducted qualitative interviews with 130 executives and surveyed 272 executives in cooperation with the EIU. As part of the analysis, we developed quantitative models that combined historical perspectives with potentially disruptive forces. We categorized selected financial markets industry participants as shown below.



*Note: *Size is defined as size of revenues: small is < US$500 million; mid is US$500 million to US$5 billion; large is >US$5 billion.*
Source: IBM Institute for Business Value/Economist Intelligence Unit Survey.

Transparency and speed: Driving a surge of industry change

Financial Services is by far the dominant sector in terms of market capitalization. As of August 2005, financial services comprised 29 percent of total market capitalization in the U.S. and U.K.; the next largest sector, Information Technology, trailed with 12 percent.[6] But the rapid growth and outsized returns that have characterized the history of the sector are showing signs of strain: in the past decade, the global ROE for many industries within the financial services sector has declined (see Figure 1).

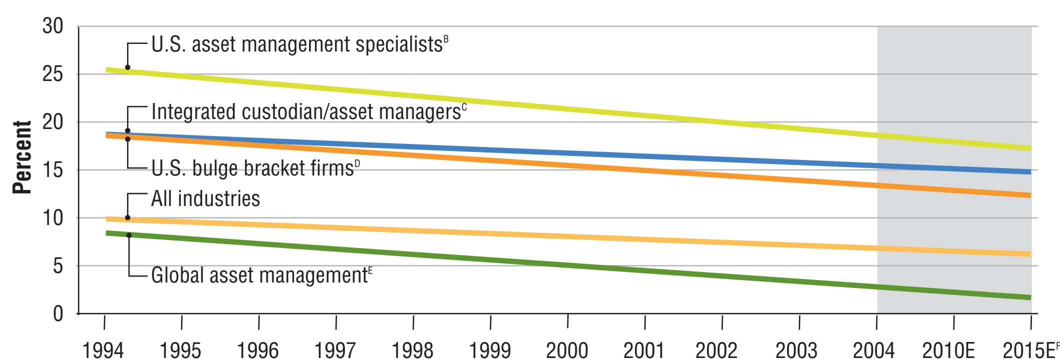
The cumulative effects of transparency and speed will be far-reaching. As the industry continues to mature and returns normalize, firms will need to find new ways to create value, including optimizing risk and return efficiency. All respondent groups agreed that the global structure of the industry will continue to consolidate moderately, as opposed to fragmenting further or remaining the same. Operating models will shift substantially as financial markets winners evaluate and enhance their relationships with risk.

When we asked each respondent to identify drivers of change in the next ten years, their answers confirmed the growing impact of transparency and speed on the industry (see the left side of Figure 2). The right side of the figure shows their most pressing current concerns, a list that closely parallels the many drivers of industry change.

Greater transparency is rapidly expanding access to markets (through electronification and exposure of Alpha and Beta) and data required for decision making (including knowledge about pricing and client profits, and the exposure of conflicts of interest). Increasing speed will drive changes on three scales: quarterly to yearly organizational and business model shifts; weekly to monthly product commoditization; and intraday and sub-second trading and downstream processing requirements.

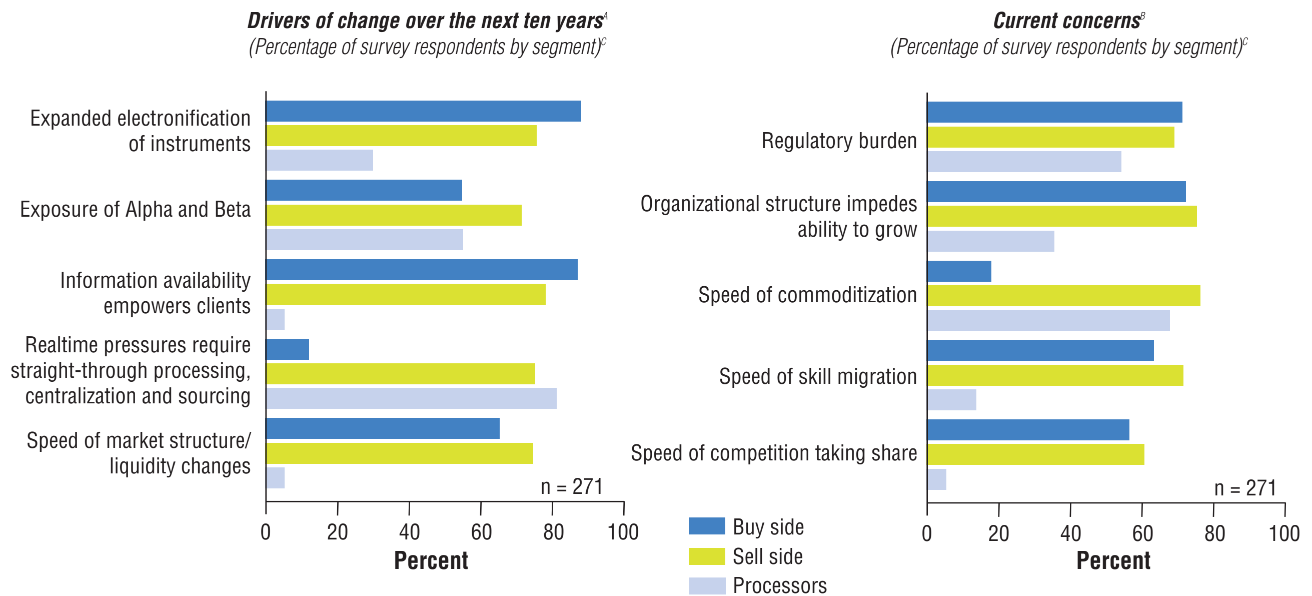
Transparency and speed are causing the evaporation of agency profits, accelerating the separation of Alpha and Beta, increasing the importance of alliances and forcing the restructuring of business and operating models around clients. As a result, the financial markets industry

Figure 1. Global return on equity trendline for selected industries, 1994-2015.[A]



Source: Note: [A]Projections are linear; [B]Includes Affiliated Managers Group, Alliance Capital, Blackrock, Eaton Vance, Federated Investors, Franklin Resources, Janus Capital, Legg Mason, Marsh & McLennan, T. Rowe Price, Waddell & Reed; [C]Includes BoNY, State Street, IBT, Northern Trust and Julius Baer; [D]Includes Merrill Lynch, Bear Stearns, Lehman Brothers, Goldman Sachs and Morgan Stanley; [E]Includes all publicly listed asset managers, figures do not include universal banks or sell side asset management divisions; [F]Shaded area: 2004 through 2015 are collapsed into two periods for prior period ROE viewing purposes.
Source: Thomson ONE Banker; IBM Institute for Business Value analysis.

