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Commentary

Exchanges: Less Talk, More Figures

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The Exchanges – Less Talk, More Figures

Profitability
First, as to profitability, we wrote frequently last year, as the credit crisis wreaked havoc upon the financial system broadly and the equity markets specifically, that the daily transactional activity of the exchanges appeared to remain fairly robust. There were, of course, somewhat mixed results reported from the exchanges, and a certain degree of earnings diminution was inevitable, particularly in Europe and Asia, as exchanges in these regions adopt the ad valorem method of pricing, which bases fees on the market value of the transaction. Clearly, as equity markets fell by 50% in nearly every region of the world last year, such companies would be expected to report a larger degree of revenue diminution than would an exchange that bases its fee structure on volume alone. This latter pricing method is almost exclusively used by the U.S. exchanges.

With over one year of data in hand, the draconian margin compression scenario so widely expected to occur last year, and especially this year during recession, has not appeared. The most recent profit margins of the exchanges in the Core Value strategy are presented below.

	Operating Profit Margin	
	Fiscal 08	Fiscal 07
CME Group (1)	42.5%	39.4%
Hong Kong Exchange	78.5%	85.7%
London Stock Exchange (2)	50.4%	52.9%
Nasdaq OMX Group	17.5%	15.0%
NYSE Euronext	18.1%	16.3%

(1) Before amortiz of purchased intangibles & impairment of long-term investment

(2) Fiscal March 09 and 08. Before amortization of purchased intangibles and goodwill impairment charge

Undoubtedly, these companies mostly reported lower earnings versus year ago periods. Yet, the current and reduced level of profitability still remains extraordinarily high relative to general corporate profit margins, perhaps the highest of any other industry. If it were remarked last year that a group of companies dependent on the health of the capital markets would be able to sustain 20%-75% operating margins throughout the credit crisis and any recessionary effects that would follow, this most likely would have been met with abundant laughter (or derision).

Given their resiliency throughout one of the worst operating periods for financial companies in history, as well as our expectation for their future prospects, we maintain a large weighting in this sector.

Competition

Among the most frequent questions, if not criticisms, is that of competition among the exchanges. Yet by a universal standard, there is much less competition today than there was only a few years ago. What would be the typical reaction if an investor could somehow be given foreknowledge that the constituents of a given industry would undergo a massive consolidation, to the degree that perhaps 20 or more competitors would be absorbed into five? It has happened already in the North American securities exchange market. Three years ago, the following exchanges existed independently; it is not an all-inclusive list:

Exchange	*General Orientation*
New York Stock Exchange	Large-capitalization stocks
American Stock Exchange	Stocks, options, ETFs
CBOT Metals Complex	Precious metals (options, futures)
Archipelago	All-electronic exchange for equities, options, futures
International Securities Exchange	All-electronic options exchange
NASDAQ Stock Exchange	Over-the-counter stocks
Philadelphia Stock Exchange, Inc.	3rd largest U.S. options market
Boston Stock Exchange, Inc.	License for trading equities, options, and clearing license
International Derivatives Clearing Group	OTC Interest Rate Swap Futures
Chicago Mercantile Exchange	Currency, interest rate, commodities futures
Chicago Board of Trade	Agricultural and U.S. Treasury futures and options on futures
NYMEX	Energy futures and options
COMEX	Metals futures and options
Swapstream	Global, OTC, electronic trading platform for interest rate swaps
Intercontinental Exchange	Energy futures and options
New York Board of Trade	"Soft" commodities exchange (e.g., sugar, coffee)
Winnipeg Commodity Exchange	Leading canola market
Toronto Stock Exchange	Stock exchange
Montreal Exchange	Derivatives exchange
Boston Options Exchange	Options exchange
Oxen, Inc. (owner of Albert Watt Exchange)	Electric power exchange

Today, 76% of the constituents of that list has been has been acquired by four North American exchanges, and one European exchange, as shown below. This next list does not include the acquisitions by NYSE of Euronext, or by Nasdaq of Norway's OMX, Nord Pool, the International Derivatives Clearing Group, or the European Multilateral Clearing Facility, and it does not include comparable acquisition activity in the rest of the world.

