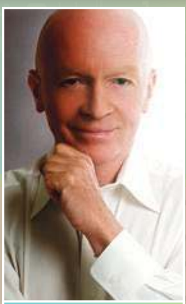
THE TRADE GROWTH MARKETS

the BRICS and beyond

TRADING AND INVESTMENT SERVICES IN EMERGING AND FRONTIER MARKETS



Mark Mobius, Templeton Emerging Markets Group

high-level view

forum

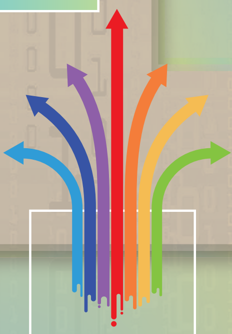
Kent Rossiter Allianz Global Investors

Paul Collins, Franklin Templeton Investments

James Stothard J. P. Morgan Asset Management

Victor Torchia ING Investment Management

broker selection



asset classes

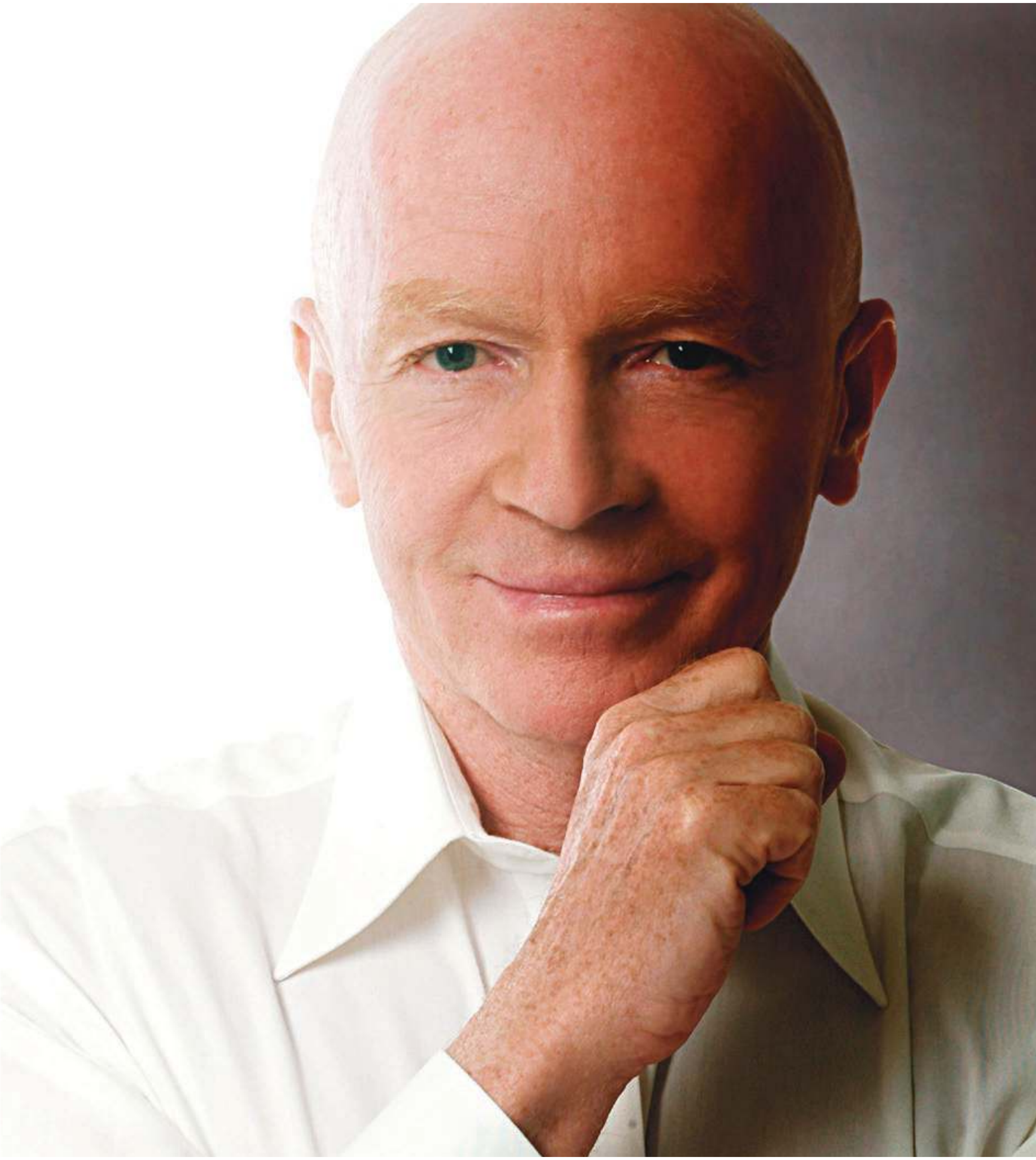
electronic trading

The TRADE Growth Markets — The BRICS and beyond

THE TRADE GROWTH MARKETS

the BRICS and beyond

High-level view



Frontiers man

Mark Mobius, executive chairman of the Templeton Emerging Markets Group, is a leading authority on emerging markets investing. In an exclusive interview with The TRADE Growth Markets, he discusses his approach to investing alongside the challenges and opportunities he sees ahead in emerging and frontier markets.

Trade Growth Markets: As a leading investor in emerging economies do you find the BRIC acronym in any way useful?

Mark Mobius: The BRIC concept makes a lot of sense from a marketing point of view. People can get their arms around it. They know where Brazil is, they know where Russia is, they know where India is, they know where China is, so the term BRIC encompasses a lot – it covers the largest land area in the world, contains the most populous countries et cetera – so in that sense it was a very good concept.

The problem from an investor perspective is that whenever you restrict yourself to specific countries or specific sectors you are going to run into downturns. Although the BRIC group of countries has lots of spark and lots of variety, the reality is that sometimes collectively they don't perform well. And that's what's happened. By contrast, Thailand has been doing well, as have a number of other emerging economies. Now the frontier market space is getting exciting.

I was interested to see the BRIC concept extended to South Africa. It doesn't make sense including South Africa for the sake of it. In fact, it's not necessarily a good concept for investing.

TGM: When you enter a new market, is your initial attraction the market itself or purely the investment opportunity within the market?

Mobius: Definitely a particular company, a particular spark, actually, a focus. We don't approach investment decisions from the perspective of saying, "Russia looks great, let's put x percentage in Russia." Our approach is to focus on the bargains we detect around the world. For example, if we see a great oil company in Russia, we evaluate how that compares with Exxon or PTT in Thailand.

TGM: Do you have any a priori preference for using local or global brokers when you're implementing those kinds of decisions?

Mobius: We use both. I should emphasise however, that we don't use them for stock selection or stock recommendations. We don't pay any attention at all to what the brokers are recommending, simply because there's too many conflicts of interests. They're doing their own trading. We use their research selectively. If a broker has researched a

High-level view

Manga Mobius

In 2007, a manga version of a comic book on the life of Mark Mobius was published under the title, 'Mark Mobius – an illustrated biography of the father of emerging markets funds.' It is currently available in six languages.

There are few portfolio managers, if any, granted near-legendary status for the markets and sectors they invest in. Mark Mobius is clearly one, with a list of achievements and credits in the emerging markets space that would require an article in its own right.

Recalling the legend, among his many monikers, Mobius has been called the 'Indiana Jones of Investing', referring to his propensity to spend most of the year visiting the outlying frontiers of global investing. Other nicknames such as the 'Pied Piper of emerging markets' and the 'dean of emerging markets' reinforce his standing as the leading authority on emerging markets investing.

But what's in a name? The answer can be found in any one of the numerous books that Mobius has authored, 'The investor's guide to emerging markets,' and 'Mobius on emerging markets,' among them. In 1999, the Carson Group singled out Mark Mobius as one of the top ten money managers of the 20th Century.

Mobius built his reputation as president of the Templeton Emerging Markets Fund, a closed-end mutual fund, and the first emerging market equity fund available to US investors. A quarter of a century later he is executive chairman of the Templeton Emerging Markets Group, where he is responsible for directing the Templeton research team, housed in offices in 18 emerging markets. From the first closed-end mutual fund he now manages over 50 closed-end and open-end mutual funds worldwide.

specific sector, for example, that can be of use. But at the end of the day we do our own stock research. We visit the companies and conduct a five-year analysis that looks back at historical performance and five years forward. We are very reliant on our own research.

TGM: Are there any opportunities, especially these days with increased regulation, compliance and reporting, that you have had to forgo because, although the particular stock may have been attractive, the investment environment in terms of trading, clearing or custody wasn't sufficiently robust?

Mobius: Yes, this can be a problem. For example, though we don't necessarily want to buy something now, we are interested in Mongolia. The problem is we don't have a custodian there. The number one priority whenever we enter a market is to have the support of a global custodian. Ideally they will have a local presence, but should they rely upon a subcustodian to sakekeep assets they will need to have undertaken a tremendous amount of due diligence.

Returning to the case of Mongolia, just this morning I got a response to an email inquiry concerning our custodial set-up in the country. Evidently, legislation has been passed that would allow custodians to operate in Mongolia. Unfortunately, it's going to take six months to implement. In this scenario, if you spy an investment opportunity that's really attractive, you do proxies. In other words, you get a company that's listed as an ADR or GDR in London or New York. Alternatively, you might opt for an investment via participatory notes, what we call P-Notes, issued by registered foreign institutional investors (FIIs) to overseas investors. In effect, they buy on our behalf and issue a P-Note that will evidence our ownership of a particular stock. It costs a little bit more but it remains a simple and attractive route into the market.

Essentially, it's a contract issued by the FII that states they have purchased x number of stocks at x price for us and that whenever we want to sell they will sell on our behalf. At that point the market price will prevail, because there's no indicated price with P-Notes, they're directly related to the stock price. It's a contract to hold, buy and sell a particular stock.

TGM: Previously you mentioned frontier markets as performing particularly well. In your view, are there any markets that have graduated from frontier to emerging in the past few years?

Mobius: No. None of them have graduated yet. If you go back to the original idea of an emerging market, an emerging market was a market or country that was in the middle- and low-per capita income bracket, according to the World Bank. Frontier markets refer to the countries that were not included in the original definition of an emerging market and were largely unexplored from an investor perspective.

There is a notable exception however, and that's the Middle East. You have Middle East countries that were not originally included in the emerging markets category, even though a number certainly have high per capita income. What we've done is taken those countries and classified them as 'frontier'.

TGM: So is it a question of accessibility that places a country in the frontier category?

Mobius: Yes. Accessibility increases over time. Today, you've got countries like Saudi Arabia, which has a large and relatively liquid market. They were not originally included in emerging markets, because they were among the so-called 'oil rich' countries. Now we include them among the frontier markets.

TGM: Looking across the MENA region, would your allocation to the markets in that region be different if restrictions were lifted?

Mobius: Definitely. MENA as a region is generally open. We had intended, for example, to go into Libya. We already invest in Morocco.

"It's an interesting possibility that eventually the Shariah funds will find favour amongst non-Muslim investors."

We are waiting for these countries to recover. We are in Egypt already. So there's no problem. The only restricted country now is Saudi Arabia, where we can buy the P-Notes. That's where we use P-Notes. Iran, for obviously political reasons, we can't can't go into, but we would like to because

High-level view

they have a stock exchange with excellent activity rates. As far as Iraq is concerned we can get exposure to a number of companies listed in London, which have all their assets in Iraq. Genel Energy, founded by the former head of BP, is a good example, of a company with registered offices in Jersey, a field office in Turkey, and production operations in Iraqi Kurdistan.

TGM: Can you take a regional approach to investing in MENA?
Mobius: Not at present. There are some interesting developments underway. Dubai, for example, is trying to develop a capital market. Overall however, you'll find that there are not many indigenous institutions that have exposure across the region. The Lebanese banks might qualify, although no bank has a 20% share of every market in the Middle East.

Looking forward, a number of Middle Eastern banks, particularly from the Gulf, are expanding throughout the region. And there's no reason why that strategy shouldn't succeed in the Arab world. They share a common language and the Shariah concept of finance is very favourable to equities in particular.