Figure 2. Drivers of change and current concerns.



Note: [A]Executives were asked: "By how much will the industry change over the next 10 years and what top reasons come to mind?;" [B]Executives were asked: "What keeps you up at night?; [C]Percentage may be greater than 100 due to multiple responses; Buy side includes institutional and retail asset managers and plan sponsors; sell side includes institutional broker dealers; processors includes custodians, clearing firms and exchanges.
Source: IBM Institute for Business Value primary client interviews; IBM Institute for Business Value analysis.

will experience a bifurcation of value into risk assumption and risk mitigation – leaving firms to reassess the role risk will play in their long-term strategies.

The evaporation of agency profits

As market electronification extends to fixed income and derivatives, clients will increasingly refuse to accept paying premium commissions on simple transactions. The essentially risk-free intermediary will not provide the value that it once did. Accordingly, survey respondents, on average, plan to shrink their number of traders from forty to four across most product groups, and they expect to organize around industries versus product silos.[7] Agency trading will still play a role, but will likely earn no more than a slim economic profit, and in some cases serve as a loss leader for other, more profitable areas of business.

With almost limitless electronic access to market information, clients will seek to lower costs by trading and performing investment research themselves. While the majority of surveyed firms acknowledge that agency profits are dwindling, it is striking that most respondents associate the threat only with equity products – in fact, electronification will have a similar impact across the entire spectrum of instruments.

"Unbundling and electronification will make or break firms within three to five years…We're working on a global strategy for this: transparency is key, clients will know everything. Even prime brokerage will be unbundled."

– Division Head, investment bank, Hong Kong[8]

With the diminishing value of agency, some financial markets players will have to uncover new sources of profit. At the end of 2004, there was a fifty-fifty split between the revenue contribution of agency trading (risk-free) and principal trading (risk-incurring activities that include proprietary trading) for sell side firms.[9] By 2015, the split will likely be 70 percent for principal activities versus a slim 30 percent for agency.[10] Another example of the move toward greater risk assumption is the rise of structured products (such as derivatives), which are capital intensive and also considered higher risk; we project average growth of 12 percent over the next ten years.[11] Entering less developed markets (such as Eastern Europe and China) is another type of growth opportunity that combines greater risk with potentially greater rewards. To profit in this environment, firms will need to excel at executing riskier activities that require more firm investment and more control.

The separation of Alpha and Beta

Today, roughly 70 percent of worldwide assets are in the form of traditional long only active management investments (most commonly, mutual funds).[12] These products currently bundle *Alpha* (the value the portfolio manager seeks to add in the form of excess returns) with *Beta* (exposure to the market benchmark). In the future, investors (both retail and institutional) will be less willing to pay Alpha fees for Beta returns, and the way that funds are priced and managed will have to change.

Two ongoing developments will accelerate the split of Alpha from Beta: global pension plan under funding and weak active asset manager performance. First, as record numbers of people retire worldwide in the next decade, rising costs will make current government and private retirement plans unsustainable. On one hand, the growing number of companies shifting from defined benefit to defined contribution pension plans are separating Alpha from Beta by shifting from actively managed mutual funds to indexing (aiming to match the return of major market indices, such as the S&P 500).

On the other hand, those companies with defined benefit pension plans will separate Alpha from Beta to better match assets to liabilities. As such, these institutional investors are expected to increase their allocation to more volatile funds (such as certain types of hedge funds and private equity) in the hopes of achieving Alpha. These firms are expected to obtain market exposure (Beta) by either holding index funds or shifting a percentage to derivatives.

"The quest for Alpha will become very difficult. This is why we outsource active management."

– Portfolio Manager, large U.S. public plan[13]

Second, a trend of weak performance by active asset managers has called into question their ability to add value for clients. Between 1993 and 2004, only 29 percent of U.S. traditional active fund managers outperformed the Morgan Stanley Capital International U.S. Broad Market 2500 Index.[14] Such results are increasingly leading clients to turn away from active funds.

The separation of Alpha from Beta is expected to shift profit away from traditional long only active funds toward the extremes of *unconstrained Alpha-generating investing* (more volatile pools, such as certain types of hedge funds and private equity) and *passive investing* (index funds, exchange-traded funds and certain types of derivatives). Firms that understand how to best match assets to liabilities – and, over time, can execute on that understanding – will attract and retain the most assets, from both institutional and retail investors.

The battle for Alpha

Alpha returns will become more difficult to obtain in the future. Many end investors who have been investing in traditional, constrained asset management ("dumb money"), for example, will change their investment philosophy: these "Alpha donors" will depart for indexation or in search of Alpha. But the battle for Alpha is ultimately a zero-sum game, so these new investors will find themselves battling for Alpha against those incumbents who have been vying for their very own pieces of the Alpha pie all along.

"Hedge funds will continue to extract the most talented people from the buy side and the sell side. How will [incumbent] firms retain such people to generate Alpha?"

– C level Executive, universal bank, New York[15]

The growing importance of alliances

In an industry reshaped by speed and transparency, growth and competitive differentiation will increasingly depend on partnering. Strategic alliances will be critical to overcoming the inertia, inefficiency and redundancies that a "build it yourself" philosophy and siloed organizational structure have wrought. U.S. broker dealers, for example, reported that internal inefficiency resulted in unnecessary costs of US$2.2 billion in 2004 – more than half from processing redundancy (US$1.2 billion), with the balance attributed to both operational inefficiency (US$650 million) and unnecessary risk exposure (US$400 million).[16]

By partnering, firms can address pressing internal challenges and improve their ability to respond to change; in other words, achieve greater levels of agility (see Figure 3). To do this, financial markets firms will increasingly turn to partners, both to enhance core capabilities and gain access to non-core capabilities.