NYSE Euronext	**Acq. Date**
American Stock Exchange	Oct-08
CBOT Metals Complex	Mar-08
Archipelago	Mar-06
NASDAQ OMX Group	
Philadelphia Stock Exchange, Inc.	Jul-08
Boston Stock Exchange, Inc.	Aug-08
International Derivatives Clearing Group	Dec-08
Chicago Mercantile Exchange	
Chicago Board of Trade	Jul-07
NYMEX	Aug-08
COMEX	Aug-08
Swapstream	Aug-06

Intercontinential Exchange	**Acq. Date**
New York Board of Trade	Jan-07
Winnipeg Commodity Exchange	Aug-07
Toronto Stock Exchange	
Montreal Exchange	May-08
Boston Options Exchange	Aug-08
Oxen, Inc.	2007
International Securities Exchange (Acquired by Deutsche Boerse)	May-07

A more pointed criticism of exchanges as an investment is the loss of market share by major exchanges, such as by the London Stock Exchange, NYSE Euronext and others. Such figures are reported monthly, along with other statistics, by many of the exchanges. And it is true. There is unquestionably a loss of market share by many exchanges, sometimes of large magnitude, and it has been occurring almost without surcease for a long period of time. Witness the severe loss of market share by the New York Stock Exchange in stock trading volume during the past several years; it is virtually monotonic in its decline, and since 2005 amounts to about 38% points, from over 80% to under 45%:

NYSE Handled Volume Market Share
% of Consolidated NYSE Volume

	2005	2006	2007	2008	2009	Loss, % Pts (2005-2009)
December	77.8%	69.1%	59.7%	47.9%		
November	78.3%	69.8%	60.1%	47.4%		
October	79.7%	70.9%	60.3%	47.7%		
September	79.8%	71.2%	62.2%	46.7%		
August	80.0%	71.8%	65.5%	46.5%		
July	80.1%	74.2%	66.3%	48.3%		
June	81.5%	76.5%	68.7%	51.0%	43.5%	-38.0%
May	81.0%	76.9%	68.1%	51.8%	42.9%	-38.1%
April	82.9%	75.5%	68.5%	53.6%	43.4%	-39.5%
March	81.7%	76.1%	69.9%	56.2%	44.7%	-37.0%
February	81.6%	77.5%	69.9%	58.0%	46.5%	-35.1%
January	82.3%	76.6%	69.0%	58.4%	46.9%	-35.4%

Witness also, though, the following table, over the same time frame; it describes a surprisingly consistent sequential climb in trading volume, amounting to nearly 15% per year:

NYSE Handled Volume (millions of shares)

	2004	2005	2006	2007	2008	2009
December	33,222	34,546	34,669	39,241	52,300	
November	32,357	36,467	40,848	52,835	54,921	
October	33,313	40,956	41,763	47,107	77,383	
September	28,438	36,986	36,732	38,123	66,768	
August	27,924	34,670	38,115	64,319	42,443	
July	30,335	30,886	36,737	50,009	60,956	
June	29,370	34,698	44,981	48,271	50,215	50,612
May	30,574	32,894	44,579	46,458	42,329	55,731
April	32,780	36,907	34,464	41,273	46,508	59,622
March	34,764	38,265	40,828	50,004	53,429	72,400
February	28,815	30,882	32,102	38,890	45,877	55,589
January	34,204	33,360	39,760	41,869	60,780	50,390
Total	**376,096**	**421,517**	**465,579**	**558,400**	**653,910**	**344,346**
% Change		12.1%	10.5%	19.9%	17.1%	15.1%

We described this phenomenon in a *Studies in Absurdity* review in September 2006. Lest this seem a product of an anomalous few years, the abbreviated table below describes the share volume growth at the New York Stock Exchange over the past nearly 50 years since 1960. On a decade-by-decade basis, the result is remarkably consistent at nearly 15% per annum (the subdivision of the 2000 to 2008 period is due to the change in tabulation method between the NYSE and Euronext upon their merger).

New York Stock Exchange Annual Share Volume Expansion:

1960 - 1970	14.4%
1970 - 1980	14.5%
1980 - 1990	13.3%
2000 - 2003	10.3%
2004 - 2008	14.8%

This would seem counter-intuitive relative to our understanding of most industries, for which there operates a zero-sum game for instantaneous changes in market share. For instance, if a more dynamic personal computer manufacturer or soda company were to increase its volumes by 15% in a given year, and if total market demand growth were the normal 2% or 3%, then its various competitors would have collectively lost about 13% points of market share during that year.

This odd behavior among securities exchanges is even starker in an entirely different security type, options. The following tables depict the both the trading volume of the entire U.S. options industry since 1973, and the market share of the Chicago Board Options Exchange during that period. The first year is particularly interesting, since the CBOE market share in 1973 was 100%. It will be noted that it has since lost 67% of its market share. It will also be noted that its trading volume during one of the sub-periods when its market share actually rose, the 1980 to 1990 decade, increased by less than 10% per year. Its market share during the next decade remained relatively flat and, again, its transaction volume grew by less than 10% per year. However, between 2000 and 2008, its market share dropped dramatically, and its transaction volume rose dramatically, on the order of 36% per year. In 2008, volumes rose by 26%. The same sorts of results might be produced for trading in financial futures or commodities.

