

The Role of Tokyo Market in Asia: A view from the buy-side

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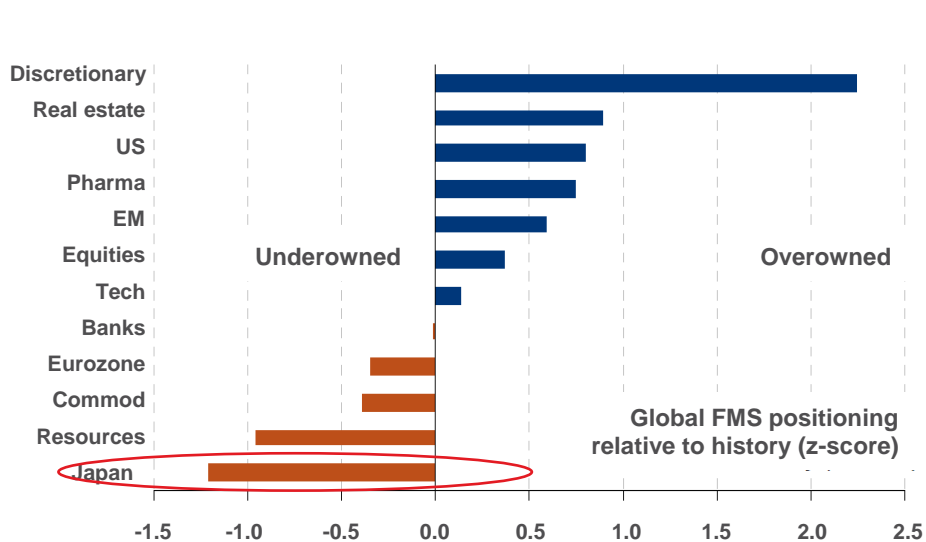
November 26, 2013

Investor behavior in Asia in 2013

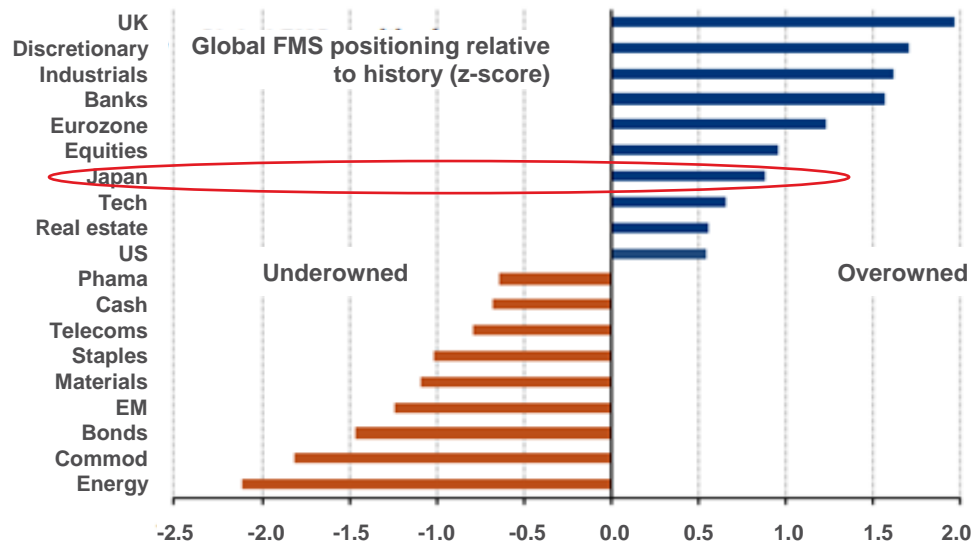
How has investor positioning changed in Asia?

- ▶ Japan climbs from being the most underowned to an overowned position
- ▶ At the same time we see EM moving from an overowned position to an underowned position

November 2012 BofAML Fund Manager Survey



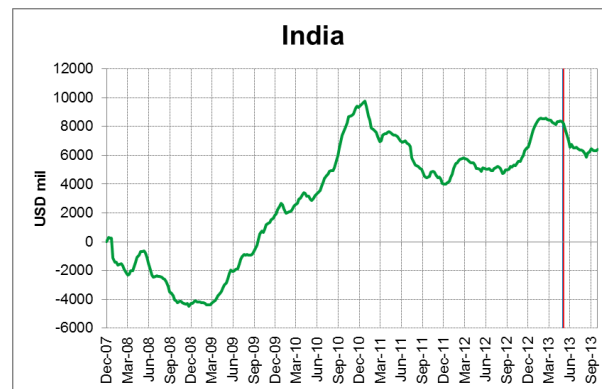
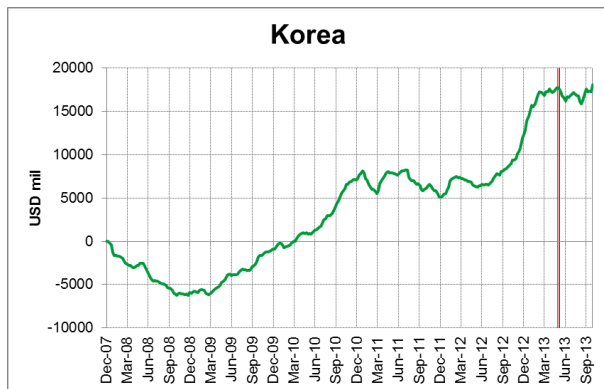
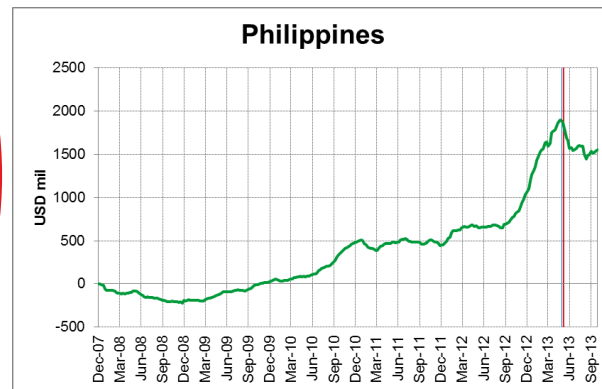
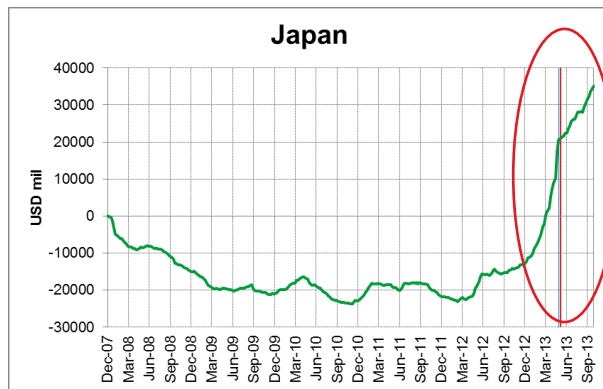
November 2013 BofAML Fund Manager Survey