"How can I keep providing these services within this context of rapid growth? We need to fundamentally rethink our operational model and skill set to support growth."

– Divisional Head, universal bank, Hong Kong[17]

Through necessity, collaboration will rise sharply among financial markets ecosystem participants (buy side, sell side and processors). For example, an increased reliance on processing firms, like custodians, along with a rise in the use of vendor utilities will help reduce the bloat that exists on the sell side. Although the sell side still performs much of its own processing, transparency and speed pressures – as well as the push for innovation and specialization – are driving the sell side to follow in the footsteps of the buy side by turning to processors.

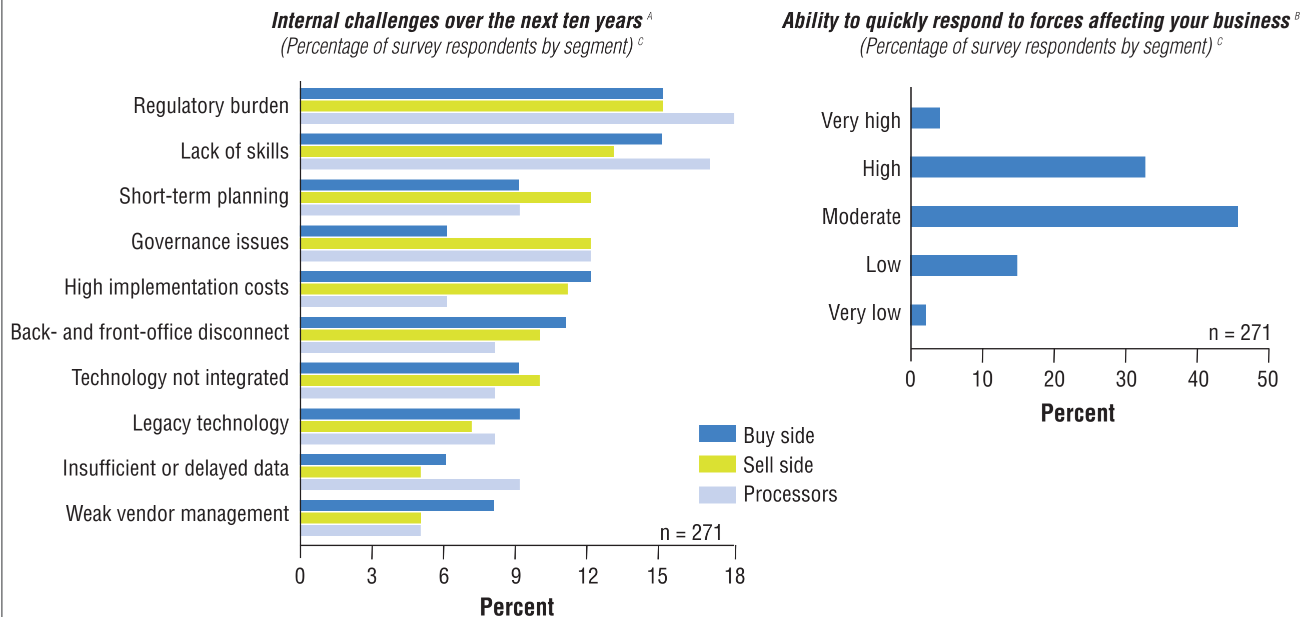
The restructuring of business and operating models around clients

For some time, firms have acknowledged the importance of focusing on client needs, but the shift toward true client orientation is only in its infancy. Clients have become savvier and more demanding, and responding to their needs will require firms to restructure their operating models. Clients want evidence of:

- *Investment* – Financial commitment to improving client relationships
- *Innovation* – An innovative culture that goes beyond product innovation
- *Specialization* – The ability to meet specific client demands better than the competition.

Client demands will ultimately require that firms become specialist enterprises. Most firms equate specialization with shrinking capabilities, headcount and breadth, but this is not the underlying intent. Specialization is about far greater levels of focus on the client.

Figure 3. Internal challenges and business agility.



Note: [A]Executives were asked: "Which of the following internal barriers are most likely to impede your firm's ability to execute its strategy over the next ten years?" (Choose up to three); [B]Executives were asked: "How would you rate your firm's ability to respond to external forces affecting your business? (Rate on a scale of 1-5)."
Source: IBM Institute for Business Value/Economist Intelligence Unit Survey.

"Clients will demand more choice and even more customized information. Firms need much deeper client insight to create meaningful client interactions – but achieving this depends on being focused on your specific domain. Being generic just won't work anymore – specialization is key."

— Chief Strategist, Wall Street firm, New York[18]