> "As soon as Chavez came in. We looked at it, we listened to what he was saying, and we said we're out of here."

TGM: Is there an opportunity for Shariah-compliant funds to be promoted amongst mainstream investors?
Mobius: Currently, these types of funds are directed only at Muslim investors. However, I think you've raised a very interesting point. There are lots of our investors, many non-Muslims amongst them, who want to adhere to exactly the same principles that Shariah promotes. That is: no alcohol, no gambling, that sort of thing. So, it's an interesting possibility that eventually the Shariah funds will find favour amongst non-Muslim investors.

TGM: Are there any frontier markets or emerging markets where you've pulled out completely, not because you were disenchanted with the stocks you were investing in but because the investment environment was no longer tenable from your point of view?
Mobius: Yes, Venezuela. There's no other country where we have wanted to pull out because the environment was bad. Irrespective of the environment we will retain a presence in a market where the largest companies are global in scope.

TGM: When did you take the decision to withdraw from investing in Venezuela?
Mobius: As soon as Chavez came in. We looked at it, we listened to what he was saying, and we said we're out of here.

Sem Deixar Pegadas – walking without leaving footprints

Gary Stone, chief strategy officer, Bloomberg Tradebook, explains how smart technology can preserve the integrity of executions on Brazil's BM&F Bovespa exchange.

In a highly transparent central limit order book market such as BM&F Bovespa's equity market, liquidity, managing impact and information leakage are particularly challenging. To spread their footprint, buy-side traders will split orders across brokers – for example, giving each broker 20% of an order. However, most traders still rely on intuition, familiarity and past experience when designing their implementation strategy. BM&F Bovespa has a unique access model. Leveraging DMA 2, where the customer connects to a DMA provider, who in turn connects to the exchange, a Brazilian 'broker wheel' can be created that manages many of the buy-side's challenges … and more.

BM&F Bovespa is highly transparent (see Figure 1). Broker quotes (orders) are identified by a mnemonic in the order book (at each price level). The executing broker is also identified in the trade recap post-trade. A trader watching a trading monitor and reading the 'tape' can easily identify when a broker is working a large order. This leakage may be beneficial – a large seller will know which broker relationship to tap to arrange a trade. However, with greater use of

Gary Stone

high-frequency data mining techniques, more and more often such leakage may result in adverse price impact.

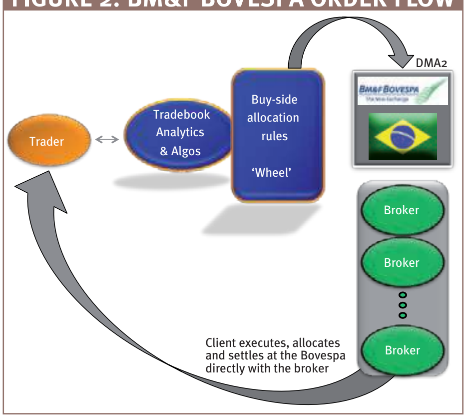
Spreading your footprint

With such a high degree of transparency, buy-side traders are trying to split their orders across several brokers in an attempt to 'spread the

FIGURE 1: BM&F BOVESPA'S TRANSPARENT ORDER BOOK

Source all figures: Bloomberg Tradebook

FIGURE 2: BM&F BOVESPA ORDER FLOW



footprint'. However, this makes managing orders especially difficult. Additionally, depending upon how the order is divided, orders may be in competition with one another or the buy-side trader may not have a firm grasp of how the overall trade is working.

A comprehensive solution combines: (1) advanced analytics that advise traders on liquidity conditions and algorithms / trading strategies that may be appropriate for the order, and (2) sophisticated execution technology that manages orders – scattering the footprint and making a large order appear to the marketplace as a series of uncorrelated random orders. BM&F Bovespa DMA2 connectivity enables technology providers, among them Bloomberg Tradebook, to create a workflow that includes direct broker-neutral access to the matching engine (see Figure 2).

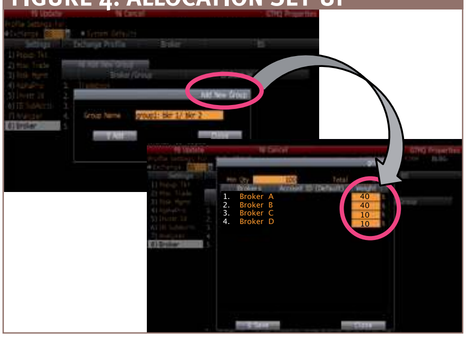
The first step in optimal execution management is determining how to execute the order. A strategy analyzer, such as Tradebook's STAZ <GO> (see Figure 3), can provide traders with statistical insights into execution implementation. For example, STAZ can help traders glean information about trade difficulty, stock characteristics and projected price path from analytics on market data. Using actual execution results, transaction cost data and models, statistically-guided suggestions on optimal algorithms can be made. The trader can select an algorithm for the entire order and have the 'broker wheel' scatter the footprint.

The broker wheel

An execution strategy is managed by a 'parent order' (a benchmark algorithm – Arrival Px, VWAP etc.) being sliced into smaller 'child orders' and the 'children' released into the market. The executing broker for the child orders can be rotated. This is the basic concept of the 'broker wheel' – assigning the child order executions across different executing brokers. Traders can create customised allocation algorithms by defining allocation groups. For example, an order can be allocated across four different brokers – where two brokers receive 40% of the order and two others split the remaining 20% (see Figure 4).

FIGURE 3: STATISTICAL INSIGHTS

FIGURE 4: ALLOCATION SET-UP



Because the splits occur at the child-order level, the parent order retains integrity. The parent algorithm is still managed in a homogenous manner. Smart order routing techniques are also consistent so traders get a familiar experience. At BM&F Bovespa, the trade is assigned (allocated) to different executing brokers. If the trader is looking for a VWAP or arrival price benchmark, the algorithm manages to that target. What changes is that the wheel randomises the executing broker at the exchange. The 'broker wheel' is a solution for maintaining execution benchmark integrity while managing impact and information leakage. However, many buy-side traders may also see the wheel as a technological solution that can be used for commission allocations. This enables them to efficiently track their commission and research budget. All the child orders use the same BM&F Bovespa clearing mechanisms – just as if the trader had split the order manually to different brokers.

In highly transparent markets, including Brazil's, technology like a 'broker wheel' can help traders retain the execution integrity of their orders by managing market impact and information leakage at the child-order level. This technology, combined with advanced analytics such as a strategy analyzer can help traders optimise their execution results. ■

Bloomberg Tradebook

Getting to know you

Difficult economic conditions in the developed world and record low interest rates have made emerging market investing extremely popular in the years since the financial crisis.

However, despite this increased interest from institutional investors and their clients, investing in emerging markets can be frustratingly complicated, with numerous obstructions and convoluted legal landscapes to be navigated.

Common problems include national exchanges making it difficult for non-local brokers to connect, meaning trades have to be conducted through intermediaries or only those international brokers with a local office.

Foreign ownership laws can also be onerous, restricting the pool of liquidity sources available and, in the worst cases, requiring brokers to trade via p-notes, which can push up the costs of trading.

Legal restrictions aside, effectively sourcing liquidity is almost always at the forefront of a trader's mind. While this is also true in the developed markets, many emerging markets present their own liquidity challenges.

Many of the smaller markets simply lack the market depth that is seen in developed countries, while elsewhere a simple lack of familiarity with the local market and an absence of 'on the ground' eyes and ears can increase the difficulty of tapping into OTC opportunities.

The bulge-bracket has made a big push into the emerging markets and many now have a local office, at least in the larger countries, and are able to support institutional investors outside of their time zones.

Similarly, buy-siders themselves should be getting more innovative in how they source liquidity and how they work with their brokers to get more acquainted with the granular functions of a local market, the kinds of restrictions in place and how best to use the tools and information available.

The TRADE asked four buy-side traders what their biggest challenges are when trading emerging markets and what solutions they and the sell-side have developed to extract alpha.

Paul Collins

head of equity trading, EMEA, Franklin Templeton Investments

Kent Rossiter

head of trading, Asia Pacific, Allianz Global Investors

James Stothard

head of international desk, J. P. Morgan Asset Management

Victor Torchia

senior global trader, ING Investment Management

PAUL COLLINS

head of equity trading, EMEA, Franklin Templeton Investments

"Understanding the local culture, flow and quality of execution should be the bedrock of your strategy."

"One of the biggest challenges when trading emerging and in particular, frontier markets is sourcing liquidity efficiently and ensuring that your market impact is kept to a minimum. Now is the point in these markets' lifecycles when they don't have the depth and maturity relative to their developed market counterparts so they are still very much block-driven markets.

These markets also tend to be more volatile by nature; hence they represent a different challenge to developed markets. Liquidity is more challenging but one must understand that it varies across regions. This is not about applying a blanket perception of liquidity, it is about being on the ground and understanding the vagaries of each country and region.

What is critical to a successful trading strategy is local knowledge. A solid understanding of the local culture, flow and quality of execution should be the bedrock of your strategy. Trust is key to understanding liquidity and whether your broker relationships have the tools and knowledge in place in order to access local markets effectively. That knowledge and strength of relationships means we can pinpoint who we speak to, reducing the number of touch points. This leads to less information leakage and reduced market impact.

At Franklin Templeton, we have 12 desks located across the globe which gives us a strong local presence and expertise which not only enables us to navigate these markets effectively and efficiently, but also provides us with that 'on the ground' insight that we can feed back into our research groups, providing a strong, collaborative partnership with our analysts and portfolio managers. It is about thinking globally and acting globally.

When we don't have a local desk in a particular market, we still have people embedded or focused in the region, within the time zone. They are constantly receiving information on the local market and talking to people in that market, as part of enhancing the overall investment process. I think this presence is vital as part of a global operation. If you don't get it right, the potential market impact can be considerable.

Efficiency of exchanges vary and you always have to remain flexible and adaptable; for example, setting up in some markets can be more labour-intensive than others. A lot of the initial challenges that we have to deal with in emerging markets are operational so it is imperative that you have a good operations team internally coupled with a strong custodian." ■

KENT ROSSITER

head of trading, Asia Pacific, Allianz Global Investors

> "Sales traders that match blocks between different investor segments can save us time and market impact."

"Legally, most Asian markets are open for trading by foreign investors, but obstacles remain for many Asian venues. To invest directly in China A-shares, investors must apply for a Qualified Foreign Institutional Investor (QFII) allocation, which is a comprehensive process. Although A-share markets are liquid, foreigners constitute a tiny fraction of trading activity. The number of brokers they can use is limited and there are restrictions on repatriating proceeds.

In India, 'Foreign Institutional Investor' accounts are required before trading, and certain activities that investors take for granted elsewhere – such as shorting stocks, aren't available to foreigners.

Investors in Asia often like to have direct investment access, their own ID's and custodians, but an option to keep things simple, from settlement through to FX on underlying trades, is to trade 'p-notes'. These are available in most of Asia's emerging markets, but not necessarily on every stock. Due to registration costs, brokers may be reluctant to set them up if trade sizes are not meaningful.

Smaller markets like Vietnam can be more challenging for traders, as liquidity can be a concern. There is less depth of coverage for stocks and obtaining information is a hurdle.

There are emerging markets where foreign shareholdings have reached such high levels that foreign investors cannot buy shares. In India, stocks like Grasim, Federal Bank, or PNB are names in which buyers have to search out foreign sellers to obtain positions, often requiring the payment of a small premium. In Thailand, names like Siam Cement and KBANK are full and trade at premiums, though demand has slackened as Thailand's market is not as favoured today as it was earlier this year.

Some stocks lend themselves to a certain investor class. One stock may trade ten times the volume of another, though their market caps/sector may be similar. This could be because they have sticky shareholders who are of the 'buy and hold' mentality. Other stocks can be tightly held by family members.

We appreciate the local colour and market insight provided by Asian sales traders. With the exception of certain frontier markets, international brokerages are well represented around Asia. Some trade directly in those markets, while others concentrate their execution services from hubs such as Singapore and Hong Kong.