Source: Bank of America Merrill Lynch Global Research

Are retail investors buying into the move in Japan?

Not just professional investors, but retail has shown a focus on Japan



* red line denotes May 22, 2013

Source: EPFR

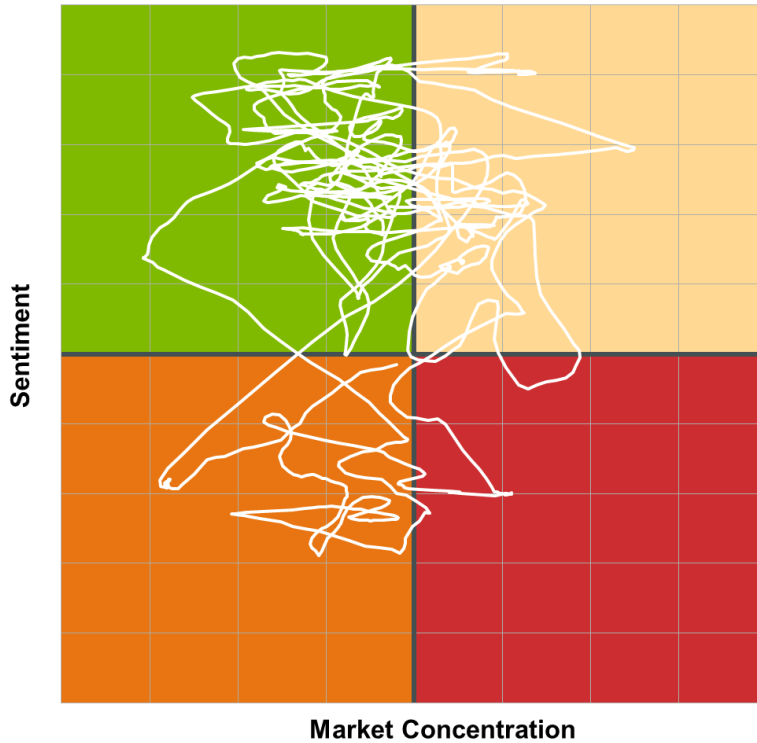
As of 23 October 2013

How do we look at risk and sentiment in markets?

Multi-asset Concentration Indices

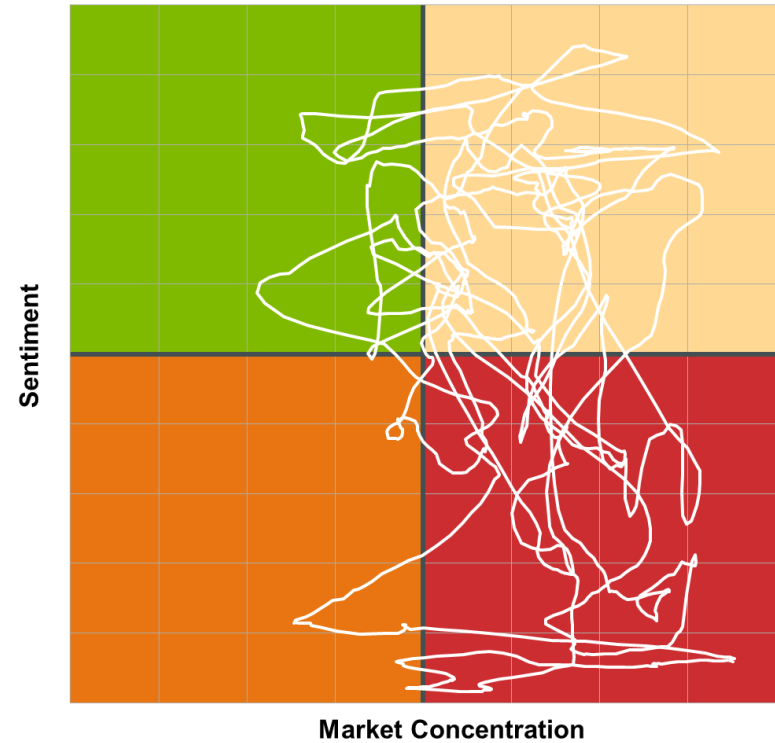
2002 - 2007

- ▶ Pre-2008 markets are diversified and risk is rewarded. The velocity of change in market structure is low