New value engines – Risk assumption and risk mitigation

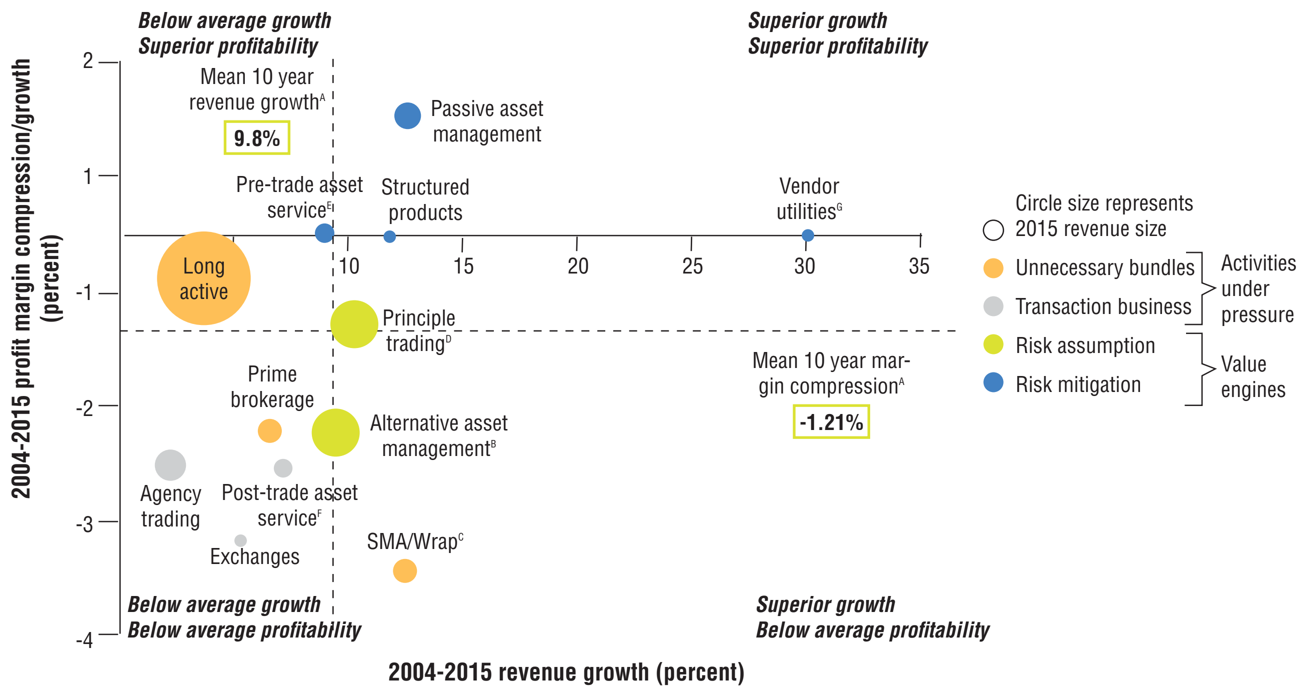
As 2015 approaches, where will the new sources of profitability and revenue growth emerge? Thanks to the wide-ranging effects of transparency and speed, profit opportunity will bifurcate on a risk dimension, into risk assumption and risk mitigation activities. On one hand, there will be value in activities that require the assumption of risk (alternative asset management and performance sharing, for example). On the other hand will be activities that reduce risk on behalf of others (such as those performed by custodians, vendor processing utilities or advice givers).

To better understand probable sources of growing and declining value over the next ten years, the IBM Institute for Business Value developed a financial model to gauge the likely profitability and revenue outlook for a range of industry activities (see Figure 4). The analysis focused on activities that are expected to have a high degree of positive or negative growth over the next ten years.

The left side of this profit map model depicts pressured activities that are expected to experience slow growth. These *unnecessary bundles* are indicated by orange circles. Also under pressure will be *transaction businesses* (indicated by gray circles) that all fall within the lower left quadrant, indicating below average growth and below average profitability.

The model indicates that future growth and profit potential are within the new value engines of *risk assumption*[19] (indicated by green circles) and *risk mitigation* (indicated by blue circles). Successful firms will embrace selected value engines as they simultaneously focus on reducing expenses associated with activities that have come under pressure. By default, those standing the middle ground will have the most to lose in this new environment (including traditional long only active asset managers and retail and institutional agency brokers).

Figure 4. Projected profit margin and revenue growth, 2004-2015.



Note: [A]Industry average is derived from the figures in the approach section of the appendix, revenue growth and margin compression are compounded annual growth rates; [B]Alternatives is inclusive of hedge funds and private equity; [C]SMA is separately managed accounts inclusive of high net worth and mass affluent; [D]Principal is inclusive of client principal trading and proprietary trading; [E]Pre-trade is middle office sourcing, securities lending, performance analytics, risk and compliance services; [F]Post-trade is custody and fund accounting; [G]Vendor utilities are processing service providers for sell side processing components

Source: IBM Institute for Business Value profit map model; IBM Institute for Business Value analysis.

An ongoing challenge: Regulatory compliance

Not surprisingly, for the buy side, processors and the sell side alike, regulatory burdens were near the top of the list of both external and internal challenges – no small hurdle for firms seeking global expansion. On average, financial markets managers spend 20 to 30 percent of their time handling regulatory requirements; this is expected to continue into the foreseeable future.[20]

One respondent's comment about the regulatory burden:
"It will cost US$10 to15 million, including technology, to meet regulatory requirements [for one of our divisions]. There are so many exception reports to be generated and that means more costs."
– Head of Compliance, universal bank, New York[21]

And another comment, from a regulator's perspective:
"The marketplace will always feel that there is more regulation than necessary. Brokers don't want to pay fees, and do not want to be regulated because any additional regulation means an additional cost. Compliance is simply a necessary condition."
– Regulator, India[22]

To better manage regulatory compliance, leading firms are beginning to see the value of two actions: leveraging new value from the necessary compliance investments, as well as sourcing where it makes sense. Data gathered for compliance purposes, for example, can be used to cull new, profitable insights. And, in the future, firms may benefit from sourcing some of the burdensome activities that support regulatory requirements.

Power will shift: Growth opportunities

Today, industry power is shifting to investors – and to those firms that can best meet investors' needs. Across the changing financial markets landscape, this power shift is creating strong growth opportunities:

- *Market roles* – As industry players jockey for position, the buy side, best able to meet investor needs, will dominate for a while; over time, power will shift toward the sell side
- *Client relationships* – As investors become more influential, innovation can help firms close the gap between client expectations and interaction reality
- *Benefits of scale* – As firms fully leverage the benefits of scale, whether internally or by partnering, they can pull ahead of the competition.

Today's terminology may lose relevancy by 2015

There are certain terms we use to describe financial markets industry participants: *buy side, sell side* and *hedge funds,* among others. This terminology – used today out of convenience – may eventually become irrelevant. What categorization lies ahead? Perhaps it will ultimately simplify into *advisers* and *principals.*

Jockeying for position: Who can meet investors' changing needs?

While the buy side is likely to dominate (ability to generate profits and to influence industry behavior) in the short term, driven largely by hedge fund growth, this is not expected to last. Over time, investors will increasingly demand access to better asset/liability matching. Sell side firms, supported by service providers, will then be best positioned to satisfy investor needs through risk taking activities such as creating structured products.