Many bulge bracket brokers in Southeast Asia are established to support offshore investors. Whilst

KENT ROSSITER

continued

developing some domestic investment banking relationships, they may not find it profitable to offer local brokerage to retail, corporates or institutional investors.

We keep relationships with smaller single-country brokers. In Korea, Indonesia, and the Philippines, the real-time transparency of broker activity on the screens means we must be careful to avoid using certain brokers.

Also, some stocks are only traded by locals and if foreign brokers start trading those stocks, it could attract retail punters who try and get ahead in the queue, thinking these foreign brokers must be trading in size, which will push the stock.

Foreigners and domestic investors often have different perspectives. It is not unusual for locals to be selling when foreigners want to accumulate. Savvy sales traders who can match up blocks between different investor segments can save us time and market impact on executions." ■

JAMES STOTHARD

head of international desk,
J. P. Morgan Asset Management

"In the emerging markets, liquidity has always been the biggest challenge as it can be much harder to source than in developed markets. That said, you can't generalise too much because every market is different. The way we are structured means that, from London we cover emerging markets in central and Eastern Europe, the Middle East, Africa and Russia, while the New York desk covers Latin America and our Hong Kong team deals in Asian markets. Every single market is different and has its own peculiarities when sourcing liquidity, including what kind of stocks being traded.

To help us combat some of these issues, we've changed our behavior in emerging markets trading. As our assets have increased, our average trade size has also grown, but we have been successful in significantly reducing our overall trading costs. We've achieved this by focusing on large trades and using creative styles to find trading solutions. When trading large blocks we're tapping into a much more diverse range of liquidity flows, sometimes we go to brokers, other times to institutional investor trading networks such as Liquidnet and also going direct to companies.

Venues in the emerging markets have been developing their capabilities and we've also seen a lot of brokers launch algorithms in the emerging markets as well. While dark trading doesn't really exist in most of the markets that we trade in

"Dark trading will become a growing feature of developing economies."

from London, you can trade some emerging market stocks that are listed in developed markets in the dark. It is something that people are starting to talk about in emerging markets and I think it will become a growing feature of developing economies.

When it comes to the brokers we use, there is certainly value in going to a local player in that they will often have good local research and expertise that can be useful. However, they can often lack the scale that we need and also the risk appetite that the larger international brokers have. In many cases, bigger brokers are quasi-local anyway. If you look at a bulge bracket bank they will usually have a local office to give them that expertise on the ground and they will know many of the main players in the market.

The Middle East can be a challenging region to invest in, with a lot of rules that restrict foreign investors. If I were to single out an individual market that can be particularly obstructive for trading it would be Saudi Arabia. At the moment, international investors cannot hold stock out there. You can trade Saudi shares by using participatory notes with brokers but this is not ideal because those notes are held in the broker's name and so you need to trade through them. Saudi Arabia has often discussed lifting these restrictions but as yet this hasn't happened." ■

VICTOR TORCHIA

senior global trader,
ING Investment Management

"Emerging markets continue to transform to resemble the efficient markets operating in mature economies."

"The quality of buy-side execution in emerging markets is improving as countries reduce barriers to access, but challenges remain. Overall, spreads have narrowed, reducing implicit execution costs which is a positive outcome for asset managers. Narrower spreads give a

VICTOR TORCHIA

continued

more realistic view of market value and improve liquidity, which is key for improved buy-side execution.

The advent of direct market access (DMA) has given the buy-side trader greater control of execution while limiting information leakage, although dark trading remains fairly nascent across emerging markets globally. Some countries, Brazil in particular, offer dark execution, which appears to be working well. Also, a number or bulge bracket firms' algorithms access those countries so execution in their internal crossing engines can occur.

The electronification of emerging markets has improved access for asset managers, and Brazil is the key example, as this didn't exist five to seven years ago. More recently the government has pushed for a relaxation of foreign investor rules also, but for asset managers like ING, these rules have had little impact as we have long-established links through global brokers and their local counterparts.

Relying on global bulge bracket brokers is key to our execution strategy in emerging markets and we have a list of around 15 global brokers that facilitate execution. Some of these partner with local brokers in certain markets for execution where they are not present and this can improve the trading workflow dramatically.

Local brokers still play a role on the research side, however, specifically for their focus on small- and mid-cap names – and this trend mirrors the focus of niche brokers in the US market.

The further relaxing of market access rules is also a trend that will continue in the long-term, but in the short-term there will be little change. For instance, it's common for a central banker to declare there will be a push to open markets, but ultimately the rules only change at the behest of the political administration running the country at any given time.

American depositary receipts (ADRs) and global depositary receipts (GDRs) continue to offer buy-side firms the ability to gain exposure to a local stock without direct ownership, but there can be drawbacks. Many, especially in India, have a significant premium compared to the underlying, which can reach upwards of 20% due to foreign restrictions on ownership. If a buy-side trader is using the underlying as a benchmark, such a premium will make exposure unattractive.

However, in some cases the ADR can be more liquid than the underlying, which can balance out such a premium. Depositary receipts can also trade at a discount compared to the local shares, creating an arbitrage opportunity if the instrument is easily fungible to the underlying.

Although instruments like ADRs and GDRs provide a mechanism for asset managers to tap local markets, the focus will remain on gaining exposure to underlying stocks though direct access as emerging markets continue to transform to resemble the efficient markets operating in mature economies." ■

THE TRADE in 2014

WHAT'S NEW IN 2014

THE TRADE

1. Industry leading surveys, featured in each edition.

- Q1 The 7th Annual Algorithmic Trading survey – **long only results**
- Q2 The 7th Annual Algorithmic Trading survey – **hedge fund results**
- Q3 Buy-side broker selection – sales trading, algos, dark pools, CSAs, TCA
- Q4 EMS

2. THE TRADE intelligence

A special supplement, mailed out with The TRADE, focused on a key industry theme.

- Q1 Outsourcing
- Q2 Buy-side automation
- Q3 Accessing liquidity in fixed income markets
- Q4 Trading & clearing in CEE & Russia

THE TRADE derivatives

The Q2 edition of The TRADE Derivatives will feature the OTC derivatives prime broker survey.

THE TRADE 100

10th anniversary special issue

The 100 people, events and institutions that have shaped the world of automated trading over the past decade and will fashion its future.

Includes:

- The buy-side 40 – the head traders at the heart of The TRADE
- Industry legends

THE TRADE technology

Available in print and via an App, The TRADE Technology will provide a comprehensive directory of product and vendor offerings. A range of upgraded entry options is available:

(1) full contact details;
(2) company logo;
(3) html link to website;
(4) enhanced written entry;
(5) interview with senior company executive;
(6) product demo (static);
(7) product demo (video).

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Putting words into action

The depth and direction of change in the Russian financial system is such that trading Russian stocks on the Moscow Exchange could soon challenge the pre-eminence of depository receipts, writes Tim Bevan, managing director, prime services sales at BCS Financial Group.

Moscow is not "in a struggle with London" over liquidity, the bourse's chief executive officer Alexander Afanasiev said in a December 9th interview in London. "We strive for investors to trade more Russian shares rather than depository receipts, an outdated product, which reflects a deep mistrust of investors. After the Russian securities market reform, we don't see any reasons for such mistrust."

Now this may be considered a little optimistic by some, but there is growing evidence following reforms in the Russian market this year, that already we are seeing a migration of liquidity from London traded depository receipts (DRs) on Russian shares back to the home market.

Indeed, this would not be the first example of such a phenomenon. London did boast good liquidity in Turkish and Polish DRs some years ago before it was repatriated, but the issues investors faced when trying to trade the domestic Russian market were so deep and structural, can we really now be predicting the disappearance of the London traded market altogether?

Tim Bevan

Having talked about forthcoming reform in the Russian market for some years, it has been a relief to many to see some actual delivery in 2013. The much publicised move from a pre-delivery (T0) order book to T+2 trading has removed some of the liquidity constraints and significantly reduced the costs of trading in local shares; changes to corporate actions laws have removed a lot of the uncertainty around dividend payments and as a consequence, equity pricing; and probably the biggest single reform was the whole cleaning up of the post-trade environment in Russia with the creation of the National Settlement Depository, the first time Russia has had a legally recognised central securities depository (CSD).

That's a lot to achieve in one year and although there are still some creases to be ironed out, this represents a root and branch re-engineering of equity markets infrastructure in Russia.

Major milestone

The last major milestone was in early September with the move to T+2, so it may be a little early to draw hard and fast conclusions, but there is both strong anecdotal and some quantitative evidence to suggest that these structural reforms are having the desired effect.

"Taking back control of equity trading is just part of a broader plan to better integrate Russian financial markets with the rest of the world."

Certainly from a specialist Russian broker perspective, we have seen a huge uptick in interest in the Russian market this year from all segments of the market – wholesale banks, agency brokers, traditional hedge funds and asset managers active in EM equity and also proprietary/HFT trading groups.

Some of these groups, such as agency brokers, have been effectively excluded from participating in the Russian market until now due to structural and cost barriers, so we can clearly see already that the global distribution network for trading local Russian shares will go up by a significant factor over the next 12 months.

Naturally there is a time lag for the transmission effect to take hold; it takes time for the market to analyse and adjust to change, and the vast majority of the impact of what we have seen to date is yet to be felt. Nonetheless, there is an expectation, not just amongst stakeholders such as the Moscow Exchange, but increasingly international buy-side, that migration of liquidity back to the domestic market now looks almost inevitable.

Looking at the data, it definitely appears to be the case that Moscow is regaining the initiative. There has been a significant swing in terms of market share over the past quarter from London to Moscow, though we probably need longer-term data before pointing to a firm trend. One other noticeable factor has been the narrowing premium between certain depository receipts and the underlying shares; both Magnit and Mobile TeleSystems have narrowed to historically low levels suggesting that some holders are switching.

Linked to the emergence of the local equity market, is the increasing importance of the ruble on the international stage and the growth of Moscow as an international financial centre. Taking back control of equity trading is just part of a broader plan to better integrate Russian financial markets with the rest of the world.

Future challenges

There remain many challenges; not least ongoing concerns with regard to corporate governance, corruption and an intrinsically weak judicial system. The major difference now is not just a willingness, almost an eagerness, to engage and integrate with global markets, but tangible progress beyond rhetoric, something we've not seen before.

The actions of the Central Bank of Russia in revoking a number of banking licenses over the past few weeks indicate a significant crackdown on the domestic banking sector, aimed at those banks poorly capitalised or engaged in money laundering (moving cash offshore). This suggests more than a cosmetic change or PR exercise, but something much more fundamental. Significant risks still exist, but the depth and direction or change within the Russian financial system should give rise to cautious optimism.

