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IBM'S PERSPECTIVE ON THE FINANCIAL MARKETS - A VISION OF THE FUTURE

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IBM Canada – SIS

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➤ Summary

Value creation in 2015

Power shifts

Call to action

We surveyed over 400 business leaders and conducted extensive secondary research to develop a vision of the future

- How will value be created in the future?
- Which firms are positioned to succeed?
- What capabilities will be required?
- What steps must executives take now to prepare for the future?

IBM Institute for Business Value

Economist Intelligence Unit

The Economist

Scope

- Our analysis focused on selected financial markets industry participants¹:
 - Buy side: institutional and retail asset management
 - Sell side: institutional sales and trading
 - Processors: asset servicing/custody, exchanges, alternative trading systems, clearing
 - Academia, plan sponsors, IBM Research, industry associations, key regulatory bodies across US, Europe and Asia

Approach

- We surveyed 402 business leaders from 296 financial markets firms²:
 - Qualitative interviews of 130 executives
 - Survey of 272 executives, in partnership with the Economist Intelligence Unit
 - Interviews and survey spanned three geographies
 - 37% US, 32% Europe and 31% Asia
- We developed quantitative models that combined historical perspectives with potentially disruptive forces

➤ *We have combined a vision of the future with actionable recommendations.*

Summary

Business models will shift substantially by 2015; winners will redefine their relationships with risk**Summary of Findings**

- Transparency and speed will create new sources of value
- Agency profits will die
- Alpha and beta will separate
- Alliances will be critical
- Clients will demand investment, innovation and specialization

❖ *Value in 2015 will bifurcate into risk assumption and risk mitigation; leading firms will capitalize on this apparent paradox.*

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Summary

❖ **Value creation in 2015**

Power shifts

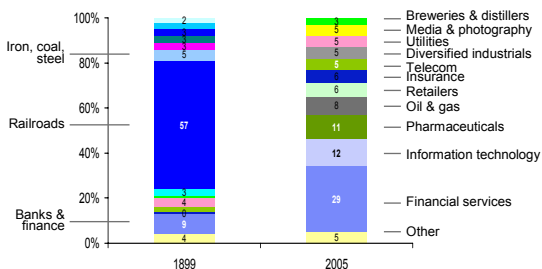
Call to action

Appendix

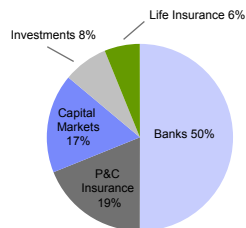
Value creation in 2015

Financial services has amassed substantial market capitalization over the last century and is now the dominant sector

Sector Composition of Market Capitalization, US and UK, 1899-2005¹
(MSCI Indices, Percentage)



Financial Services Sector Composition of Market Capitalization, Worldwide, 2005¹
(MSCI Indices, Percentage)



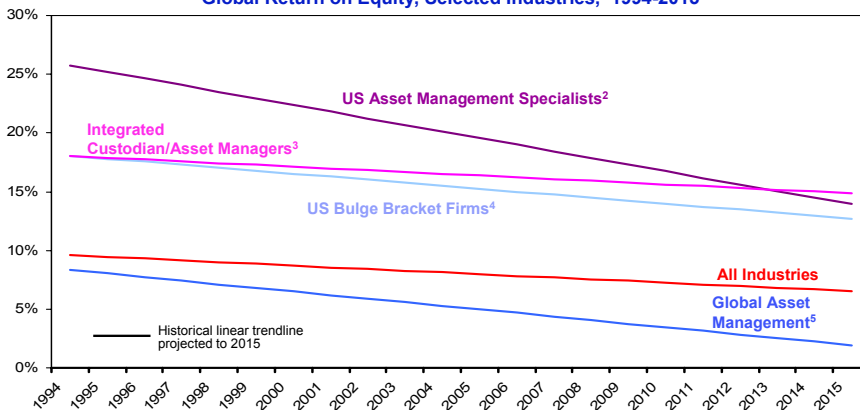
Note: ¹Through September 2005

Source: Dimson, Marsh, Staunton; MSCI data; Thomson Financial; IBM Institute for Business Value analysis

Value creation in 2015

In the future, firms will need to find new ways to create value in a maturing industry...