"There is no point in paying for Beta. Beta will go to zero. Internal management will probably be responsible for Beta management and we will purchase structured products directly from the sell side."

– Large public plan[23]

Between 1995 and 2005, the two fastest growing buy side products were active mutual funds and passive institutional funds. Client segments offering the most growth in this period were defined benefit corporate plans and high net worth.

In the next ten years, buy side respondents expect their greatest growth opportunities to lie in delivering Alpha-generating products and serving wealthy investors. Surveyed buy side executives predicted that the most growth will be in private equity and hedge funds, serving ultra high net worth, high net worth and mass affluent client segments. As investors seek trusted advice, buy side distribution strategies are expected to shift – moving away from retail brokers and asset managers, and toward independent financial advisors and universal banks. As a result, firms will reconsider housing manufacturing (asset management) and distribution (advice) in the same firm.

For the sell side, the two fastest growing products between 1995 and 2005 were equities execution and underwriting. Regional broker/dealers and large, traditional managers were the client segments that grew the most during that time.

Sell side firms see growth opportunities in riskier activities and will compete with buy side firms for pension clients. Respondents from the sell side anticipate the greatest growth in structured products and financing, serving client segments that include pensions, insurance funds and large, traditional managers.

Processors' greatest product growth from 1995 to 2005 was in custody and clearing. Large, traditional managers were their highest growth client segment for that period, followed by regional broker/dealers.

Processors can grow by taking on activities that are closer to the front office, such as providing pre-trade and trade services to existing clients, with the most growth in products for risk management, performance analytics and middle-office sourcing. It's important to note that the end-to-end "lift-out" model of outsourcing is on the wane; rather, middle-office sourcing will be a growth engine when provided in a componentized manner.

Expanding into new geographies will also provide attractive growth opportunities for many firms. On average, respondents expect China to be the site of the most rapid growth over the next ten years. The buy side also anticipates high potential growth in India, the sell side finds Eastern Europe attractive, and processors are enthusiastic about Western Europe.

The bedrock of competitive advantage: Client relationships plus innovation

Whatever a firm's size, seizing emerging growth opportunities will require deeper client relationships and a sharper focus on innovation. Regardless of their specific industry roles, respondents recognized the needs to *build strong client relationships* and *create differentiated products* as the coming decade's top two most important sources of competitive advantage (see Figure 5).

Too often in the past, the ability to forge strong relationships has been thwarted by the gap between a firm's brand promise and the way it treats its clients. In addition to improving the client experience and deepening client relationships, respondents rated other client initiatives as "important" or "very important": *managing acquisition and improving retention*, and *optimizing existing marketing and sales processes*.[24] To meet these client-focused goals, financial markets firms will have to create and sustain a culture of ongoing innovation to gain a better understanding of client needs and make the most of this well recognized source of competitive advantage.

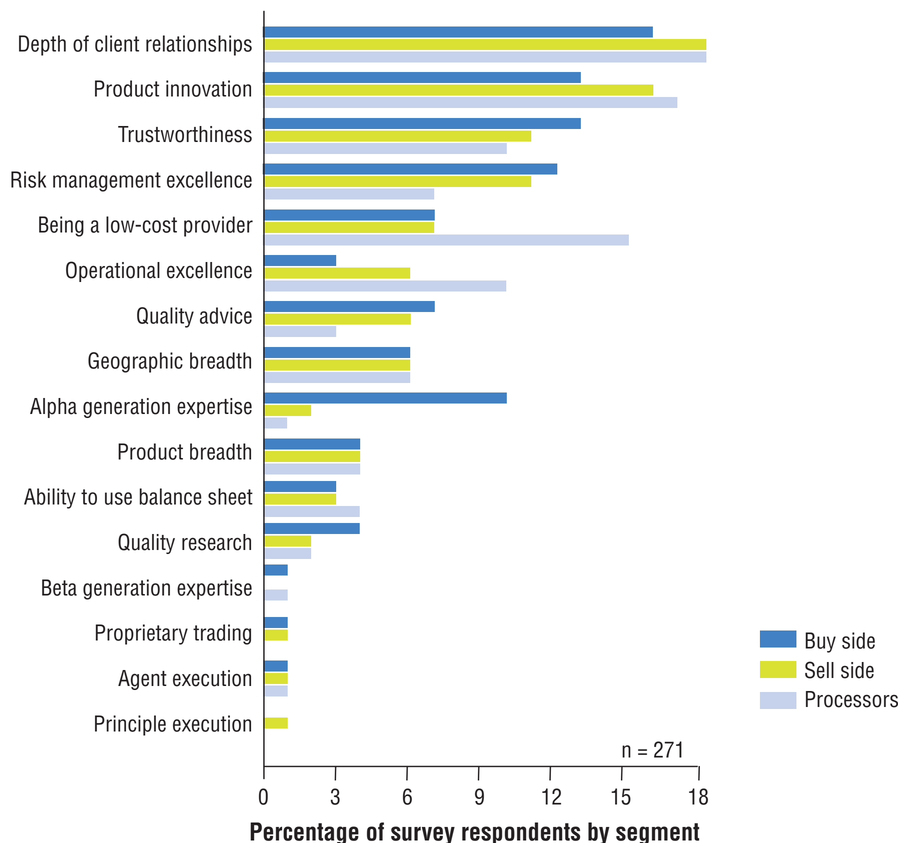
Beyond efficiency: Leveraging scale can tip the scales

Overall, survey respondents expect scale to be a top competitive advantage in the coming decade. Because of universal banks' diversified offerings, client base and distribution breadth, their scale potential was cited as a significant edge. More than 75 percent of all respondents named *universal banks* (for example, Citigroup) when asked "Which types of firms are most likely to succeed over the next ten years?"[25] The next two most common answers, each mentioned by fewer than 36 percent of respondents, were *Wall Street/Tier 1 broker-dealers* (for example, Goldman Sachs) and *boutique alternative investment managers* (for example, Farallon Capital).[26]

"Wall Street firms will be acquired by banks – there is a great amount of value in the universal banking model."