DRs are no longer route one to market

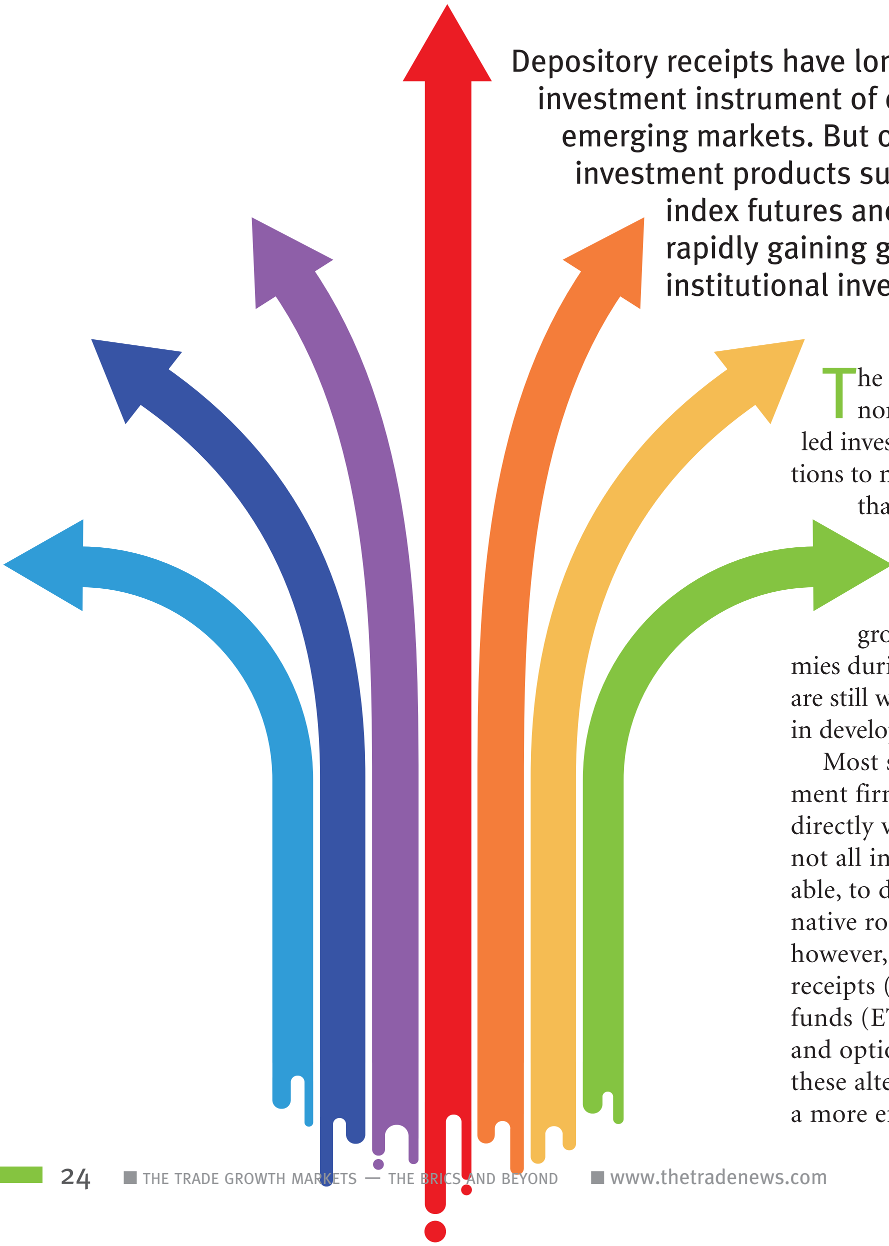


Image: iStockphoto

Depository receipts have long been the investment instrument of choice to enter emerging markets. But other alternative investment products such as ETFs and index futures and options are rapidly gaining ground among institutional investors.

The challenging global economic environment has led investors to increase allocations to multi-asset strategies that incorporate a wider array of countries and asset types. Despite comparatively slower growth in emerging economies during 2013, growth rates are still well above those being set in developed economies.

Most sophisticated investment firms access such markets directly via local exchanges, but not all investors are willing, or able, to do so. There are alternative routes to these markets, however, including depository receipts (DRs), exchange traded funds (ETFs) and index futures and options. In some cases, these alternatives are viewed as a more efficient or cost effective way of tapping emerging market growth than direct investment.

Depository receipts

DRs typically represent non-US ordinary shares and trade on traditional and OTC markets and stock exchanges. They originally were designed to enable non-US companies to broaden their US shareholder base or raise capital through registered public offerings or private placements. Created in 1927, American depository receipts (ADRs) are US securities that represent shares of a non-US company and trade in the US financial markets in US dollars, similar to those of ordinary shares of US companies. Global depository receipts (GDRs) enable simultaneous offerings in multiple markets.

The aim of a GDR is to enable investors in developed markets, who would not necessarily feel comfortable buying emerging market securities directly in the securities' home market, to gain economic exposure to the intended company using the procedures with which they are familiar.

Capital raising by companies using DRs picked up modestly in the third quarter of 2013, according to BNY Mellon's DR Market Update, which was published in October 2013. The growth was led by offerings from Asia-based firms and rose to more than US$ 5.6 billion through the first nine months of the year. Companies coming to market ranged across sectors, from traditional industrials to alternative energy. Combined, they raised more than US$ 2 billion during the quarter, up from US$ 1.4 billion in the second quarter of 2013.

Of note during the quarter was the global DR offered by Taiwan-based Fubon Financial Holding Co., which amounted to US$ 850 million. This was one of three offerings from Asia in Q3, along with ReneSola and JA Solar of China. Companies from the region have accounted for more than US$ 2.6 billion, or nearly half, of the global capital raised through September 2013, said BNY Mellon.

Outside of Asia during the quarter, discount airline Volaris staged a circa US$ 500 million initial public offering in a dual listing from Mexico, which incorporated certificates of ordinary participation in Mexico and ADRs on the New York Stock Exchange. South African transport software and hardware management company MiX Telematics launched an IPO in August, listing ADRs on the NYSE and raising just over US$ 100 million.

The year 2014 marks the 20th anniversary of the first DR to be issued in Russia by BNY Mellon. In the case of post-Soviet Russia, DRs were attractive because securities markets were at an early stage of development and investors perceived the post-trade infrastructure to be poor. With a DR, the depository bank takes the local share into custody and issues a dollar-denominated, clearable DR that can be traded, custodised, cleared and settled in the same way as a share from any other developed market.

"2014 marks the 20th anniversary of the first DR to be issued in Russia."

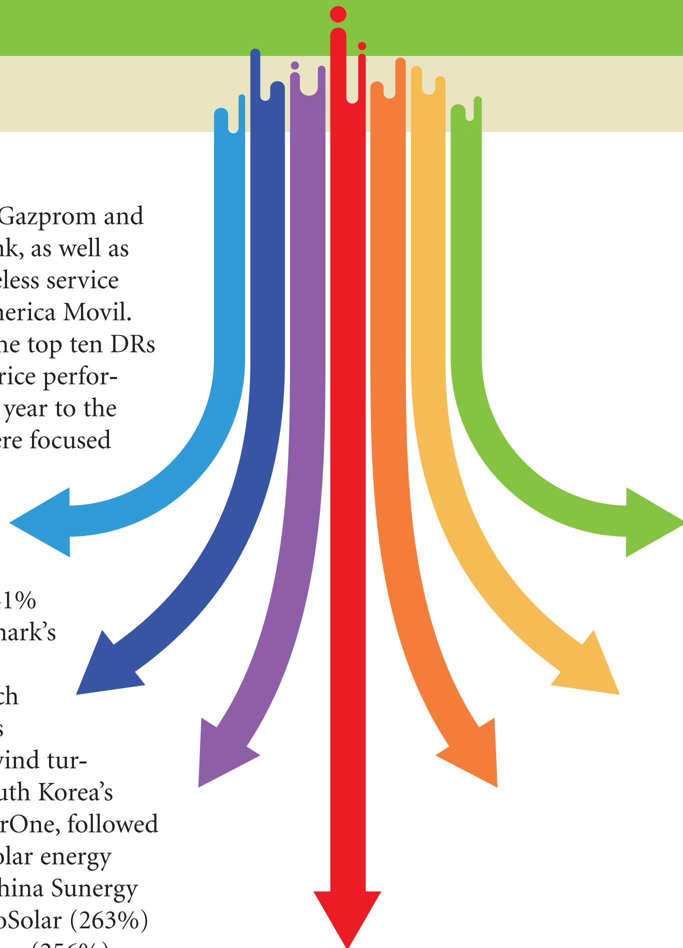
Since the initial DR launch in Russia, significant improvements have been made to the Federation's market infrastructure; the two local stock markets, RTS and Micex, have merged and a single central securities depository, NSD, has been established. Additionally, the requirement for pre-funding of settlement in rouble-denominated shares has been removed and the maintenance of share registries has been improved.

Despite this improvement, some investors continue to use DRs to access Russia. This is because participation in corporate actions such as rights offerings and issues can be quite complex for non-resident investors. Much of the information surrounding an individual corporate action may not be available in the language of the investment institution or investor. If a DR is used, the depository bank provides the necessary services around corporate actions and is more likely to have a deeper knowledge of the local market practices.

According to BNY Mellon's figures, the most actively traded DRs globally by value during Q3 2013 included China's Baidu (a Chinese language internet search provider), Brazil's Vale (a mining firm) and energy conglomerate Petrobras, Russia's energy giant Gazprom and bank Sberbank, as well as Mexico's wireless service company, America Movil.

Many of the top ten DRs in terms of price performance in the year to the end of Q3 were focused on renewable energy companies. These included a 341% leap by Denmark's Vestas Wind Systems, which manufactures and installs wind turbines and South Korea's Hanwha SolarOne, followed by Chinese solar energy companies China Sunergy (323%), JinkoSolar (263%) and Trina Solar (256%).

During the period globally, there were 108 billion DRs valued at US$ 1.9 trillion traded, representing decreases of 3% and 7%, respectively, compared with the same period in 2012.



Exchange traded funds

An ETF is an investment fund traded on stock exchanges, much like stocks. Most ETFs track either an equity or a bond index. Their appeal is based on their low-cost, tax efficient nature and this has propelled them to be the most popular type of exchange-traded product. Many emerging markets require investors to attain foreign investor status, a local bank account and a local custodian. But if an investor uses an ETF,

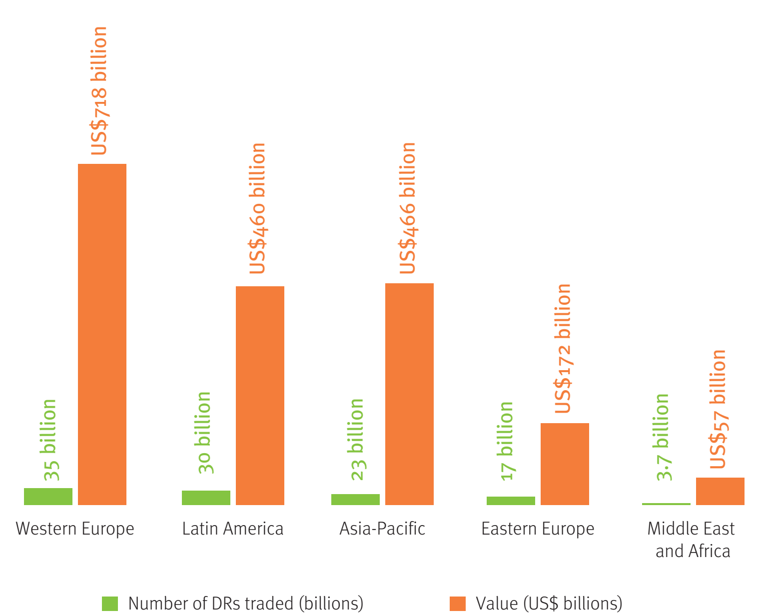
> "Analysis of smart beta ETFs has revealed that they can outperform traditional beta-index funds, but at the price of higher volatility."

they do not need special status or to set up accounts. Additionally, because of the breadth and depth of benchmarks and asset classes covered, small minimum investment requirements, liquidity, transparency, and efficient cost structures, ETFs have become valued tools for multi-asset class investors implementing a variety of asset allocation models.

At end November 2013 the global ETF and exchange-traded product (ETP) market had reached a record high of US$ 2.4 trillion, according to industry research firm ETFGI. During November 2013 net inflows into the sector reached US$ 17 billion. Equity ETFs/ETPs were most popular during the year to end November, with US$ 213.5 billion of inflows compared to US$ 22.3 billion for fixed income products.

During the past few years emerging market ETFs have grown in value. In the year to 10 October 2012, 35% of the total funds invested in emerging markets (US$ 60.2 billion) were via ETFs, according to fund tracking firm EPFR Global. Equities were the most popular asset for ETFs; however fixed income ETFs are also becoming more common.

FIGURE 1: DRs TRADED BY REGION



Source: BNY Mellon

> "ETFs provide a cheaper alternative for investors to access emerging markets, particularly smaller, illiquid markets."

ETFs provide a cheaper alternative for investors to access emerging markets, particularly smaller, illiquid markets. By investing via an ETF, investors do not have to set up a custody account or work with local broker dealers.