Global Return on Equity, Selected Industries, 1994-2015¹

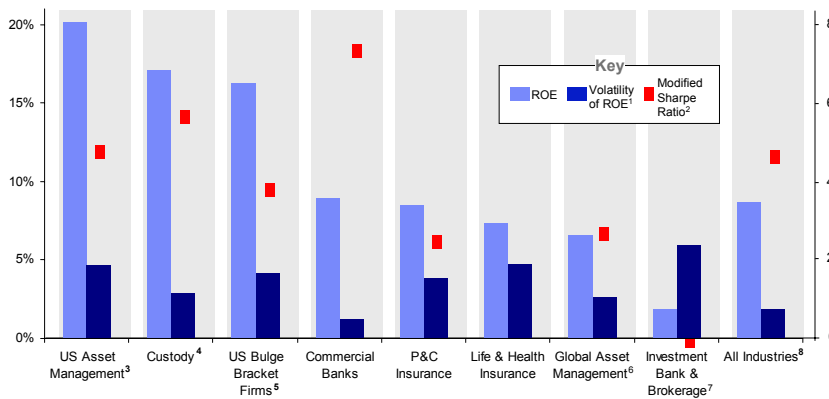


Lines are linear projections that indicate the industries' actual historical RoE trend; projections include financial markets with all industries as the benchmark

Value creation in 2015

...and new ways of maximizing risk / return efficiency

Global Return on Equity & Volatility, Select Industries, 1994-2004



Value creation in 2015

Transparency and speed will cause agency profits to die, alpha and beta to separate, and alliances to become more important

Change agents

Future state implications

Transparency

- Risk transparency & portability
- Exposure of conflicts of interest
- Pricing & client profit transparency

Speed

- Organizational shifts
- Product commoditization
- Trading & downstream processing

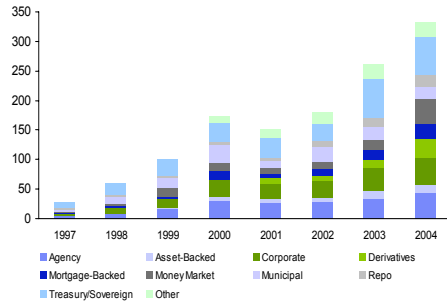
- 1 Death of agency profits
- 2 Alpha/beta separation
- 3 Criticality of alliances

Source: IBM Institute for Business Value analysis

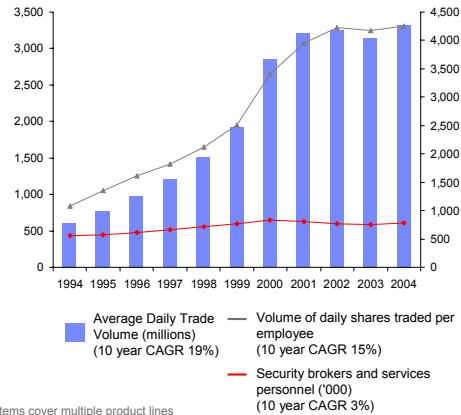
Value creation in 2015

1 Pervasive technology will influence all asset classes...

Number of US and European Electronic Trading Systems¹, 1997-2004
(Number of Electronic Trading Systems by Type of Market Supported)



Average Daily Trade Volumes vs. Headcount, 1994-2004
(Millions of Shares; Number of Employees ('000), Volume per Employee)

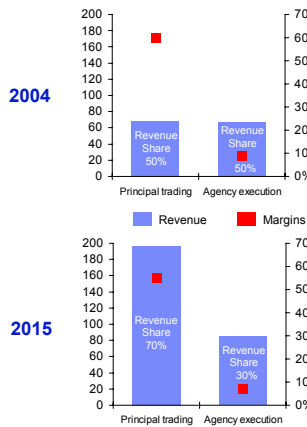


Note: ¹Totals may exceed the actual number of systems listed since some systems cover multiple product lines
Source: The Bond Market Association; Reuters; SIA; IBM Institute for Business Value analysis

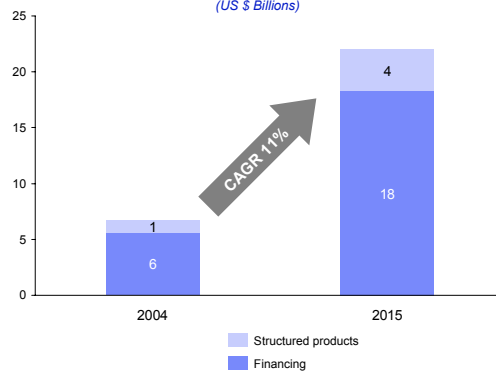
Value creation in 2015

1 ...causing agency margins to die and value to shift toward riskier activities

Agency vs. Principal¹, 2004 and 2015
(US \$ Billions, Margin Percentage)



Financing and Structured Products Revenue, 2004 and 2015
(US \$ Billions)

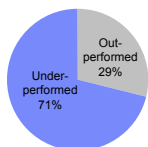


Firms unanimously agreed that proprietary trading will be an increasingly important source of profit over the next ten years; regulators indicated they will not prevent it.