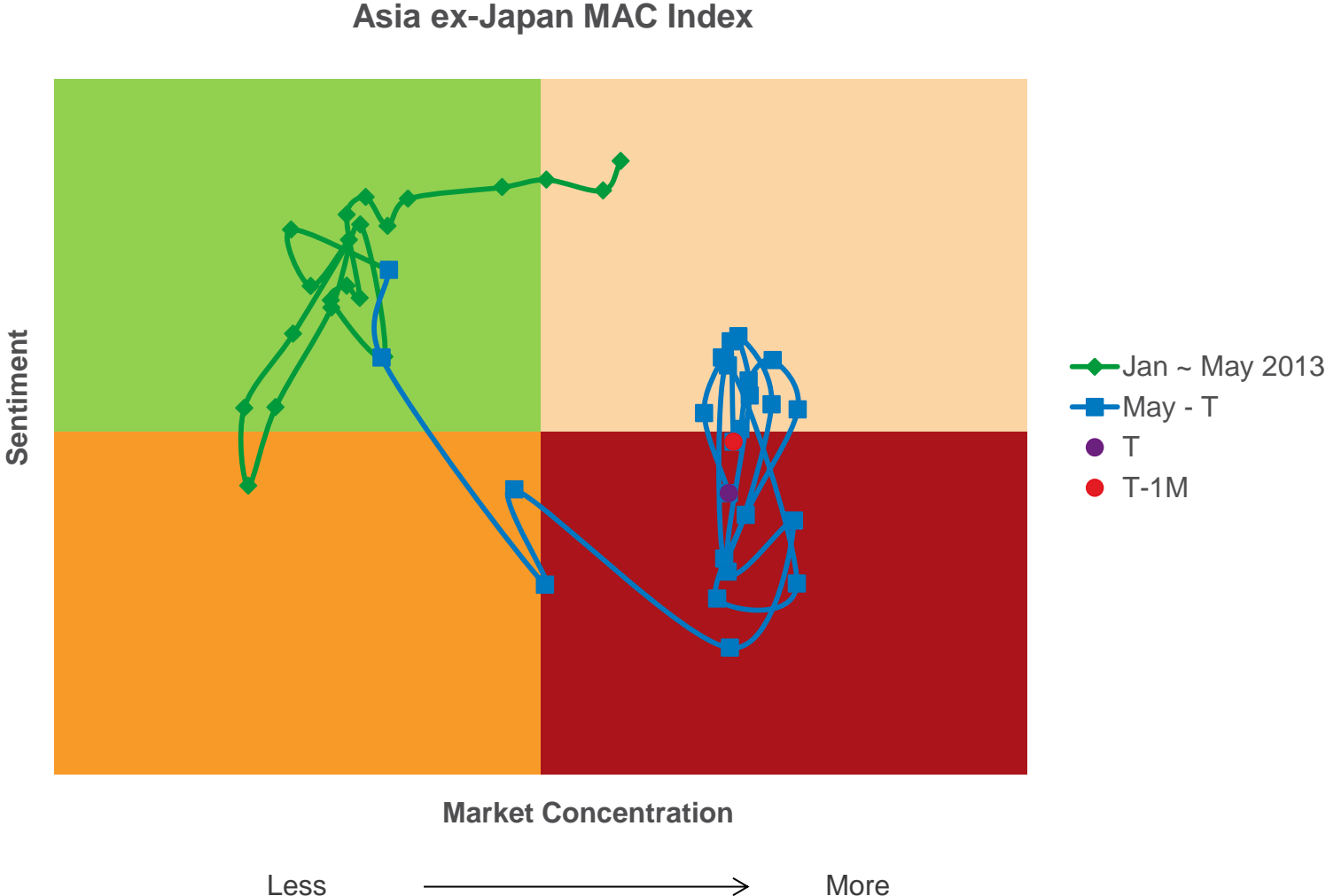
2008 - 2012

- ▶ Post-2008 markets are less diversified and risk is not always rewarded. The velocity of change in market structure is high.