– Head of Sell Side Operations, Wall Street firm, U.S.[27]

Figure 5. Most important sources of competitive advantage over the next ten years.

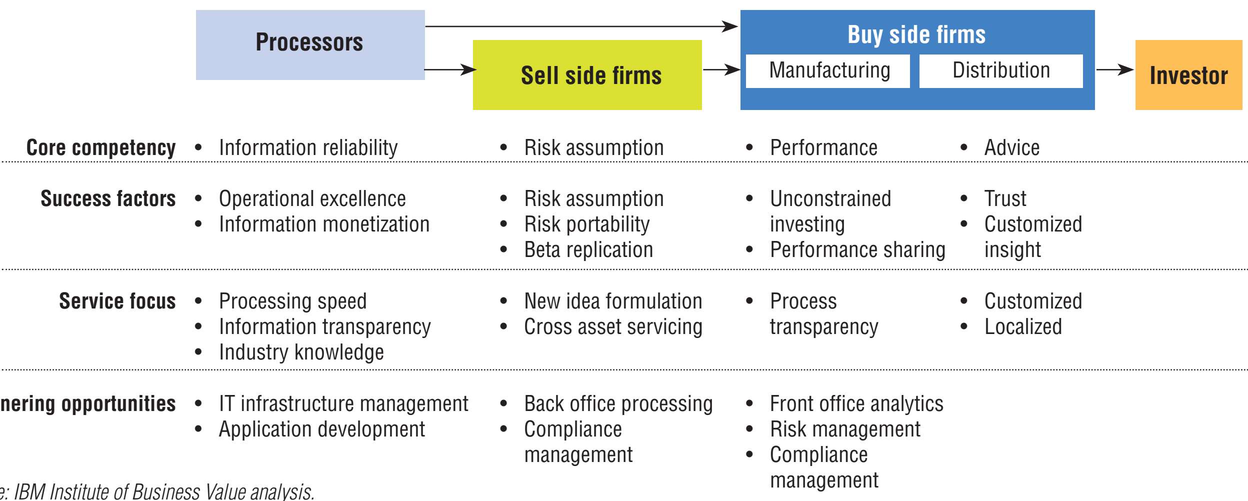


Note: Executives were asked: "Which sources of potential competitive advantage are likely to be most important to your firm over the next ten years? (Choose up to 3)."
Source: IBM Institute of Business Value/Economist Intelligence Unit Survey.

One of the assumptions underlying the attractiveness of the universal banks' business model is that efficiency automatically comes with scale. In reality, however, firms often end up squandering potential scale benefits. Survey results show that firms often fail to leverage their large numbers of client relationships and extensive distribution networks for either improved cross-selling or product innovation. And, those firms that do successfully achieve efficiency through scale, aiming for other important scale benefits – such as greater scope, depth and breadth – will prove vital to seizing opportunities and combating margin pressures. To support their chosen risk roles and their future growth strategies, firms will need to leverage scale while avoiding its traps (for example, internal silos or excessive bureaucracy).

Ultimately, investor needs will dictate future operating model attributes for financial markets industry participants (see Figure 6). Current capabilities notwithstanding, no existing operating model will ensure a firm's success or failure in 2015. The key to remaining relevant is to verify that the operating model optimally supports the firm's chosen role in the ecosystem and its strategy for sustained growth.

Figure 6. Future operating model attributes.



	Processors	Sell side firms	Buy side firms: Manufacturing	Buy side firms: Distribution	Investor
Core competency	• Information reliability	• Risk assumption	• Performance	• Advice	
Success factors	• Operational excellence • Information monetization	• Risk assumption • Risk portability • Beta replication	• Unconstrained investing • Performance sharing	• Trust • Customized insight	
Service focus	• Processing speed • Information transparency • Industry knowledge	• New idea formulation • Cross asset servicing	• Process transparency	• Customized • Localized	
Partnering opportunities	• IT infrastructure management • Application development	• Back office processing • Compliance management	• Front office analytics • Risk management • Compliance management		

Source: IBM Institute of Business Value analysis.

For processors, the core competency of *information reliability* depends on success factors such as *operational excellence* and the capability to *monetize information*. Because of shrinking margins, the efficiency provided by scale is critical. Processors' partnership opportunities include IT infrastructure management and application development.

Sell side firms, with their core competency of *risk assumption*, will rely more upon derivatives to enable *risk portability* and to *replicate Beta*. Partnering for back-office processing and compliance management will help them meet their goals.

As for buy side firms, the design of their optimal operating model can vary based on their targeted success factors: for the core manufacturing competency of *performance*, *unconstrained investing* and *performance sharing* are most important; for the distribution competency of *advice*, it will be essential to exhibit high levels of *trust* and *customized insight*. Buy side firms should consider partnering to attain more cost-effective and higher quality front office analytics, as well as risk and compliance management capabilities.

Executing today with 2015 in mind

With value migration already underway, financial markets firms must start now to translate their potential competitive advantage into real profits. Future success hinges upon a longer-term market perspective that is supported by concrete actions:

- Determine your optimal long-term relationship with risk
- Partner selectively to fully exploit your strategic, differentiating capabilities
- Optimize the profitability of each client
- Develop a purposeful, systematic culture of innovation.

Determine your optimal long-term relationship with risk

Does your culture make your firm better suited to act as a risk taker or a risk mitigator? In either case, careful planning is vital to strengthening risk management capability. Offering both risk assumption and risk mitigation – although ideal from a shareholder standpoint – presents many challenges across an entire firm, spanning the culture, from employee compensation models, all the way to the technology infrastructure.

After you identify your optimal long-term risk posture, incorporate innovative technology to better manage risk. Study respondents named many technology-related innovations that they expect will provide a competitive edge (see Figure 7).

Risk measurement systems were cited as the number one technological innovation to help achieve strategic goals. Improving capabilities in client analytics, data distribution and client/advisor connectivity were among the most frequently mentioned – all are key to supporting client relationships. Other technology improvements, such as multi-asset class platforms, services oriented architecture and disaster recovery systems were also frequently mentioned.