Whatever one might say about securities exchanges, the empirical data, whether employing a multi-decade time frame or examining the tumultuous past two years, does not support the notion that market share and volume growth are mutually exclusive; if anything, the results are consistent with the opposite viewpoint, that competition is associated with increased volumes.

Historical Options Industry Volume
1973 - 2008

Annualized Growth

1980 - 1990	**8.1%**
1990 - 2000	**13.2%**
2000 - 2008	**22.0%**
2005 - 2008	**42.5%**
2007 - 2008	**36.9%**

Total CBOE Options Contract Volume
1973 - 2008

Annualized Growth

1980 - 1990	**9.4%**
1990 - 2000	**9.7%**
2000 - 2008	**17.6%**
2005 - 2008	**36.6%**
2007 - 2008	**26.4%**

Year	Total Industry Options Volume
1973	1,119,245
1974	5,682,907
1975	18,103,018
1976	32,373,925
1977	39,637,328
1978	57,231,018
1979	64,264,863
1980	96,728,546
1981	109,405,782
1982	137,306,205
1983	150,056,075
1984	196,437,361
1985	232,910,547
1986	289,211,135
1987	305,168,935
1988	195,948,591
1989	227,016,660
1990	209,922,748
1991	198,801,600
1992	201,995,757
1993	232,662,095
1994	281,382,402
1995	287,296,909
1996	294,797,702
1997	353,823,118
1998	406,343,198
1999	507,891,483
2000	726,727,939
2001	492,615,219
2002	457,717,950
2003	535,143,977
2004	815,899,814
2005	1,234,309,674
2006	1,705,689,052
2007	2,611,445,719
2008	3,574,445,814

Year	Total Volume	Yr/Yr Change	% of Industry Vol
1973	1,119,177		100%
1974	5,682,907	408%	100%
1975	14,431,023	154%	80%
1976	21,498,027	49%	66%
1977	24,838,632	16%	63%
1978	34,277,350	38%	60%
1979	35,379,600	3%	55%
1980	52,916,921	50%	55%
1981	57,584,175	9%	53%
1982	75,735,739	32%	55%
1983	82,468,750	9%	55%
1984	123,273,736	49%	63%
1985	148,889,091	21%	64%
1986	180,357,774	21%	62%
1987	182,112,636	1%	60%
1988	111,784,045	-39%	57%
1989	126,765,253	13%	56%
1990	129,500,018	2%	62%
1991	121,689,918	-6%	61%
1992	121,467,604	0%	60%
1993	140,348,955	16%	60%
1994	183,934,483	31%	65%
1995	178,533,465	-3%	62%
1996	173,944,877	-3%	59%
1997	187,243,741	8%	53%
1998	206,865,991	10%	51%
1999	254,331,851	23%	50%
2000	326,359,531	28%	**45%**
2001	306,667,851	-6%	62%
2002	267,616,496	-13%	58%
2003	283,946,495	6%	53%
2004	361,086,774	27%	44%
2005	468,249,301	30%	**38%**
2006	674,735,348	44%	40%
2007	944,471,924	40%	36%
2008	1,193,355,070	26%	**33%**

Perhaps there is a special form of Moore's law that operates for securities exchanges, a sort of Securities Exchange Moore's Law. (Intel co-founder, Gordon Moore noted in a 1965 paper that since the invention of the integrated circuit in 1958, the number of transistors that could be economically placed on an integrated circuit had increased exponentially, doubling roughly every two years. That phenomenon has continued for the almost one-half century since that paper's publication.)

What could be the various enabling factors for exchange volumes, analogous to the process, physical chemistry and engineering advancements that facilitate the operation of Moore's law? First, it should not be ignored that the mere expansion of the world economy, business activity, corporate profits and private savings will result in an expansion of the market capitalization of companies and the number of shares that can be traded, and of the volumes of commercial exposure that must be hedged via futures contracts, and so forth. Beyond that, it would appear that virtually any development in regulations, technology, portfolio or trading practice, or product innovation that lowers a barrier to trading, whether it is via increased transaction speed, lower transaction costs, better or more diverse tools for hedging, diversifying, reducing risk or acquiring risk, will invite more trading. Accordingly, one could hardly list all of the variables that have historically contributed to trading volume expansion in the absence of a comprehensive study.

As to future innovations, some of these can only be imagined – and they will be imagined. We believe that the pace of innovation has accelerated and that securities exchanges are now at the doorstep of a golden age. We might examine a few that are right now in the process of explosive development, in a future communication.

While the current economic environment is not without its challenges, we continue to believe the current investment environment offers a once in a generation opportunity for the long-term investor. The prior comments attempt to demonstrate there are companies that have only experienced share price compression in the past year, not fundamental diminution of value. Accordingly, we continue to monitor our businesses, as well as search for new ideas. We remain committed to our belief that the patient, long-term investor will ultimately be rewarded with superior returns.