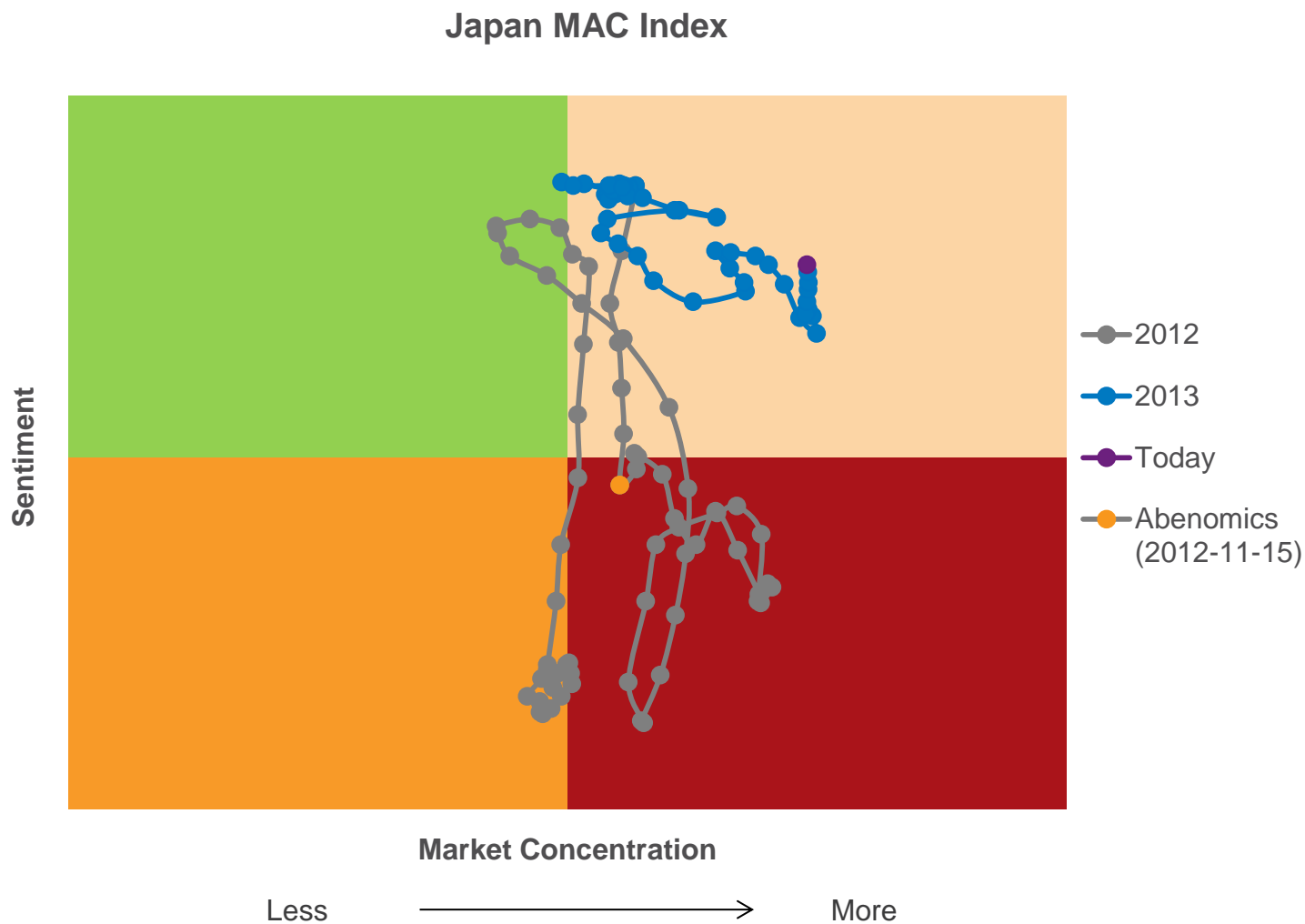
Source: Blackrock

What has been the risk taking environment in Asia ex-Japan?



Source: BlackRock
As of November 2013

How has Japan diverged from the rest of Asia?



Source: BlackRock
As of November 2013

The role of Tokyo market structure in risk taking

What has facilitated risk taking in Japan?

Market structure will never be the principal force driving market returns

However, having the right structures in place facilitates the ability of investors to implement investment objectives and take risk

Some of the things that are important for us as investors

- ▶ Continuous improvement of market structures to facilitate ease of implementing investment objectives
- ▶ Deep and active liquidity
- ▶ Breadth of investable stocks
- ▶ Ability to implement investment objectives at reasonable costs

How have markets in Japan become more investor friendly?

- ▶ Jan-2010 : Tokyo Stock Exchange “Arrowhead”
 - Implemented global standard “speed”
 - Participation of technologically advanced market makers

- ▶ Jul-2010 : Japan Securities Clearing Corporation’s(JSCC) clearing for PTS
 - Trades started to be settled from July 23, 2010
 - Reduced credit risk for using PTSs

- ▶ Oct-2010 : Short Selling on PTS
 - Formerly banned, but now allowed
 - Essential for market making activities

- ▶ Oct-2012 : TOB Rule Exemption
 - Institutional investors can start buying shares on PTS without “5% TOB” issue