Recent developments look likely to further boost the use of ETFs in emerging regions such as Asia Pacific (ex-Japan). At present, there is no 'passporting' regime for ETFs in a region that is characterised by fragmentation of tax and regulatory regimes as well as currencies, languages and investor profiles. According to ETFGI, 20% of the ETFs/ETPs listed in the region are cross-listings from Europe and the US. Many investors in the region trade ETFs/

ETPs listed in the US and Europe, as the primary listing in the US or Europe is perceived to be more liquid. Developing and growing secondary trading in cross-listed ETFs has been and will continue to be a challenge.

At the end of Q3 2013, there were a total of 481 ETFs/ETPs in the region with 605 listings, assets of US$ 91 billion (4.1% of the global assets invested in such products), from 94 providers on 14 exchanges in 11 countries. The result of the fragmentation is that Asia Pacific ex-Japan has nearly double the number of providers serving nearly half as many countries as in Europe with a significantly smaller pool of overall assets – US$ 91 billion versus US$ 390 billion in Europe.

A proposed mutual recognition regime, whereby regulators are proposing to allow collective investment funds from Hong Kong and mainland China to be sold to investors in both locations, may help to boost the investment volumes in the region, as there is speculation ETFs will be among the first products to be offered via such a regime. Hong Kong will continue to benefit from asset managers and ETF providers deciding that they should develop locally domiciled products in Hong Kong to be able to take advantage of the mutual recognition scheme with China when it is implemented.

ETFs are not without their drawbacks, however. One current concern for investors in emerging markets is that the indices on which ETFs are based can include a number of poor performing companies. So, for example, investors seeking exposure to Brazil via an ETF have experienced poor performance because the underlying companies within the ETF are not performing well.

This problem is being addressed, however, via a 'smart beta' approach. This involves a more active investment approach to ETFs, whereby portfolios are not weighted by market capitalisation (which means the greatest exposure is to the largest companies). Instead, a focus is on outcome, rather than market cap; some funds will weight the portfolio based on fundamentals such as earnings, dividends and cash flow, while others weight it to low volatility or upward price momentum. The simplest and oldest smart beta strategy is equal-dollar weighting: investing the same amount of money in every company in an index, large or small. Analysis of smart beta ETFs has revealed that they can outperform traditional beta-index funds, but at the price of higher volatility.

The majority of emerging market ETFs are based on equities, however fixed income products are beginning to gain ground. Emerging markets governments increasingly are issuing bonds in local currency in an effort to eliminate areas of vulnerability in their economies. Issuing debt in foreign currencies leaves these countries more dependent on foreign investors and vulnerable to a mismatch between revenues denominated in the local currency and debt denominated in a foreign currency. To reduce these vulnerabilities, some governments are steadily paying off external debt and issuing new debt in local currency. While governments paved the way for local currency bond markets by issuing different types of bonds with various maturities, in recent years, many corporations have become very active issuers as well.

Emerging market debt cannot be viewed as a single category for asset allocation as different countries are approaching their fixed income markets in different ways. There has been some innovation in this area with State Street Global Advisors, for example, recently issuing an emerging market inflation-linked bond note. This is an area that has experienced significant growth during the past decade, with total capitalisation of such notes now at more than US$ 500 billion, according to AXA Investment Managers. Issuances of inflation-linked notes are growing particularly fast in Asia. For investors based in developing countries, these notes represent a valid investment alternative for the emerging markets.

The fixed income ETF market is still developing, with a level of opaqueness still surrounding how to price a bond. However, users are increasingly adopting the idea of 'slicing and dicing', using fixed income ETFs to slice and dice the yield curve via duration or credit, for example, in order to tap into emerging markets debt.

> "In China, index futures were first traded in April 2010 on the China Financial Futures Exchange."

Index futures and options

Index futures and options are products whose value closely follows the price level of their underlying indices – providing management of equity market risks and trading opportunities for both institutional and retail investors.

In March 2012, the five members of the BRICS Exchanges Alliance agreed to cross-list futures on Brazil's Bovespa Index, Russia's Micex Index, the BSE India Sensitive Index, Hong Kong's Hang Seng Index, the Hang Seng China Enterprises Index and South Africa's JSE Top40 Index. The move enabled traders engaged in arbitrage to buy and sell futures based on the same index on multiple venues.

Asset classes

In the BRICs and other emerging markets, index futures and options are increasingly seen as an important tool for access. In China, index futures were first traded in April 2010 on the China Financial Futures Exchange. The futures contracts are agreements to buy or sell the CSI 300 Index, representing exchanges in Shanghai and Shenzhen, at a pre-set value on an agreed date. In Q3 2013, treasury bond futures, used to manage interest rate risks, were launched in China. Observers said the bond futures, combined with the index futures reflected the deepening of market-oriented interest rate reforms in the country, which have generated strong demand for hedging interest rate risks.

In India, index futures trading is available via the Bombay Stock Exchange's (BSE's) BSE Sensex equity index and the National Stock Exchange's (NSE's) Nifty index. India's top 30 companies comprise the Sensex index. The NSE Nifty, S&P CNX Nifty or Nifty 50, is the main index of the NSE and contains the 50 largest companies that are listed on the exchange. These companies account for 22 sectors of the Indian economy. Futures contracts of the NSE's index Nifty listed overseas on the Singapore Stock Exchange have been successful with institutional investors, while Sensex's Eurex listing in Germany has not proved as popular.

> "In India, index futures trading is available via the Bombay Stock Exchange's BSE Sensex equity index and the National Stock Exchange's Nifty index."

Latin America is something of an exception when it comes to index futures, which are traded only in Brazil. There are many regulations surrounding the posting of collateral and opening of accounts, which makes these products quite complex. They also tend to be relatively volatile and for many investors do not represent a realistic alternative to access markets such as Brazil.

In addition to the local BRIC market indices, exchanges in developed markets are tapping into BRICs via their own indices. The London Stock Exchange's FTSE Emerging Market indices are part of the FTSE Global Equity Index Series. The series includes around 1,600 large-, mid- and small-cap securities listed in advanced emerging and secondary emerging countries.

In July 2013, Eurex Exchange introduced futures and options based on the MSCI Emerging Markets index and on sub-indices MSCI EM EMEA, MSCI EM Latin America and MSCI EM Asia. Futures were also introduced on 16 emerging market country indices.

NYSE Liffe US reported in October 2013 record monthly volume for its mini MSCI Emerging Markets futures, with more than 1 million contracts traded in September 2013. Increased liquidity and broad industry adoption during the US and European time zones had helped to push the strong growth in the emerging markets product, NYSE Liffe said.

The future for Russian GDRs?

With Russia becoming more accessible for international investors, Andrew Powell, director, electronic trading, URALSIB Securities, considers the outlook for Russian global depository receipts.

The attraction of GDRs is one of gaining economic exposure to a security without necessitating trading in the securities' home market. Further attractions of GDRs include the safekeeping aspects (i.e. DVP via Euroclear), the US dollar holding currency, lower financing costs and the fact that a high proportion of structured products are priced in US dollars. Note that GDRs and local stocks are not fungible securities.

The LSE International Order Book (IOB) listed GDRs trade circa US$ 1 billion per day, which is on a par with the daily turnover of the MICEX index, so there is obviously an attractive amount of business for The Moscow Exchange to try and repatriate.

In looking for parallels, I don't think that we can look to CE3 and Turkey for clues as to how the Russian DR story pans out, as the markets are fundamentally different. However, some of these factors that have traditionally made GDRs attractive over Russian local lines of stock are gradually being eradicated via the significant changes that have been made to Russia's legislative environment and market structure; most notably the implementation of the National Clearing Centre (NCC) as a central counterparty, the recognition of the National Settlement Depository (NSD) as an approved securities depository and the move from T+0 to T+2 market settlement.

Andrew Powell

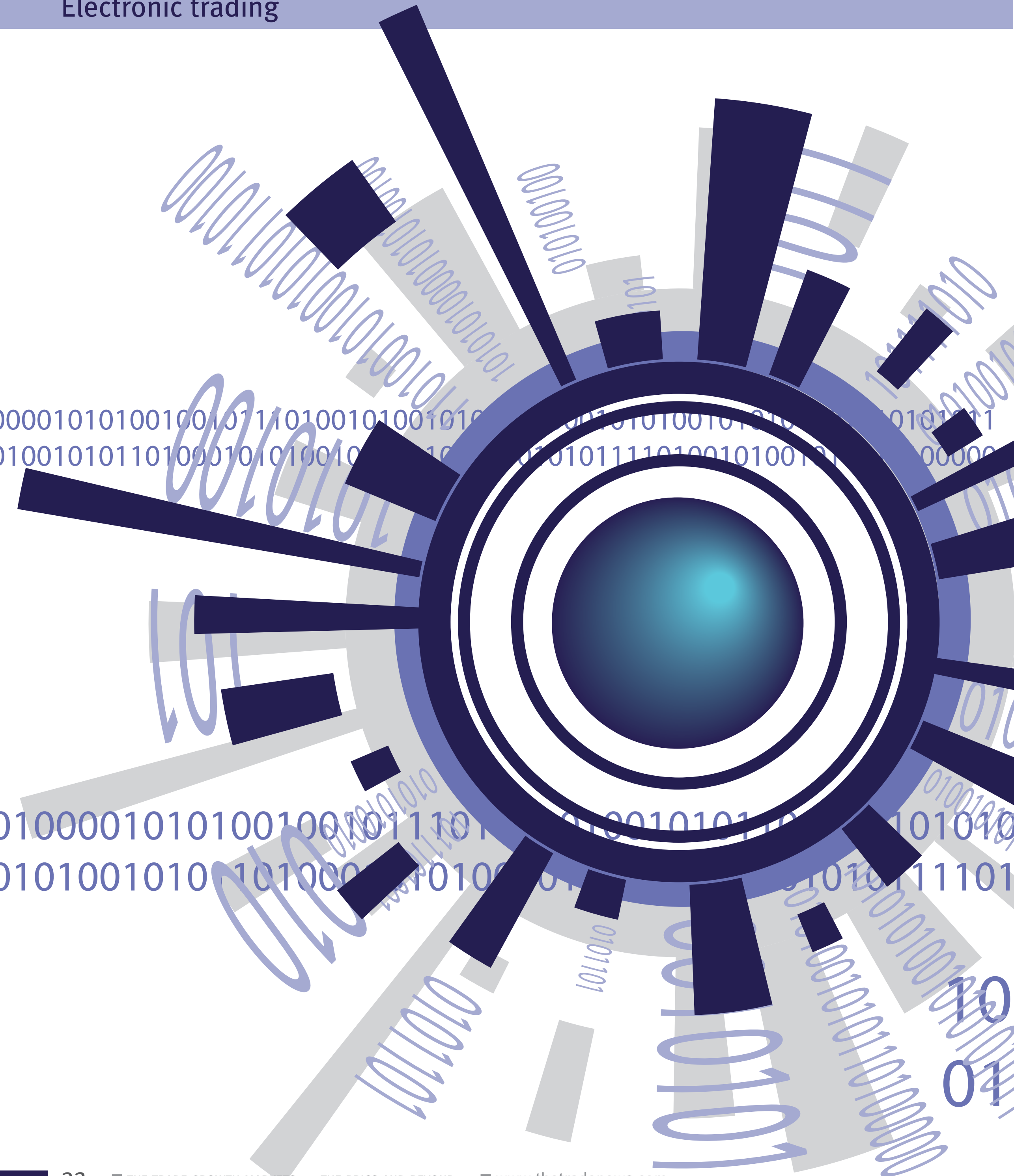
Some positives regarding trading the local lines of stock are worthy of mention and include the tightening rouble spreads, the fact that securities prices are not artificially inflated unlike DRs when issuance programmes reach their ceiling, and, of course, the lack of conversion charges that can eat into stock returns.

Looking forward, the next notable development in the market will be the ability of Euroclear and Clearstream to offer settlement services for Russian equities, which is likely to have much more of a positive impact than T+2 for the end investor. Furthermore, the discussed pension reforms and anticipated IPOs will undoubtedly result in even more business being attracted to the Moscow Exchange.