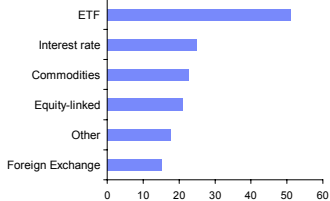
Value creation in 2015

2 Underperformance and beta availability will force separation of alpha from beta...

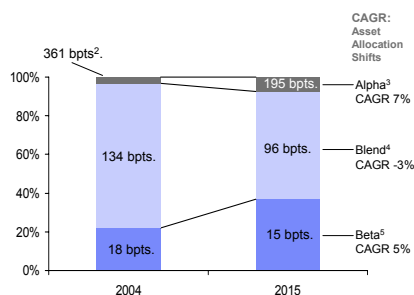
Traditional Active Manager Underperformance, 1993-2004
(US Active Funds vs. MSCI US Broad Market 2500 Index)



ETF & OTC Derivatives Market Growth, 1999-2005¹
(Compound Annual Growth Rate of Beta Instruments)



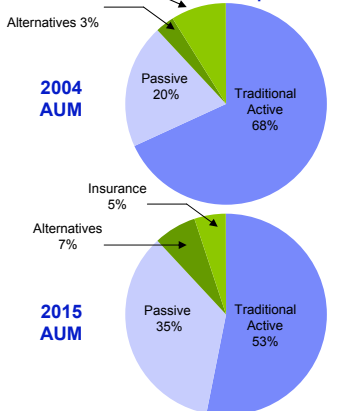
Asset Allocation and Fees, 2004-2015
(Percent Allocation, Fees²)



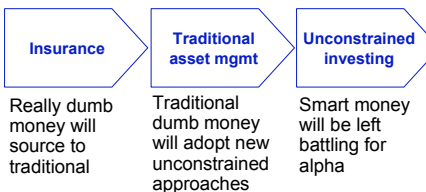
Value creation in 2015

2 ...however, alpha will become increasingly difficult to obtain

Today: Many Alpha Donors vs. Tomorrow: Few Alpha Donors



Alpha donor asset sourcing will leave smart money fighting for alpha



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

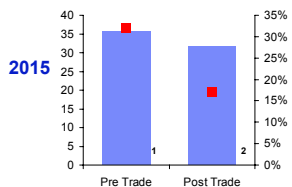
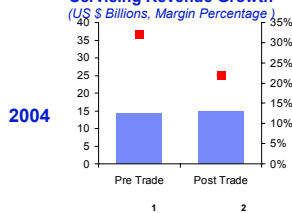
“Alpha is the new treasure, but for many investors, it will prove equally elusive.” - C-level Executive, large institutional asset manager, Boston

Value creation in 2015

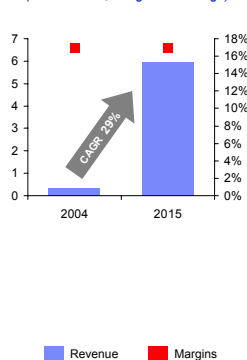
3

...and increase the importance of alliances

Pre Trade and Post Trade Asset Servicing Revenue Growth



Utilities Revenue Growth



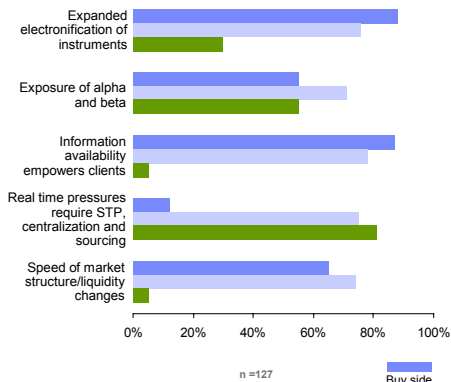
Note: ¹Pre trade includes multiple value added services carried out by custodians including analytics, attribution, risk management, securities lending, trading and cash management; ²Post trade refers to the primary services provided by custodians such as custody and fund accounting
Source: Profit map model, IBM Institute for Business Value analysis

Value creation in 2015

Industry leaders also recognize these changes and expressed their concerns

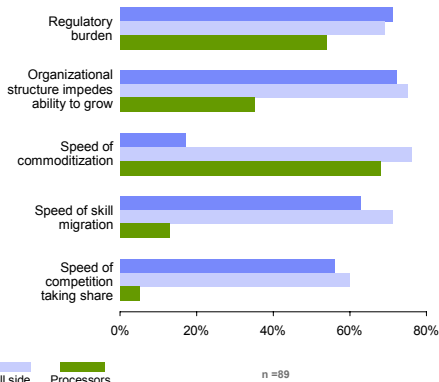
Drivers of Change over the Next Ten Years¹