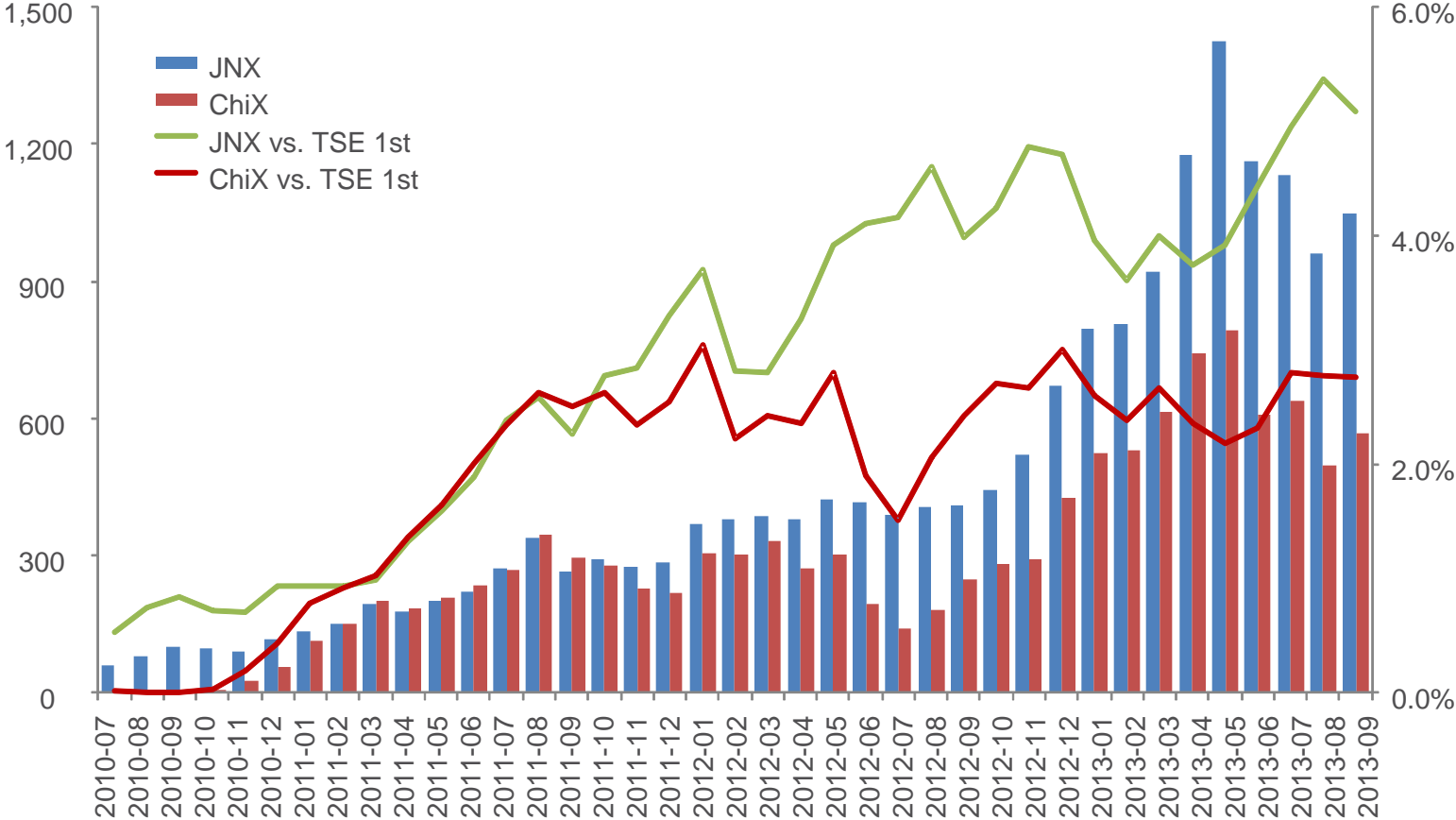
- ▶ Nov-2013 : Trigger Based Short Sell Rule
 - Investors can sell short on downticks if the price is not more than 10% below the previous day’s closing price
 - Long/short funds can manage their trading strategy more easily

- ▶ From Jan-2014 : Tokyo Stock Exchange “Small Tick Program”
 - Phase 1 in January and Phase 2 in July
 - TSE will introduce decimal tick size in Phase 2
 - Details have not been announced but Phase 3 will be in mid-2015

Source: Bank of America Merrill Lynch

What is the right amount of fragmentation?

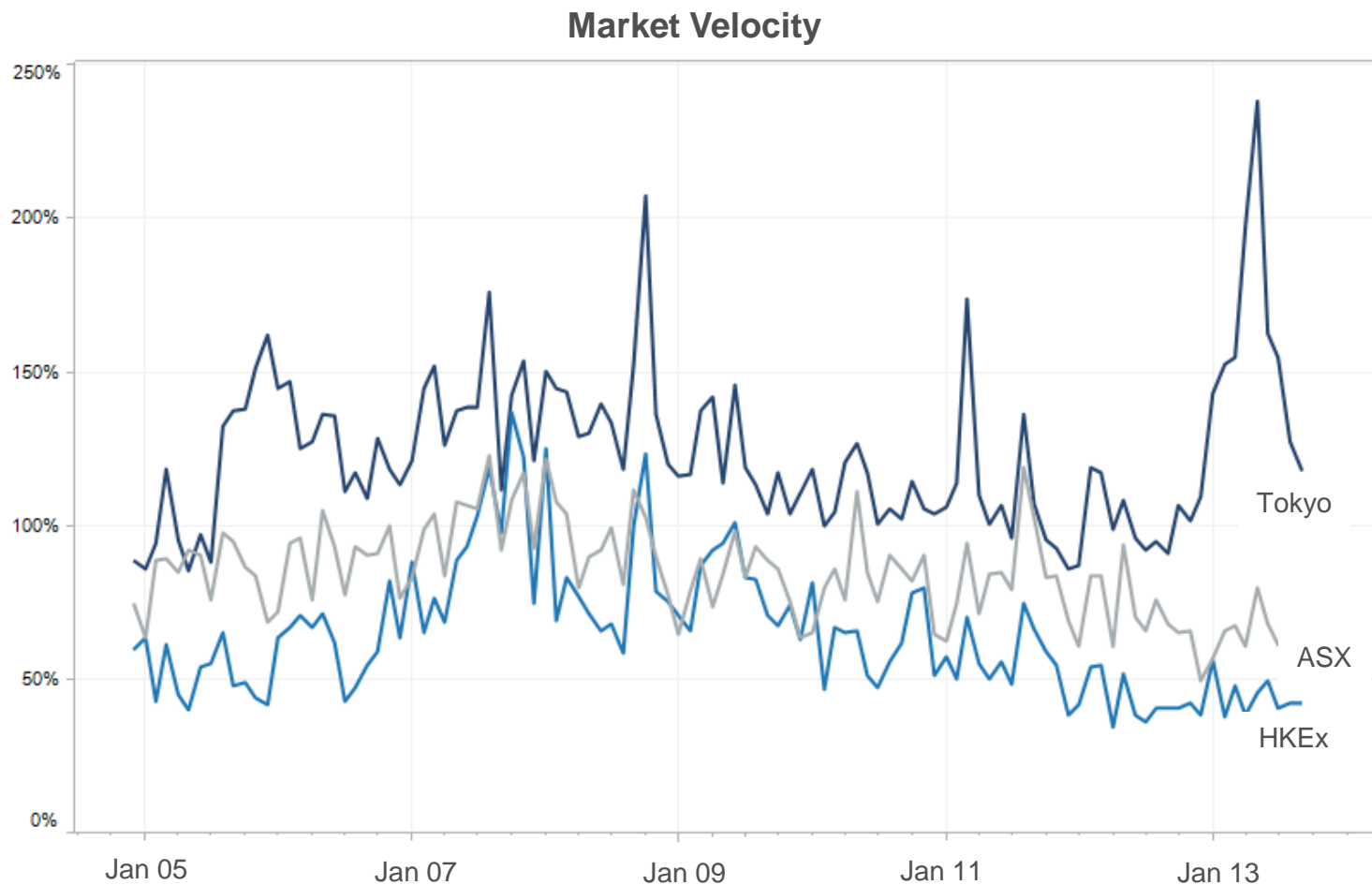
PTS volumes have steadily increased over the last 3 years