And finally, let us remember that there are some entities who cannot, or will not, invest in the local Russian market and that the overriding factor which will drive any significant increase in Russian domestic volumes depends on whether investors see Russia as a compelling investment. ■

URALSIB FINANCIAL CORPORATION

Electronic trading



Tools to shape the BRICS

Unique market microstructures make each BRIC market unsuitable for a vanilla trading tool set; picking the right equipment requires planning.

Image: iStockphoto

Electronic tools can be invaluable when trading large orders into growth markets, but the tools must be matched to the idiosyncrasies of the environment. Brazil, Russia, India and China each have a unique model for trading equities that can affect the decision to use high-touch, algorithmic or DMA trading. Other large developing markets, such as South Africa and Turkey, also have their quirks.

When trading into these countries, market-access rules and post-trade processing can affect the ability of firms to use DMA, smart order routers or execution algorithms. Due consideration should be given to the impact of these factors ahead of selecting a trading strategy.

Single-exchange markets

Brazil and Russia both have single exchanges, both see substantial trading of listed firms via offshore depository receipts (DRs) and neither allows dark-pool trading of stocks. Otherwise they are quite different to trade into.

Brazil

Buy-side traders find high levels of liquidity in the top ten or twenty stocks in Brazil, with the rest of the market deemed illiquid. As American Depository Receipts (ADRs) are available to trade in the US market for the big Brazilian firms, this is often used as an alternative way to access the country.

For small- and medium-cap stocks, trading via an algo is deemed somewhat risky as the shallow market can make stocks subject to sudden price movements. Even liquid stocks are only liquid proportional to the rest of the market; the market's average daily volume (4.5 million trades over a three month period) is lower than Nasdaq-listed Apple Inc. (11.9 million trades over a three month period). This has steered some traders away from algorithmic trading, but not all.

While a high-touch desk can be a good way to find liquidity in order to trade blocks, algos are being used by long-only buy-side firms, even tentatively in small- and mid-cap stocks. Traders mainly use percentage of volume (POV), VWAP or TWAP algos, placing tight limits upon them to protect against volatility.

Bulge-bracket brokers report interest in liquidity-seeking algos that operate passively to take liquidity within fixed price parameters; having seen some success with locally-based fund managers these are now reportedly attracting offshore buy-side firms.

DMA has been rolled out in the equity market since 2010 offering a fast route into the market. Since the delivery of the new trading platform, PUMA, to the cash segment of the market in 2012, round trip latency has become sub-millisecond. Taking such a direct route limits information leakage substantially, although its provision has also attracted high-frequency traders, currently making up 10% of the market, but targeted to make up 30% within a few years, according to the exchange.

"Managing signalling risk is particularly important when trading markets like Brazil where liquidity constraints can present unique challenges."

Todd Lopez, head of distribution, Americas, Goldman Sachs Electronic Trading

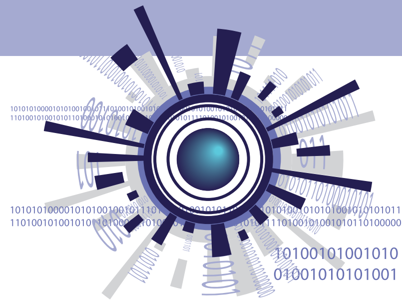
Brazil is an ID market, with the beneficial owner identified through a CVM number, given by the clearing house Companhia Brasileira de Liquidação e Custódia (CBLC). As the market is thin and has a substantial amount of high-frequency trading (HFT), front running is a real concern.

Todd Lopez, head of distribution for Goldman Sachs Electronic Trading in the Americas says, "Managing signalling risk is particularly important when trading markets like Brazil where liquidity constraints can present unique challenges. When building and maintaining algorithms for the evolving Brazilian market microstructure there has been an increasing importance put on minimising our client's footprint in the market."

The opening of a dark pool by Citi in November 2013 for the Mexican market has aroused the interest of the buy-side, with one US-based long-only trader saying, "If something like that was rolled out for Brazil, I would definitely try it, as long as buy-side firms were the only ones involved."

Russia

At present trading into the Russian market via DMA is possible and avoids



information leakage, but the settlement model makes it complicated. The top 50 stocks in the MICEX Index are settled on a T+2 basis with fractional pre-trade funding required for both sides of the trade, either in roubles or in US dollars. The less liquid a stock the higher the proportion of notional required, up to 100%. For those stocks outside of the MICEX Index, the seller must pre-fund stock ahead of the trade.

These requirements add to the broker's costs and those are passed on to the buy-side trader. However, the move to T+2, which completed in September 2013, is a substantial improvement on the previous model which required all stocks to settle at T+0 and to be pre-funded with rouble or stock for a buy or sell.

The awarding of central securities depositary to the National Securities Depository in November 2012 also improved trading conditions by creating uniformity in post-trade costs and processes. Sell-side firms note that most of the costs for trading local Russian equity were in post-trade, but they could be very difficult to calculate. For example, having to re-register a trade with a Registrar for Gazprom might cost 25 bps, and the trade's settlement could take a fortnight. As the trade would be financed in roubles from T+0 settlement date the potential exists for costs to grow significantly.

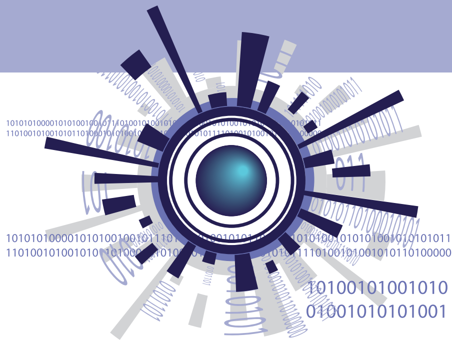
> "[In China] DMA and algos are rarely if ever available to overseas long-only firms from local brokers, who are often selected on the basis of research which is bundled together with execution."

As a result of the latest developments, DMA is more viable and many large agency brokers and wholesale banks announced that they would begin offering access into Russia in the latter half of 2013, spurring innovation in 2014.

As they move out of the hands of the odd specialist broker and into the mainstream, DMA services will see margin compression making them more cost effective for traders. Sell-side firms expect that increased competition will lead existing players to extend out their algo suites, with newcomers developing algos for the first time. At present, the single destination market, lacking alternative markets or dark pools limits the functionality on offer to basic slice and dice algos, typically VWAP, TWAP and market participation.

Alternative models have been broached before. In 2011 there had been talk of dark trading functionality being offered by the main exchange but the project was unsuccessful. The potential for a smart-order router that could arbitrage between the depository receipts available on the London Stock Exchange (LSE) and stock on the Russian market was undone by differences in the settlement cycle and the cost of conversion between instruments.

"What will probably happen next is the emergence of



dark pools, the emergence of broker crossing networks, alternative liquidity venues away from that central Moscow book," says Tim Bevan, managing director – prime services sales at BCS Financial Group. "It will then get more interesting in terms of how people source liquidity and how they use algos to do that. But we are not there yet."

Smaller markets

South Africa, which has begun to include itself as the 'S' in BRICS, and Turkey both have relatively high trading volumes for developing markets. With single exchanges and burgeoning economies they are traded in a similar manner to developed markets, although both see liquidity in a few large-cap stocks. Many South African stocks are dual-listed on the LSE, which also provides the matching system to the Johannesburg Stock Exchange.

Buy-side traders typically limit trading strategies to VWAP, POV and TWAP, however the markets should be watched closely. As firms are not allowed to trade away from the order book, occasionally firms will post a block on the order book and then hit their own trade, effectively crossing on the exchange. For algos based on volume this can create problems. If they see a spike, they may try to start moving the stock as the data indicates they are behind on volume. The consequence is that algos ought to have safety checks built in to consult the trader when a single large print is made.

Multi-exchange markets

China has two or three equity markets depending on whether one includes Hong Kong. It is currently seeing a roll out of sophisticated trading algorithms and DMA, but as a bundled market the value of execution must be weighed against that of research. India also has several exchanges, although only the National Stock Exchange and the Bombay Stock Exchange hold the significant volume. Algo trading is well-established but must be tailored to the market structure.

China

The rules around accessing the Chinese market affect the brokers that can be selected and therefore the tools on offer. Qualified Foreign Institutional Investor (QFII) status or Renminbi QFII (RQFII) status must be granted to a firm by the China Securities Regulatory Commission (CSRC), the capital markets regulator. QFII allows a foreign firm to invest directly into the otherwise inaccessible mainland A-shares market. RQFII is a similar scheme but allows the investment to be conducted specifically with yuan held offshore.

There were 229 QFII-approved firms as of June 2013, with a total quota of US$ 150 billion to invest, while the total RQFII quota is US$ 270 billion. Traders must either use their own firm's quota or that of their broker in order to trade on the main markets. At present, Tabb Group estimates 1-2% of trading volume is from overseas institutional investors with the majority, 80%, from domestic retail investors.

Trading in China A-shares, listed on the Shanghai and Shenzhen exchanges, is fairly basic. All trading by local investment management firms is conducted electronically into the exchange, effectively via DMA. Where they use broker algorithms, those algos must be hosted within the firm itself, so their trades are broken into child orders at source and sent via DMA into the market.

A firm must select a given broker for each exchange; as of a recent rule change, up to three can be used per venue. However, custodians can insist upon the same broker being used to buy and sell given shares, making it impractical to use more than one.

DMA and algos are rarely if ever available to overseas long-only firms from local brokers, who are often selected on the basis of research which is bundled together with execution. Brokers' understanding of trading strategies adopted by institutions can be basic at best, with traders reporting that a request to trade simple VWAP instructions can be challenging. They may have a retail broker mentality and take a view without consulting buy-side traders beforehand.

"They have found it difficult to follow trading instructions or understand anything beyond getting done at a price," noted one head of Asia desk at a large global asset manager.

Global brokers are offering DMA and algos, so the value these add must be weighed against the other advantages that a broker offers; it is difficult to switch brokers and can take up to three months. However, they report success with their provision access to use algorithmic strategies for domestic mutual fund managers. Those tools have since been extended to the brokers' internal proprietary desks, giving their own traders access to the market.

More recently these algos have been developed for, and are being offered to, institutional QFII-licensed fund managers to pass orders into the market, either via a worked order desk or through the electronic trading desk.

While the buy-side report a preference for self-trading via DMA/algos, their concerns around access and information leakage have held many back so far.

"What will probably happen next is the emergence of ... alternative liquidity venues away from the central Moscow book."

Tim Bevan, managing director, prime services sales, BCS Financial Group

Hong Kong

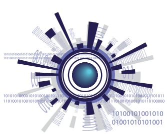
Hong Kong provides useful access to China for firms without QFII status. DMA and certain algorithmic trading strategies are both viable for trading on Hong Kong Exchange and Clearing's single equity market. However, recent rule changes have severely impacted the use of algos. From 1 January 2014, traders and investment firms must demonstrate that they have a clear understanding of the operation and workings of the algos they use.

An immediate reaction to this has been for buy-side firms to cut the number of brokers and vendor packages that they use, to limit the amount of work involved. In addition, dark pools, making up some 10% of volume, have become opt-in, requiring all traders to request access before their flow can be routed to them. As a consequence, liquidity will be harder to find and liquidity-seeking algos may become more useful, if they do not use historical data.

India

Market activity is split approximately 80/20 by volume across the National Stock Exchange and the Bombay Stock Exchange. All of the bulge bracket, investment bank-type securities firms offer access to DMA/algos on a 'one touch' basis, although some offshore funds describe the performance and reliability as "patchy".

> "Liquidnet is reportedly trialling its block-only, buy-side dark pool market in India at present, which would provide a useful channel for traders seeking anonymity with large-in-size trades."



Domestic funds in India are far more mature than in many markets when embracing electronic trading and have used the customisation of products that have been made available to them by big brokers. Many local firms are reported by brokers to be big users of algorithmic strategies, making up around 25-30% of their overall flows.

Fungibility of assets across the two exchanges make the use of smart order routing viable, however the relatively small number of stocks that trade on the BSE and the need to clear via the issuing exchange's own infrastructure – at increased cost – present limits to its usefulness.