(Percentage of Survey Respondents by Segment)²



Current Concerns²

(Percentage of Survey Respondents by Segment)³



Value creation in 2015

As the industry matures, many traditional activities will come under increasing pressure and new value engines will emerge

Activities under pressure: Margin compression and/or slow revenue growth

- Unnecessary bundles
 - Traditional long-only active management
 - Funds of hedge funds
 - Prime brokerage
 - End-to-end non-transformational outsourcing
 - Separately managed accounts/Wrap

- Transaction businesses
 - Institutional trade execution
 - Retail brokerage¹
 - Custody
 - Fund accounting
 - Exchanges

Value engines: Stable margins and/or high revenue growth

- Risk assumption²
 - Alternative investments
 - Principal trading
 - Capital lending/financing
 - Structured product creation

- Risk mitigation
 - Pre-trade and trade asset servicing
 - Efficient processing utilities³
 - Advice

❖ Successful firms will embrace selected value engines while focusing on reducing expenses for activities under pressure.

Value creation in 2015

The end state will be a separation of value into risk assumption and risk mitigation

Projected Profit Margin and Revenue Growth, 2004-2015

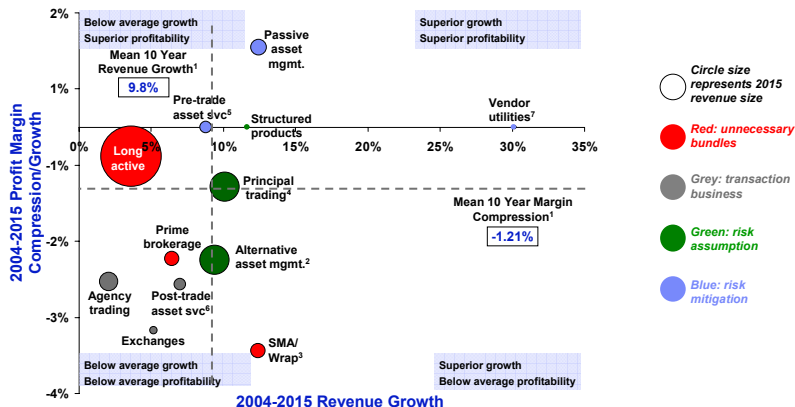


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❖ **Power shifts**

Call to action

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Industry power will shift to investors and those that can best meet their needs

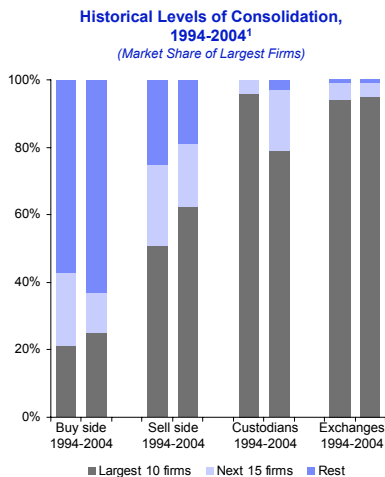
Power Shifts

- Overcapacity will lead to increased rationalization
- Buy side will dominate in the short term, but this will not last
- Firms with scale are expected to win
- Seizing emerging growth opportunities will require deeper client relationships and a focus on innovation

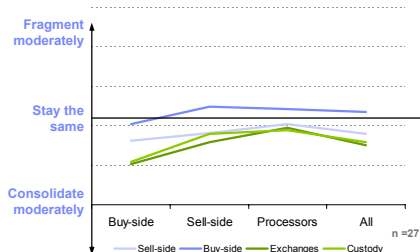
❖ *Investor needs will dictate future business models; winners will specialize in meeting specific investor demands.*

Power shifts

Overcapacity in the industry will lead to increased rationalization



Expected Level of Consolidation by Segment, 2005-2015²
(Average Survey Responses)

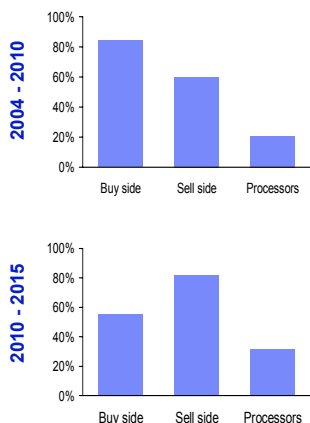


Note: ¹Number of NYSE firms doing public business, buy side is share of global assets under management, sell side is share of revenue, custodians is share of assets under custody, exchanges is share of volume; ²Executives asked: *How is the global structure of the industry likely to change between now and 2015?*
Source: SIA; World Federation of Exchanges; Pension & Investments; Buitonwood International; IBV/Economist Intelligence Unit Survey; IBV primary interviews