Source: SBI JapanNext

How does liquidity in Japan compare to other Asian markets?

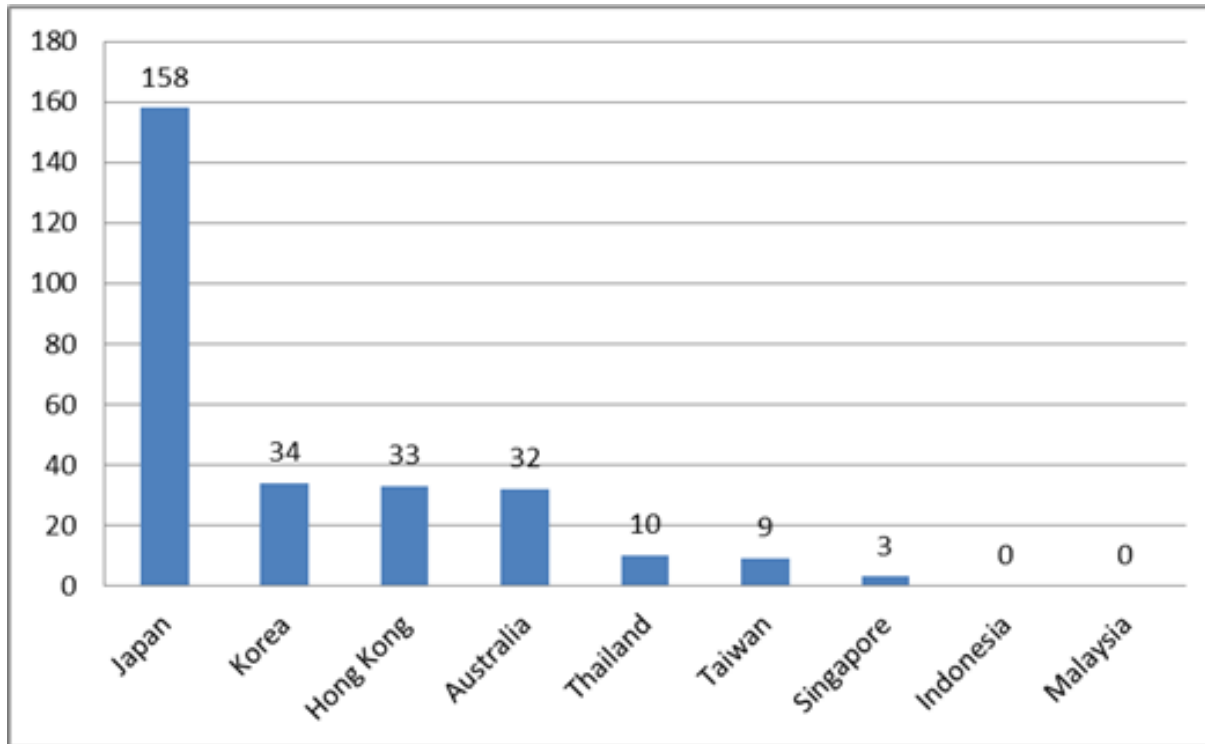
Velocity is monthly dollar value traded on exchange divided by market capitalization



Source: Credit Suisse

What does the breadth of investable stocks look like in Asia?