DMA is a real advantage in India where information leakage is a significant concern. As there can be a lack of information and liquidity around small- to mid-cap stocks, valuations can vary or suddenly change. Around 20% of market volume is reckoned to be high-frequency trading, adding to concerns about information leakage. Liquidnet is reportedly trialling its block-only, buy-side dark pool market in India at present, which would provide a useful channel for traders seeking anonymity with large-in-size trades.

The use of particular algorithmic strategies varies. Local players report that DMA is primarily used for liquid stocks and plain vanilla algos for less liquid, small- and mid-cap stocks; some algos are more suited to a wide bid/offer spread. Offshore buy-side traders make the case for never trading VWAP algos in India as the low liquidity and wide spreads can allow predatory traders to tap into liquidity too easily. Instead, algos that take or post liquidity or aggressively encourage other traders to become involved with an order are preferred. ■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Bringing liquidity home

As market structure reform brings Russia's capital market in line with international standards, Serge Alexandre, head of sales, Europe & North America, electronic trading services at Otkritie, explains why offshore trading in Russia's leading companies could return to Moscow.

In 2011 the Russian government announced its initial plans to establish Moscow as a leading international financial centre in order to create an appropriate environment for international investors and encourage capital inflows into Russia. Following this announcement, the very first reform in December 2011 consisted of merging the two existing exchanges (MICEX and RTS) into a single platform – now branded the Moscow Exchange (MOEX) – to build a strong vehicle that would drive most of the new initiatives. Two years on, it is interesting to look back at what has been done so far, what the results are and what remains on the agenda.

Growing appetite

There has been a growing appetite to invest in Russian companies over the past five years, but the hurdles to access the local market have been so high that international investors – and sometimes even Russian investors – have preferred to use an alternative platform to trade these stocks. This came in the form of Depositary Receipts (DRs), initially traded on the New York Stock Exchange, but since 2007 principally on the London Stock Exchange (LSE) International Order Book (IOB). It's been such a success that Russian stocks used to account for 95% of the trading activity of the IOB, whereas the IOB segment used to represent up to 20% of the volumes traded on the whole LSE.

Serge Alexandre

The main reason that has driven investors to trade offshore has been the poor Russian post-trade environment. While accessing the market is simple – opening an account with a Russian broker is easy, all the major ones have a presence outside Russia – investors had typically found it complicated and expensive to settle and safekeep their assets onshore. Therefore, the second major reform on the roadmap was logically to create a new modern central depository and to change the T0 settlement cycle in line with international standards.

The new central depositary has been created in two stages. The first step in June 2012 involved the merger of the two existing depositories, the National Settlement Depositary (NSD) and the Depository Clearing Company (DCC). The second step in November 2012 was to grant this new entity the status of Russian Central Securities Depository (CSD). Since the end of March 2013 the newly created entity has been fully operational, offering a single, safe, efficient and cost effective platform for settlement in Russia that complies with the 17f-7 Rule governing US investors.

Investor education

The next stage in this journey is to educate the international financial community and alter their investment habits – we know this will take time – hand in hand with opening the market structure further. In that respect, the decision to grant Euroclear the status of nominee holder for Russian Government Bonds (OFZs) in December 2012 has produced incredibly promising results. On the very first day international investors were able to settle OFZs through Euroclear, the spreads on OFZs reduced by 50bps (up to a total of 150bps over five months) with a significant uptick in the trading activity.

> "Changes to the market microstructure, while definitively on the right tracks, have been introduced almost too rapidly."

Previously, the T0 settlement cycle required funds or shares to be delivered at the exchange before buying or selling a stock, creating lots of expensive inefficiencies for international investors. The migration to a T+2 settlement cycle was completed at the beginning of September 2013 and since then, for the 50 most liquid stocks traded on MOEX, the exchange now only requires a partial collateral in cash to be deposited.

Bearing fruit

The change has started to bear fruit: in just three months, the MOEX market share against the IOB has already increased significantly while the premium between DRs and local shares prices have started to fall down.

As we can see, the Russian financial markets landscape has changed dramatically over the past two years. Changes to the market microstructure, while definitively on the right tracks, have been introduced rapidly – almost too rapidly. There are still many details to sort out and market participants will need time before they can fully capitalise on these reforms. For example, some custodian banks find the shortened settlement cycle too tight, as they are use to T+3 settlement. Local investors claim they haven't seen the benefits yet while missing the advantages of the 'fast cash' settlement that previously existed.

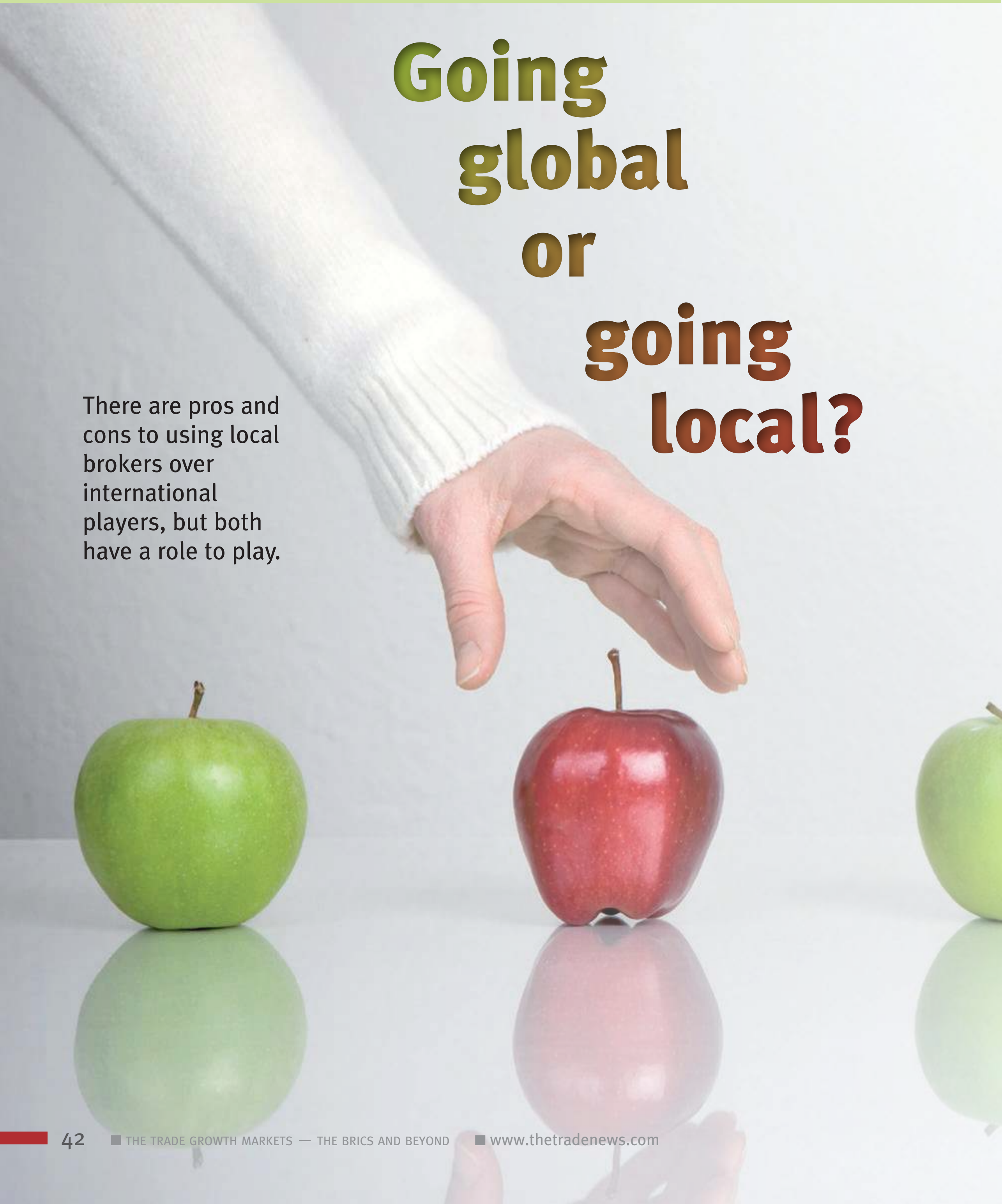
A further example of reform where the full benefit is yet to be realised is seen in the exchange closing auction price. In September 2013 this was recognised as the official closing price of the Russian market. While closing auction liquidity has already improved, the reform will only fully bear fruit once the MSCI reviews its methodology.

In 2014, two major missing pieces of the market reforms will be put in place: extending Euroclear's settlement capabilities to equities and putting in force the new dividend law to tackle the retroactive corporate action record date issue. With these two issues addressed and all the actors in the market fully embracing these reforms, the operation of the Moscow exchange will comply with international standards. We will then witness the repatriation of Russian liquidity on a major scale – a prerequisite to signal the start of Putin's long awaited US$50 billion privatisation programme.

Otkritie Securities Limited

Going global or going local?

There are pros and cons to using local brokers over international players, but both have a role to play.



The case for investing in growth markets is now well established, with investors acknowledging the potential for superior returns across a number of asset classes. However, right now performance is struggling. Data from Thomson Reuters shows that growth market returns were 50% off US market returns from 2010 until the summer of 2013.

According to JP Morgan, this has had the side effect of making emerging market assets very cheap. The investment bank says growth markets are at their cheapest for years, compared to developed markets, with a book value of around 1.4x versus 1.9x for established markets.

One of the crucial considerations when investing in growth markets is whether to opt for a local broker, choose a tier 1 global broker firm, or even use a combination of the two. This can make a big difference in important areas like settlement, clearing and, ultimately, flow.

Looking at the benefits of using local broker firms within the context of growth market investing – which is nuanced by different settlement and clearing stipulations, languages, customs, and variations in market development – local knowledge is priced at a premium.

But where local brokers can provide "deep knowledge and expertise" they, according to a number of heads of dealing, including Mark Denny, head of dealing, global markets, Investec Asset Management, "do not necessarily always know how to access liquidity better".

Yet the presence of a large broker in a small growth market where liquidity is unpredictable can have its problems. For example, a large institutional order will potentially have a greater market impact if it can be identified as such.

One feature seen in the early days of growth market investing and trading was the propensity for buy-side institutions to use one firm – almost always a tier 1 investment bank – for their broking, securities lending and back-office requirements. While global firms can also provide access to a multitude of markets, this may arguably be at the expense of providing clients with detailed coverage of often hard to trace securities.

Deep relationships

Often local brokers tend to have lasting relationships with local pension funds, which today are a vital source of liquidity in the growth markets space, but these relationships are not so cosy as they once were.

Recently, South Korea's National Pension Service, the country's largest pension fund, took the decision to scrap the minimum fees it pays its roster of brokers to execute trades. NPS ended its policy of paying a minimum 0.15% fee to brokers, thereby forcing local brokers to fight harder to maintain wallet share.

Image: iStockphoto

Broker selection

Lower trading volumes in Seoul during 2013 might further encourage competition among local brokers for international and domestic business, but the broader message is that pros and cons of the local vs global debate can change quickly, especially in a fast-changing market such as Korea.

Increasing competition is something local brokers argue will be of long-term benefit to those buying their services. For example, in Turkey many local firms are battling it out with bigger broker brands for business, with the outcome being healthier trading costs, according to Serkan Aran, managing director, equity and derivatives at IS Investment, a Turkish investment house.

Aran sees international institutional investors as having a clear choice. "If I were a buy-side trader I would not use big [global] names, because they are expensive, and they do not have as much experience as we do. The only advantage of using global [brokers] is pricing, because global names sometimes give a price first and take the risk for you.

"On the cost side, local houses have just started to get in to this world and are eager to compete with big, global names when it comes to cost of trading," he says.

Russia, Central and Eastern Europe and Latin America are reckoned to have the strongest local broker industries in the emerging markets, with a number of small players branching out to be champions of their region in recent years, either through mergers or acquisitions of other niche firms.

"In Colombia and Brazil we are seeing local heavyweights become regional players, so a broker could execute a trade not just in Bogota, but also Mexico City and Lima," reflects Philippe Carre, global head of connectivity at financial technology provider SunGard.

In his role supporting both the buy-side and sell-side to trade in difficult market conditions and in developing regions, Carre has observed local brokers carving a niche for themselves.