Power shifts

Initial buy side power gains will fade as the sell side is better able to meet investor demands for asset/liability matching

Profit Growth by Segment



Implications

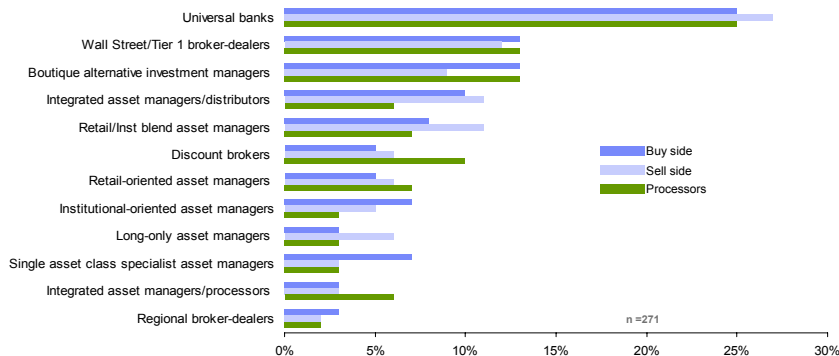
- Buy side will increase its power in the short term, driven largely by hedge fund growth
- Investors will increasingly demand access to better asset/liability matching
- Sell side firms, supported by service providers, will have the ability to best meet investor needs

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

Power shifts

Because of their existing sell side capabilities, customer base and distribution breadth, many see universal banks as having an edge

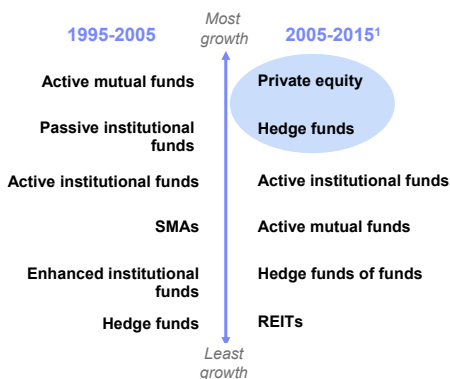
Firms Most Likely to Succeed Over the Next Ten Years¹
(Percentage of Survey Respondents by Segment)



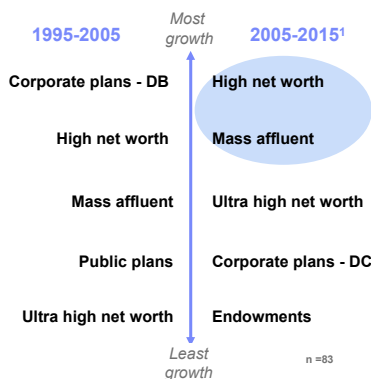
“Combining capital is a fatal weapon.” - Division Head, Tokyo, on the advantages of scale

Buy side firms expect their greatest opportunities to lie in delivering alpha-generating products and serving wealthy investors

Relative 10-Year Growth of Buy Side Products



Relative 10-Year Growth of Buy Side Client Segments



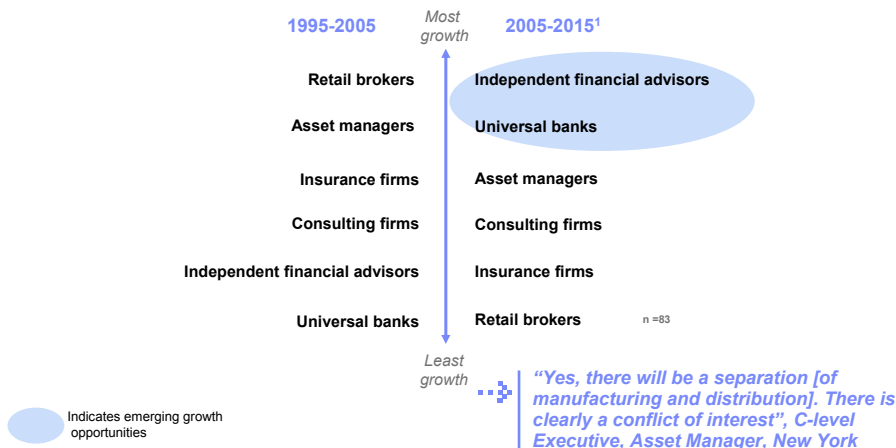
Indicates emerging growth opportunities

“We are in the beginning of the era of professional asset management...we were amateurs.” - Head of Asset Management Strategy, Universal bank, London