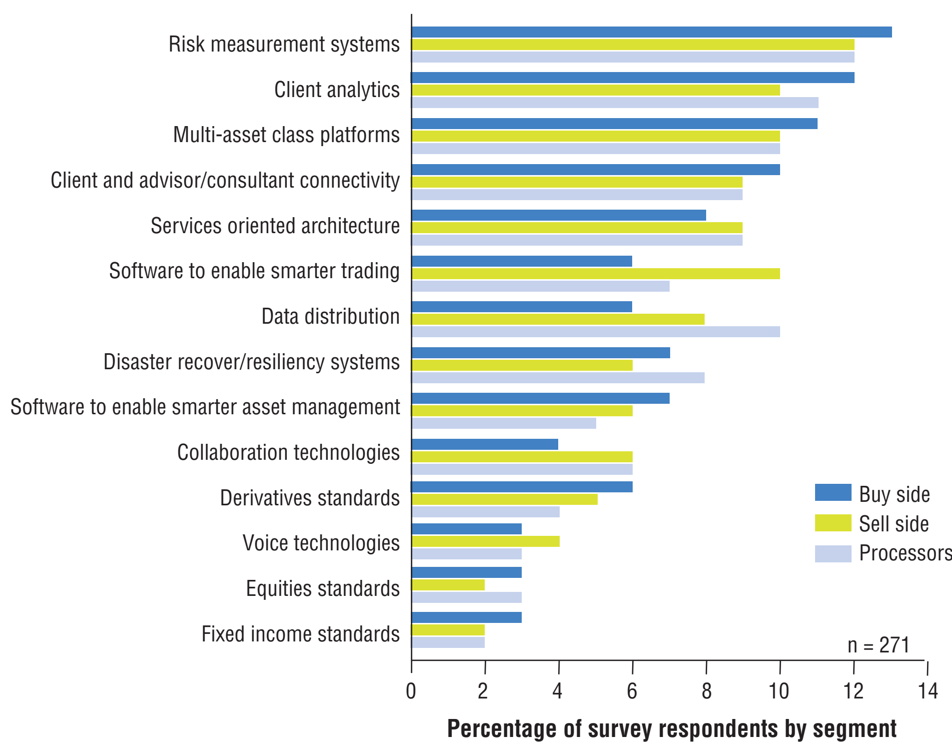
"Technology will cause firms to change. The use of technology will increase in order to truly globalize the investment and trading process."

– C-level sell side executive, universal bank, New York[28]

Partner selectively to fully exploit your strategic, differentiating capabilities

Has your firm clearly defined its risk position and the associated core capabilities, and are you fully leveraging assets, such as scale and talent, while reducing costs? The way forward is to develop a component view of your business to enable the matching of current capabilities

Figure 7. Technology-related innovations: Greatest impact on ability to achieve strategic goals over the next ten years.



Note: Executives were asked: "Which of the following technology-related innovations will have the greatest impact on your firm's ability to achieve its strategic goals over the next ten years? (Choose all that apply)."
Source: IBM Institute of Business Value/Economist Intelligence Unit Survey.

against those required for success in a radically different future (see Figure 8).

This illustrative view of current operations allows a focus on core strengths – particularly important if other players can provide non-core, operational capabilities at a lower cost or as a specialized expertise that bolsters core capabilities.

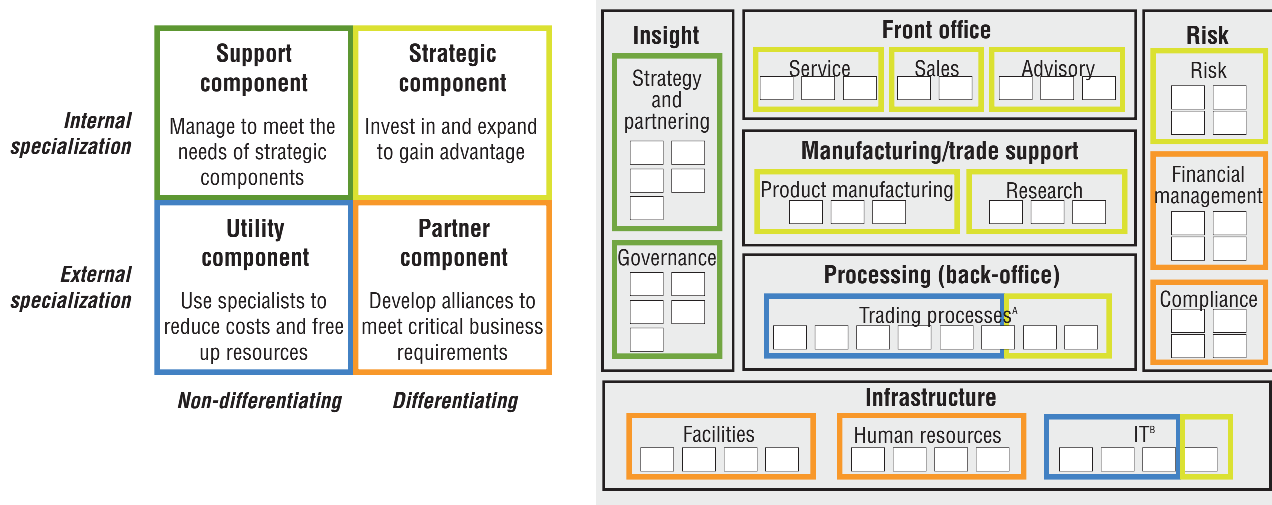
Study results demonstrate that most firms believe sourcing will greatly affect their ability to achieve their strategic goals – to strengthen, not to shrink.[29] Successful firms will partner to service their clients as specialists, with some choosing to divest parts of their firms as part of a "capability swap." Across the industry, respondents recognized the potential for growth strategies to be complementary rather than strictly competitive (see Figure 9).