> "Small local brokers are just much less likely to qualify for a buy-sider's broker list."

Salvador Palma, managing director, Alyar

The argument follows that a sales trader sitting at a London desk is handling orders in 10 different countries and struggles to specialise, whereas a local broker in Sofia, Bulgaria can contact the market directly to find out who has the stocks to trade. "In this regard, liquidity might not be easily seen on the screen of an exchange and the local office can give you a feel for the stock," adds Carre.

As such, a strong local brokerage could be in a better position to execute on a good trade idea than an over-stretched global broker without strong on-the-ground presence.

Tailored technology

Advances in the field of trading technology have the scope to level the playing field, but offer opportunities for both local and global brokers to bolster their credentials to international investors. A number of networks exist that enable local brokers to connect electronically to sell-side and buy-side counterparts globally, typically using the

FIX message protocol. In addition, technology providers are enabling their trading platforms to take more account of local market realities.

In Brazil, for example, trading technology provider Fidessa, has introduced a product to accommodate country-specific market structure and regulations, "enabling both domestic and international clients to trade efficiently while remaining compliant with local requirements".

Overall, the spread of electronic trading to many growth markets means that the technology gap between local and global brokers is narrowing.

In India, for example, the decision by the Securities and Exchange Board of India to permit smart order routing between the National Stock Exchange and the Bombay Stock Exchange led to a number of global brokers developing their execution services to ensure international clients got the best price. But it also forced local brokers to up their game in the execution space to offer state-of-the-art routing capabilities - or risk losing out on domestic and international business.

"Local brokers do not necessarily always know how to access liquidity better."

Mark Denny, head of dealing, global markets, Investec Asset Management

With so many arguments for using a local broker to help you establish trading opportunities, dig out those unheard of securities, and help smooth out chunky orders without causing too much noise, why has the lure of the tier 1 broker not totally faded – especially when many global firms are busy either cutting back on local market coverage because of profitability, or consolidating in the light of capital constraints from base camp?

One reason is that global brokers remain very adept at services that require deep resources and a global skillset, like portfolio rebalancing. For example, when an MSCI rebalancing is needed, according to Salvador Palma, who manages Alyar, a New York-based capital markets firm with Latin American insight.

While local brokers can offer added value due to longstanding relationships with pension funds, Palma points out that large buy-side investors based overseas often have specific quotas for their brokers.

"For instance, if a local broker only services one market no matter how good they are, they run a big disadvantage in the approval process," he explains.

Palma also reckons balance sheet and credit risk are important factors in swaying the buy-side towards the bigger, global firms. "Small local brokers are just much less likely to qualify for a buy-sider's broker list, especially if the investor is a mid- to large-tier name," he says.

While advantages such as local liquidity flow (particularly from pension funds) and grassroots coverage can be of benefit to those using domestic brokers, they are not necessarily the cheaper option compared to their larger rivals. For instance, a Goldman Sachs analyst can cover his costs for being based in a low-volume market because they are subsidised by the high volumes of business done in the US and Europe.

Certainly, a buy-side firm has to evaluate the added value and potential costs and determine if a particular emerging market offers the potential returns to justify an indigenous broker on its list. They also need to consider that opting for a global broker that can offer a range of bundled services, like securities lending or trading technology, could also mean greater availability of risk capital on tap versus the local, smaller broker.

"Local houses are eager to compete with big, global names when it comes to cost of trading."

Serkan Aran, managing director, equity and derivatives, IS Investment

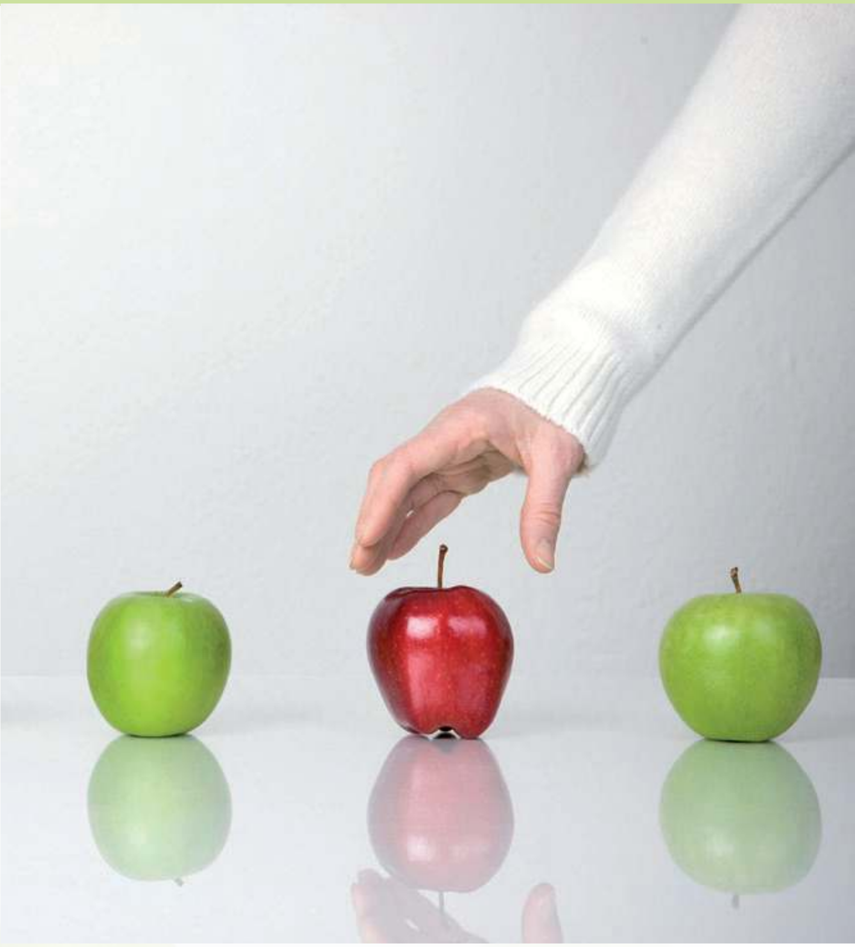
Investec Asset Management's Denny suggests that where there is increased counterparty risk with local brokers with derivatives trades, global houses typically have stronger credit ratings. "In this, they may be the preferred counterparties for bilateral derivatives trades," he says. In the case of some markets, such as the Middle East, the use of interest rate swaps is prohibited under local law, making it even tougher to execute more complex trades.

Another argument, says Denny, is that the multi-asset execution capabilities of most large sell-side firms mean that more complex operations, such as embedding FX into a bond trade, "can be easier" for the buy-side.

Best of both

The advent of sophisticated electronic trading tools has helped boost a trend of partnerships and consolidation in the growth market brokering industry, with a hybrid approach taking shape in some regions.

SunGard's Carre noted a pattern emerging in Latin America, where global brokers were partnering with a regional broker in order to gain access to a local market. In return, that local broker would get access to a range of complex electronic trading tools while both brokers retain their individual clients.



Bloomberg Tradebook's chief strategy officer, Gary Stone, says that electronic trading by its very nature "bridges the language barrier", and therefore makes the competition for business even more intense. To potentially punch above their weight, local brokers can access tailored-made agency broker solutions that take account of local regulations and laws on clearing, for instance, from specialist intermediaries like Bloomberg Tradebook. This can mean they sidestep the need for the backing of a global player to an extent.

Such relationships have obvious benefits for the agency broker looking to offer services to clients that want to trade directly in a market in which they do not have a presence. Stone says his team have the capabilities to step in if a trade is not going well, or something has gone amiss, while also observing trades on the screen across 18 growth markets to date.

Due to the fast evolving nature of most growth markets, the balance of power ebbs and flows. In Russia, for example, big investment banks including Morgan Stanley and Credit Suisse have started to provide their clients direct access to the Moscow Exchange. Local brokers like BCS already have a strong footprint in terms of electronic trading and currently can connect orders between Moscow and London in milliseconds. In this case, local brokers claim the presence of global banks will actually help to grow the overall amount of available liquidity.

Overall, there is a place for both types of broker, the small local business and the global bulge bracket bank, many argue. "Each has a specific role to offer," says Denny, with markets having room for the larger, multi-product broker and its technological clout and the local brokers sweeping behind them with detailed knowledge about local market practices, contacts and customs.

Financial market developments: a technologist's viewpoint

Technology underpins the development of modern financial markets. Changes to Russia's market microstructure over the past year, which saw the settlement cycle move from T0 to T+2, have focused attention on software development to ensure a seamless client transition to the new operating environment. Vladimir Kurlyandchik, director of business development at ARQA Technologies, explains how the company responded to the challenges.

What were the main trends in the market in terms of software development over the past year?

In the 'Russian' part of our business the project at the top of our agenda involved the transition of equity trading at the Moscow Exchange (MOEX) from a T0 to T+2 settlement mode. All software development was prioritized in line with it. We worked on two tasks: to provide clients with adequate risk management to comply with the new trading regime and to ensure they were able to operate uninterrupted in the new environment. The very possibility to trade T+ was embedded into our software long ago, when our first clients started to trade in international markets.

The MOEX project was completed on time and relatively hassle free – all our clients are on board to operate in the new T+ settlement environment.

Another important trend we have witnessed over the past year has been the growing interest in the FX market. An increasing number of brokers are now providing client access to FX trading at MOEX and on international FX venues such as the EBS system of ICAP and Thomson Reuters' spot matching. Beside gateway connection projects there has also been demand for complex infrastructure solutions consolidating FX liquidity from several sources. That was the main reason to actively use smart order routing technology and an internal matching engine.

Vladimir Kurlyandchik

Do you think the new margin credit requirements of the Bank of Russia will put a lot of pressure on your company?

We consider this a major project for 2014. Changes in respective regulations have already come into force and everybody should be compliant with them by the end of March 2014. Having analyzed how the new regulations affect technologies and the business scenarios used by clients, we released a road map for them as to when and what software would be adapted to the regulations.

Faced with tighter regulatory scrutiny, how important is risk-management today?

There are several factors at play here. The issue of risk-management is key for many of our clients not only because of new regulations or stricter application but also because of a clear understanding that an intelligently built risk-management solution offers a serious competitive advantage in an environment where market share is subject to being eroded.

Our clients today employ more trading strategies that are effectively covered by risk-management solutions. A year ago we talked about netting local shares with ADRs. Now, any composite portfolio with multiple asset-types can be evaluated in terms of margin credit and collateral in a very efficient manner.

We see a growing number of infrastructural solutions to integrate risk-management into diverse trading environments. This year we witnessed a number of risk-management implementations specifically to control high frequency trading (HFT) clients at such diverse venues as the LSE and the FX market of EBS.

It seems that the services offered by exchanges and those offered by brokers are starting to overlap.

"We see a growing number of infrastructural solutions to integrate risk-management into diverse trading environments."

What is your view on this?

Yes, it is a global trend. Quite frequently the classic role re-distribution initiative comes from both sides. There are lots of examples. NASDAQ made it clear that they are prepared to provide algorithms like TWAP and VWAP on the basis of their trading system, whereas earlier algorithmic trading was offered on broker platforms. NASDAQ believes it is time these algos became a part of the exchange functionality.

DMA is a way for the exchange to reach the end client. In this scenario, the broker's role is effectively neutralized. Conversely, internalization is an example of how brokers are encroaching on exchange functionality by offering their clients the ability to cross internal liquidity.

The battle goes on but it is important to think of a balance of interests. From the technology point of view a solution is always available.

What are the major trends concerning the end clients trading practices?

I would name a few important trends. One of them is providing the end client with a variety of devices to utilize as a trading tool. In our world of rapid technological development that we are all familiar with in everyday life, building solutions for trading from a stand-alone computer, iPhone, iPad, Android communicators, etc. are a must.

Another trend involves extending automation functionality to the end client. For example, this could cover programming language LUA inbuilt into a QUIK terminal or allowing an external client's trading platform to be integrated with a broker's platform using a universal tool such as FIX protocol. And last but not the least is the increasing requirement to trade different asset classes, often in multiple currencies, using one screen. ■

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