Power shifts

Buy side distribution strategies are expected to shift as investors seek trusted advice

Relative 10-Year Growth of Buy Side Distribution Channels

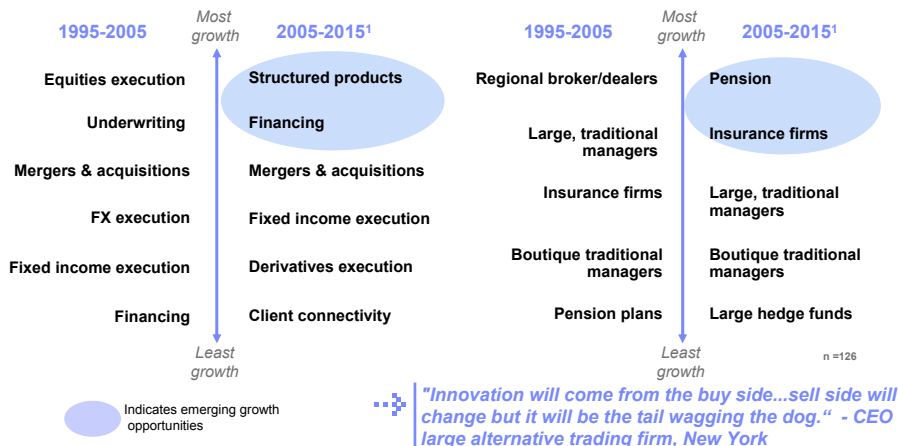


Power shifts

Sell side firms see growth opportunities in riskier activities and will compete with buy side firms for pension clients

Relative 10-Year Growth of Sell Side Products

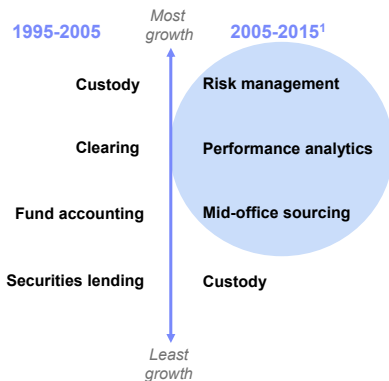
Relative 10-Year Growth of Sell Side Client Segments



Power shifts

Processors expect growth in providing pre-trade and trade services to existing clients

Relative 10-Year Growth of Processor Products



Indicates emerging growth opportunities

Relative 10-Year Growth of Processor Client Segments

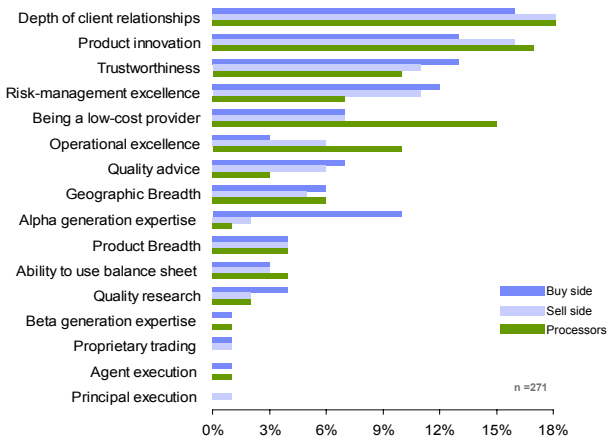


Surprisingly, hedge funds were not cited as being a high growth opportunity.

Power shifts

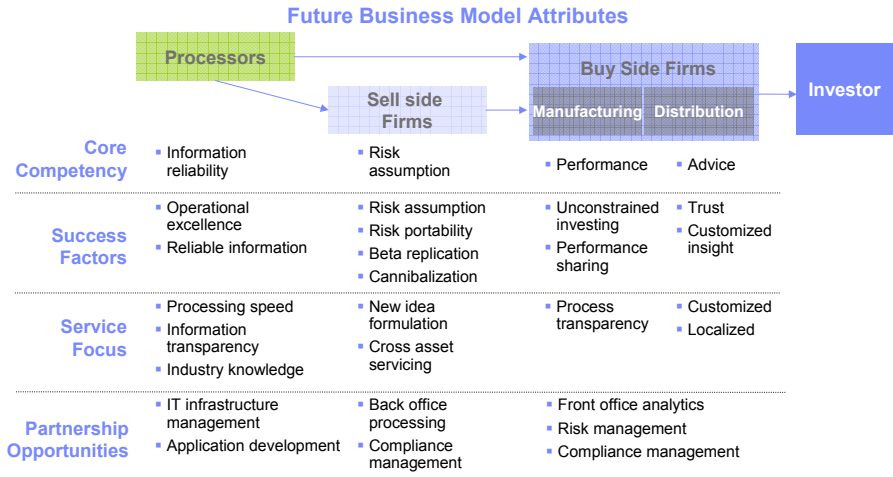
To capitalize on growth opportunities, firms will need to build strong client relationships and create differentiated products