Merrill Lynch and BlackRock: Alliance to separate in-house fund unit[30, 31]

In February 2006, Merrill Lynch and BlackRock Inc. announced a planned merger that will create the fourth largest family of broker-distributed U.S. funds and a top ten asset manager (in terms of worldwide assets under management). The deal follows a nascent trend of big financial services firms splitting off in-house fund units, while keeping a stake in the new business to maintain the profit stream.

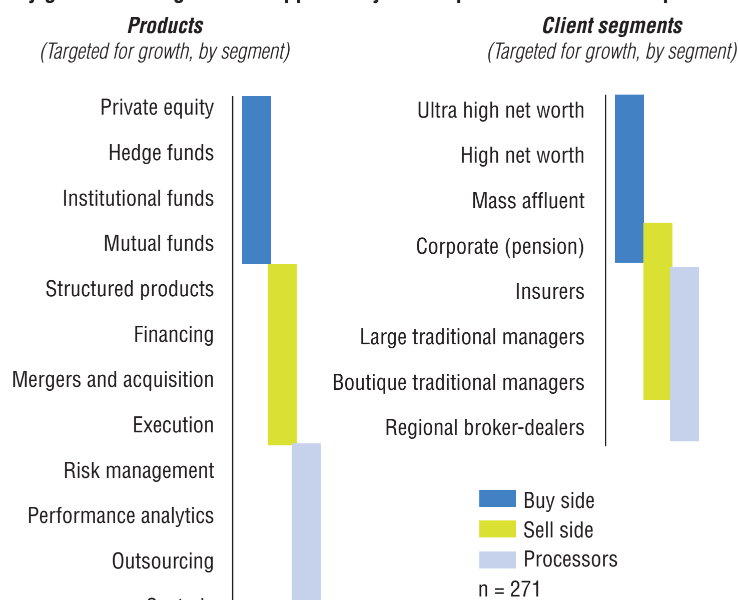
BlackRock CEO Larry Fink was quoted as saying that he felt Merrill Lynch and BlackRock could compete better in Asia by combining efforts, citing the importance of having a strong foothold and a strong retail platform. This combination of Merrill Lynch's asset management business with BlackRock will have US$992 billion in assets under management and expects savings of US$170 million eventually, with US$70 million in savings the first year.

Figure 8. Business component decision matrix with decisions applied to illustrative 2015 financial markets firm.



Note: ^A Trading processes in this scenario would be leveraging the utility for some but not all trading processes; ^B IT infrastructure in this scenario would be leveraging the utility for some but not all IT components.
Source: IBM Institute of Business Value analysis.

Figure 9. Complementary growth strategies offer opportunity for cooperation without competition.



Note: Executives were asked: "In which segments/products do the main growth opportunities lie for your firm over the next ten years? (Choose all that apply)."

Optimize the profitability of each client

Do your clients agree that your firm consistently keeps its client service commitments? Since that is frequently not the case, work is needed to close the gap between the brand promise and the interaction reality.

Investments will be necessary to shift from a transaction orientation to a client orientation. Clients will insist upon doing business with firms that can demonstrate that they also have "skin in the game" – whether by assuming more risk, providing quality advice or becoming better at understanding client needs. Restructuring will be necessary to develop the capabilities to meet client demands, whether they are algorithms, trading ideas or financial planning advice. Over time, this investment will lead to profits as those that can become trusted advisors are compensated for the insight they provide.

"We must shift from managing the product to managing the client."

– Division Head, Sales & Trading, universal bank, London[32]

Yet firms cannot afford to overlook another type of investment as part of becoming client oriented: gaining the capability to mine profits. The ability to measure client profitability is essential, especially to justify the costs of offering advice and tools. This poses a challenge, but it is also an opportunity. Only one interviewed firm already had the ability to measure client profitability across product lines and geographies.

Develop a purposeful, systematic culture of innovation
Does your firm have a formal, measurable system for encouraging, communicating, developing and tracking new ideas? Continuing to create differentiated, innovative products, such as custom derivatives or asset-liability matching funds can help provide the right balance between client demand and innovation.

Survey respondents recognized the importance of product innovation, but place much less emphasis on the broader types of innovation – new ways of servicing clients, refined transaction processes, new ways to enter markets, radically different business models and more – that will be required in the emerging environment. A purposeful, systematic culture of innovation encourages innovation at all levels of the business.

Measuring up

So, how can you determine where you stand when it comes to preparing for the financial markets landscape of 2015? As you rethink the meaning and value of risk in search of future profitability, the following questions can help you appraise your own firm's strengths and weaknesses.

- *Do you have risk eminence?* Are you recognized as a risk management leader and are your risk management organizations, systems and data analysis organized across products and business segments? Or, do a siloed risk management organization and lack of comprehensive data analytics peg you as a follower?
- *Do you squander the potential benefits of scale?* Do you use a component view of your firm to leverage shared, efficient use of platforms, systems and processes to identify and eliminate redundancy across products, channels and geographies?
- *Do you deliver on your brand promise?* Have you proven your ability to match brand promise with well-defined, measurable initiatives that meet client needs and attain high levels of client satisfaction?
- *Do you use data as a weapon?* Do you capture market and client data on a single, firmwide basis, with storage and analysis capabilities that enable insights and actions across client and business silos?
- *Do you foster a culture of innovation?* Are you committed to invest in, nurture and reward ongoing, multidisciplinary ideas in products, markets, processes and operating models?

Conclusion

Ultimately, firms need to reexamine their relationships with risk to uncover new ways to grow in the industry's renaissance. Transparency and speed are driving firms to develop a true client orientation and optimize risk/return efficiency, and are pushing them to become specialist enterprises – a task that will require a conscientious approach to innovation and significant modification of their operating models. By assessing its own particular strengths and long-term strategic goals, each firm can then articulate and execute its most profitable future relationship with risk.

To learn more about this IBM Institute for Business Value financial markets study, please contact us at *iibv@us.ibm.com*. You can also browse a full catalog of our research at:

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Acknowledgements
We would also like to thank the 130 clients who participated in our qualitative interviews and the Economist Intelligence Unit for overachieving on survey execution.

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Route 100
Somers, NY 10589
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04-06
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G510-6270-01