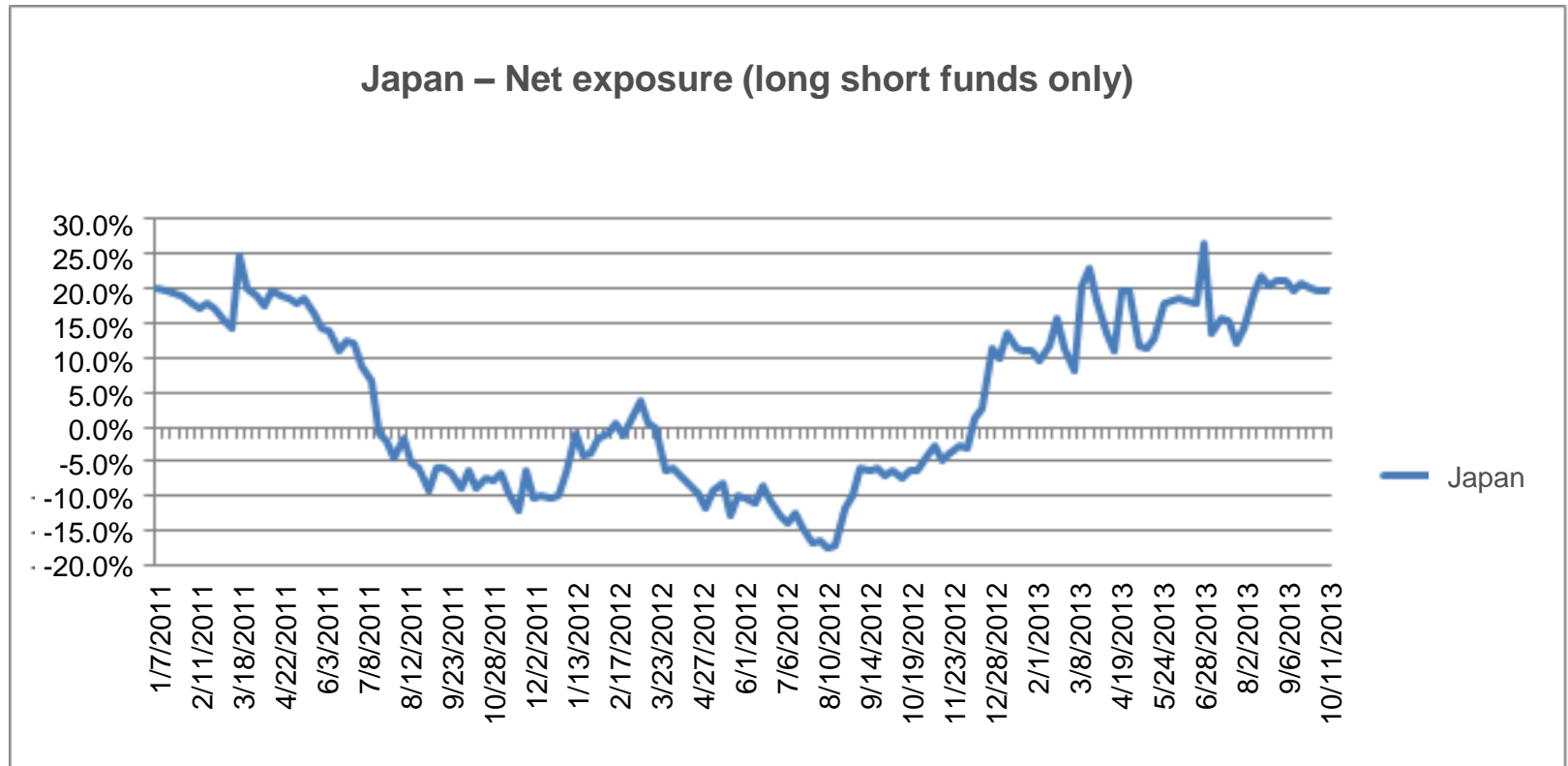
Number of stocks that have average daily turnover > \$30mm



Source: Bank of America Merrill Lynch

Why do we like deep and liquid markets?