Most Important Sources of Competitive Advantage Over the Next Ten Years¹
(Percentage of Survey Respondents by Segment)



Power shifts

Ultimately, investor needs will dictate future business model attributes for all participants



Source: IBM Institute for Business Value analysis

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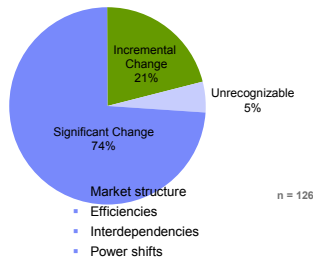
❖ **Call to action**

Appendix

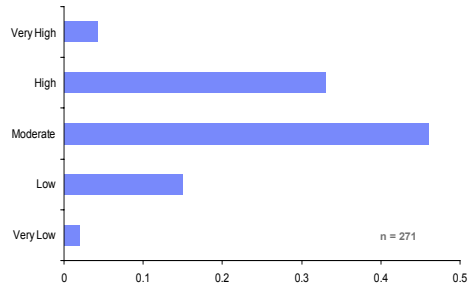
Call to action

Most firms believe that the industry will be significantly different in 2015, but they are only moderately able to respond to change

Degree of Change Over the Next Ten Years¹
(Percentage of Survey Respondents)



Agility: Ability to Quickly Respond to Forces Affecting Your Business²
(Percentage of Survey Respondents)



“There will be significant change. Commissions will be lower, volumes will be higher, regulatory environment will keep getting tougher.”
 - Divisional Head, Wall Street firm, New York

Note: ¹Executives asked: How much do you expect the industry to change over the next 10 years? (Select one of the following: Unrecognizable, significant change, change in incremental ways, stay the same). ²How would you rate your firm's ability to respond to external forces affecting your business? (Rate on a scale of 1-5).
 Source: IBV Economist Intelligence Unit Survey

Call to action

Firms should take concrete steps today to prepare for a radically different future

Imperatives

- Determine capabilities necessary to meet future goals
- Focus on core strengths and partner for everything else
- Eradicate inefficiencies that create barriers to change
- Develop a purposeful, systematic culture of innovation

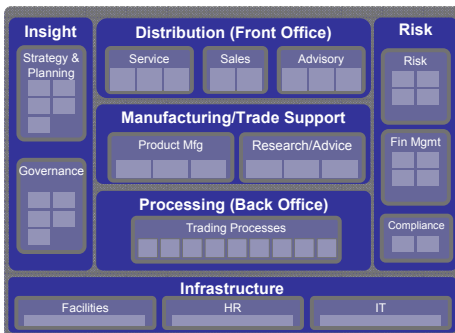
EXECUTE!

Call to action

A component view of the firm enables matching of current capabilities against those required for future success

Determine capabilities necessary to meet future goals

Componentized View of FM Firm (Illustrative)



Strategy

Critical Questions

- Which components are strategic elements of the firm's core business?
- Are there additional capabilities required to meet strategic goals?

Operations

- Should you maintain redundant systems and/or processes within or across components?
- Are there other players that can provide non-core, operational capabilities cheaper?

Execution

- Do current capabilities enable excellence in execution?
- Are there capabilities that can be obtained through partnerships that will enhance execution?

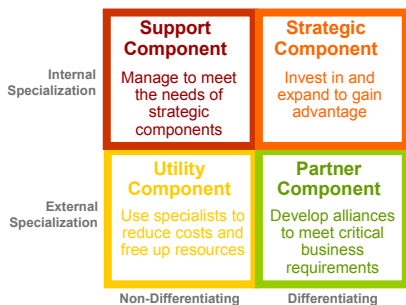
Source: IBM Institute for Business Value analysis

Call to action

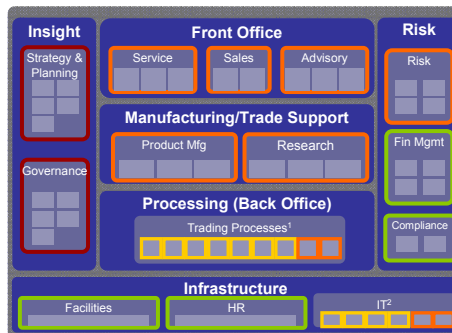
Firms' next steps should be based on a strategic understanding of their current and potential advantages

Focus on core strengths and partner for everything else

Business Component Decision Matrix



Component Decisions Applied to 2015 FM Firm (Illustrative)



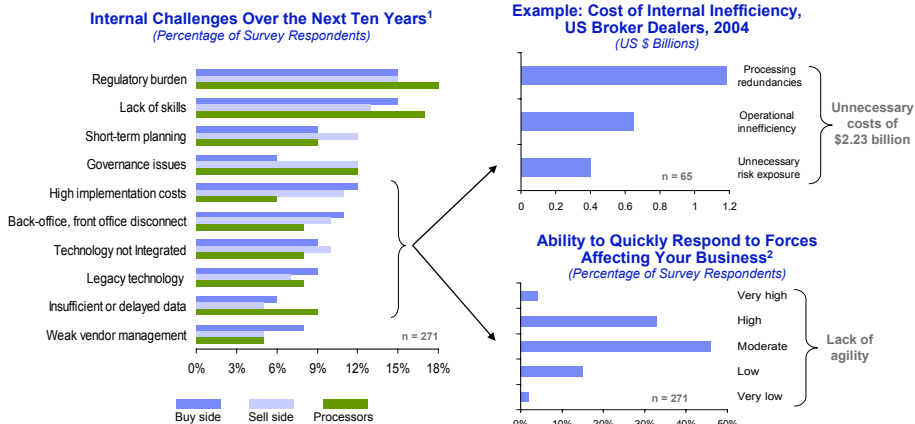
Note: ¹Trading processes in this scenario would be leveraging the utility for some but not all trading processes; ²IT infrastructure in this scenario would be leveraging the utility for some but not all IT components

Source: IBM Institute for Business Value analysis

Call to action

Eradicating internal inefficiencies will reduce unnecessary costs and improve firms' ability to respond to change

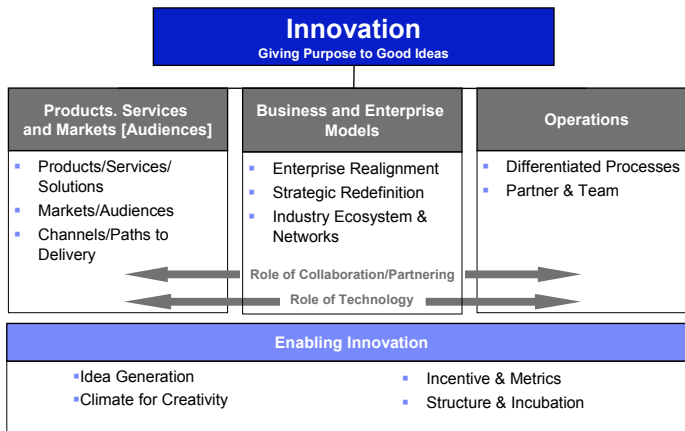
Eradicate inefficiencies that create barriers to change



Call to action

Innovation will be critical to future success and must be fostered and encouraged across the firm

Develop a purposeful, systematic culture of innovation



Source: Global IBM CEO Study, 2006

The IBM SIS Business Model provides the business context for the component build of the Revitalization Program

	New Business Development	Implementation	Client Service	Core Value Add Product Operations		IT Services/Support	Management Infrastructure
Planning & Analysis	Marketing	Methodology Configuration	Account Planning	Offering Definition		IT Strategy/Architecture	Business Strategy
	Offering/Sales Planning	Client Mgmt/T Governance		Resource Planning		Capacity Planning	Alliance Strategy
Checks & Controls	Contract Due Diligence	Project/Arch Compliance	Contract Oversight	Product Governance		IT Governance/Coordination	Audit/Compliance
		Implementation Oversight	Contract Audit	Product Performance		Change Control	Business Continuity
Operations & Execution	Sales	Requirements Def / User Acceptance Criteria	Inquiries & Reports	Trade Processing	Tax	Help Desk/ Problem Mgmt	Financial Management
	Marketing Execution	Implementation Planning	Account Maintenance	Corporate Actions	Fees	Production	HR
	Contract Development	Configuration & Conversion	Cash Processing	Pricing/Market Data	Performance	Vendor Management	Security Services
		WMS Training	Improvement Projects	Cash Management	Information Delivery	Development Test	Procurement
			Manual Processing	Reconciliations		Production Support	Treasury
			CA Voluntary Elections	Static Data Maintenance		UAT	Facilities
				Accounting Operations			Internal Training

Call to action

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EXECUTE!