Flexible markets that allow for rapid change in risk positioning

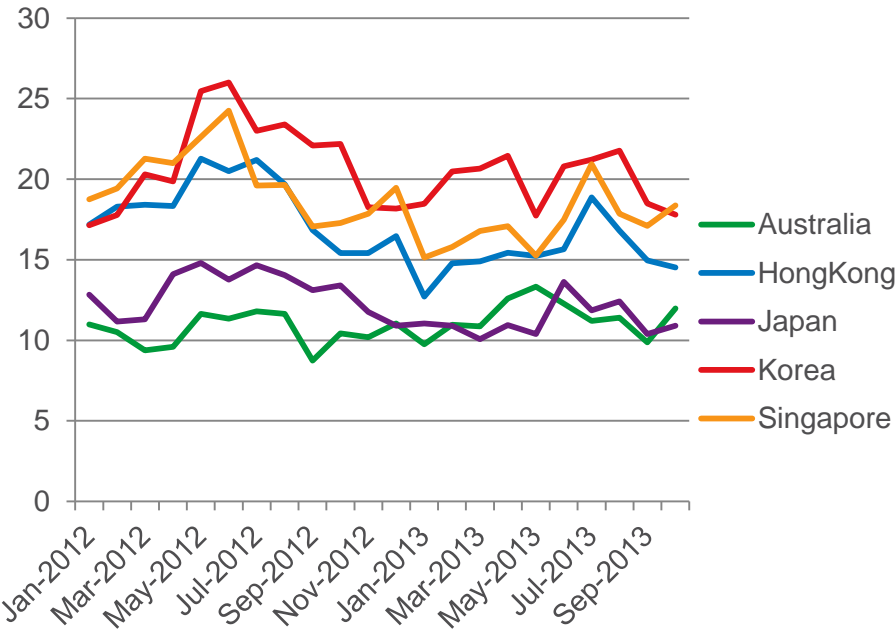


Source: Credit Suisse

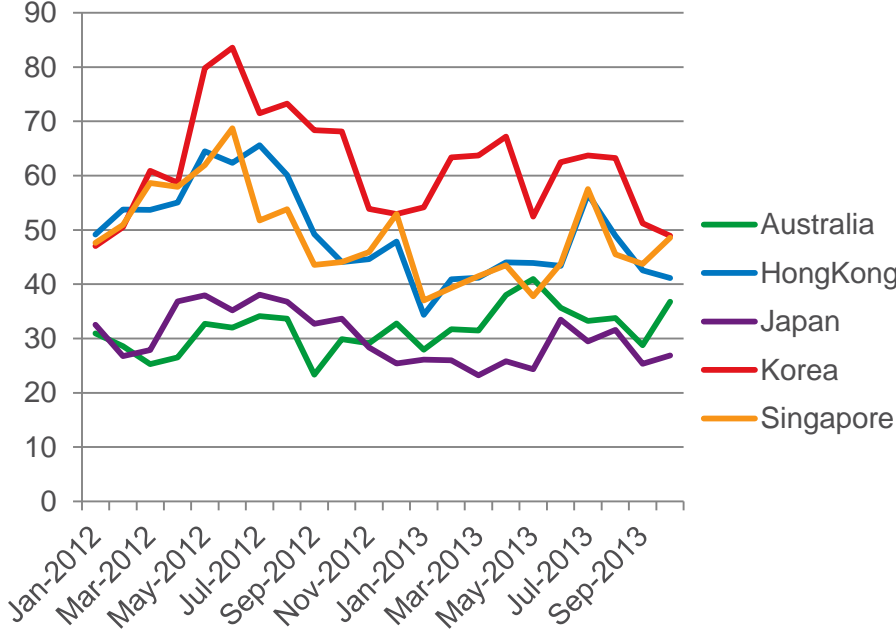
What does it cost to trade in Asian markets?

The Tokyo market has one of the lowest costs to trade in Asia

Expected impact for \$2bn trade



Expected impact for \$10bn trade



Source: BECS, Citi

Some challenges ahead

How have regulations changed the way we do business?

Regulation gets tighter

1 Basel III raises bank capital requirements

- ▶ Minimum common equity required: 2.5% → 7.0% by 2019
- ▶ More onerous definitions for risk weighted assets

2 Dodd-Frank limits OTC and proprietary trading

- ▶ Volker Rule: proprietary activities limited to 3% of tier 1 capital
- ▶ SIFI (Systemically Important Financial Institution) capital buffers
- ▶ High-margin OTC derivative business subject to central clearing
- ▶ Swap Execution Facility mandate increases electronic trading
- ▶ Europe and Asia regulatory changes to follow

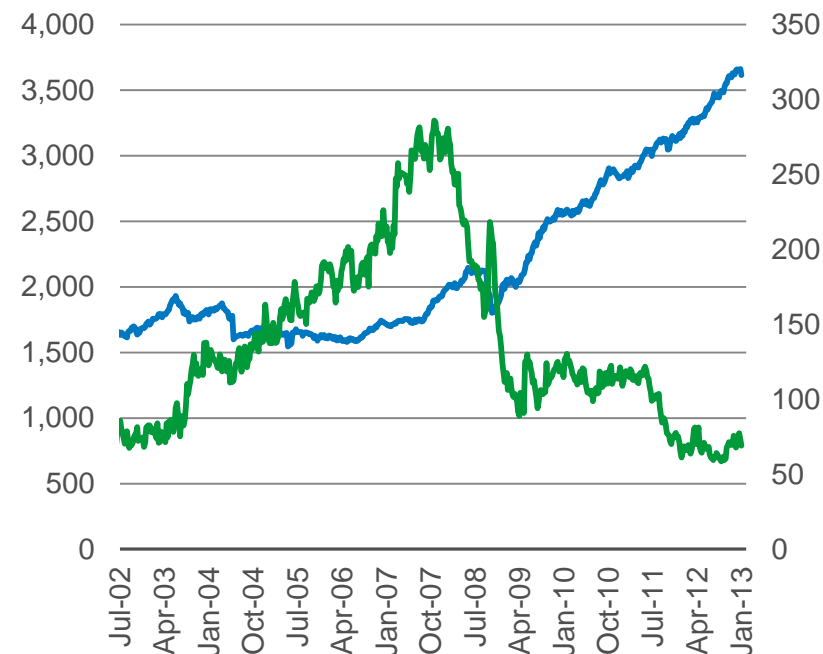
3 'Back to basics' product environment

- ▶ Overcapacity in the sell-side model for complex products
- ▶ "Originate to distribute" model will become challenged

4 Ratings agencies taking aggressive action

- ▶ US and European sovereign downgrades
- ▶ US and European bank downgrades
- ▶ Many negative outlooks issued

Liquidity provision by broker is getting less...



— Market Value of the Investment Grade Corporate Index (LHS)
— Primary Dealer Corporate Positions (RHS)

Source: Federal Reserve Bank of New York; Barclays

What are some challenges we face that are unique to Tokyo?

Strict prohibition of cross transactions

- ▶ “Cross transactions” defined as buy and sell orders of the same stock between different funds managed by a single asset management company
- ▶ Intentional cross transactions are prohibited and there is a further requirement to avoid ‘unintentional’ cross transactions
- ▶ Legacy prohibition resulting from inappropriate transactions in the past
- ▶ Excludes Japanese clients from the opportunity to save on trading costs from cross transactions
- ▶ Creates monitoring burden as well as introducing cumbersome process changes to prevent unintentional cross transactions

Inability to adopt commission sharing agreements (CSAs)

- ▶ CSAs are used to mitigate potential conflict of interest between the execution function and the investment management function
- ▶ Unbundling execution services from research services to more efficiently allocate client commission dollars

Order bulking and average price booking

- ▶ Futures orders for multiple clients are handled as independent orders which can lead to increased trading costs due to multiple orders trading at the same time
- ▶ Trying to achieve the same investment objective for different clients is not possible
- ▶ Client approval required to bulk orders even for cash equities

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