SIA RESEARCH
REPORTS

Volume VI, No. 12 December 20, 2005

THE YEAR IN REVIEW / THE YEAR AHEAD

Frank A. Fernandez
Isabelle Delalex
Grace Toto

SECURITIES INDUSTRY ASSOCIATION – info@sia.com, http://www.sia.com
120 Broadway, 35th Floor, New York, NY 10271-0080 – 212-608-1500, fax 212-968-0703
1425 K Street, NW, Washington, DC 20005-3500 – 202-216-2000, fax 202-216-2119

THE YEAR IN REVIEW / THE YEAR AHEAD

Table of Contents

Information relating to Securities Industry Performance for 3Q'05, 4Q'05 and full year 2005 are SIA estimates, unless otherwise noted. All information contained herein for full year 2006 are SIA forecasts.

THE YEAR IN REVIEW / THE YEAR AHEAD

Summary

For the U.S. securities industry, 2005 proved to be a very good year thanks to exceptional second half results and next year is expected to be even better. Pre-tax net income rose to $23.7 billion in 2005, a 14.4% increase over 2004 results, as the net revenue growth rate accelerated to 8.1%, compared to 5.2%. Strong growth in investment banking revenues (propelled by mergers and acquisitions (M&A) activity and debt issuance) and proprietary trading profits led to these better results throughout the year, which were augmented by a surge in both retail and institutional investor activity in secondary markets in the second half of 2005. Both the economy and the capital markets have considerable momentum and favorable prospects entering the New Year, and are expected to support continued solid growth in revenues and higher profits for the securities industry in 2006. We expect industry profits (pre-tax net income) to reach $25.6 billion next year, an 8.1% increase over 2005 results and the second-best annual performance for the industry after the record $31.6 billion earned in 2000. These strong results should support 3% growth in industry employment in 2006, similar to what has been seen this year.

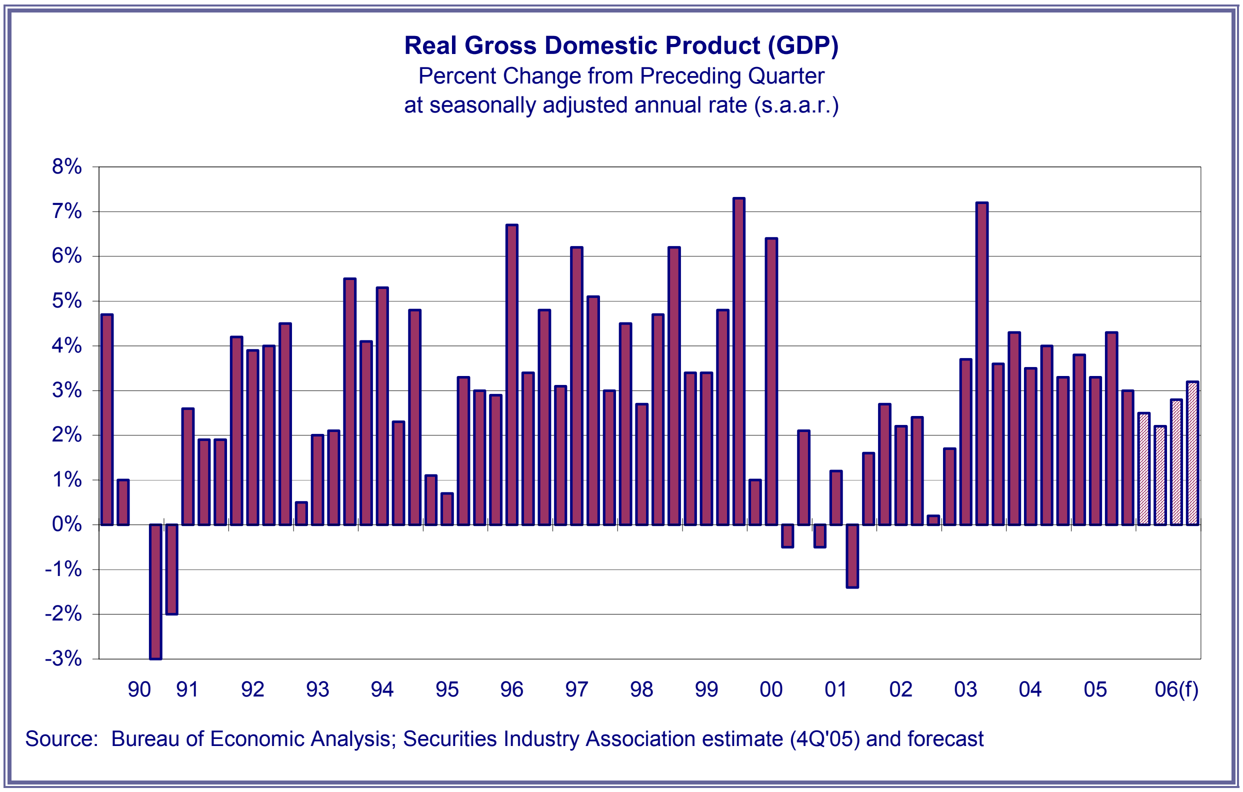
2005 has proved to be a record-setting year in a number of areas. Strong growth of business fixed investment, up 8.6% in real terms, helped support strong growth in primary capital markets. The U.S. securities industry raised a record $3.15 trillion of capital for American business this year through corporate underwriting activity, 9.0% above the previous record of $2.89 trillion underwritten in 2003. Total corporate bond underwriting also set a record, reaching an estimated $2.96 trillion, led by record issuance of asset-backed securities (ABS), which jumped 27.5% to $1.75 trillion, more than offsetting a decline in straight corporate debt placements. Municipal bond underwriting also set an annual record in 2005, reaching an estimated value of $407.8 billion, 14.5% higher than the prior year and 7.5% above the previous record set in 2003.

Net corporate equity issuance was negative in 2005 as announced stock buybacks reached an estimated $440 billion, easily a record. Trading activity surged in September and October and helped lift the average daily share volume on the New York Stock Exchange (NYSE) to a record in 2005 of 1.6 billion shares, up 9.7% from 2004 levels. The average daily number of institutional equity trades, or tickets, also set a record in 2005, as this volume indicator averaged 1.014 million tickets per day, a doubling of trade processing volume over the past six years and a four-fold increase since 1996.

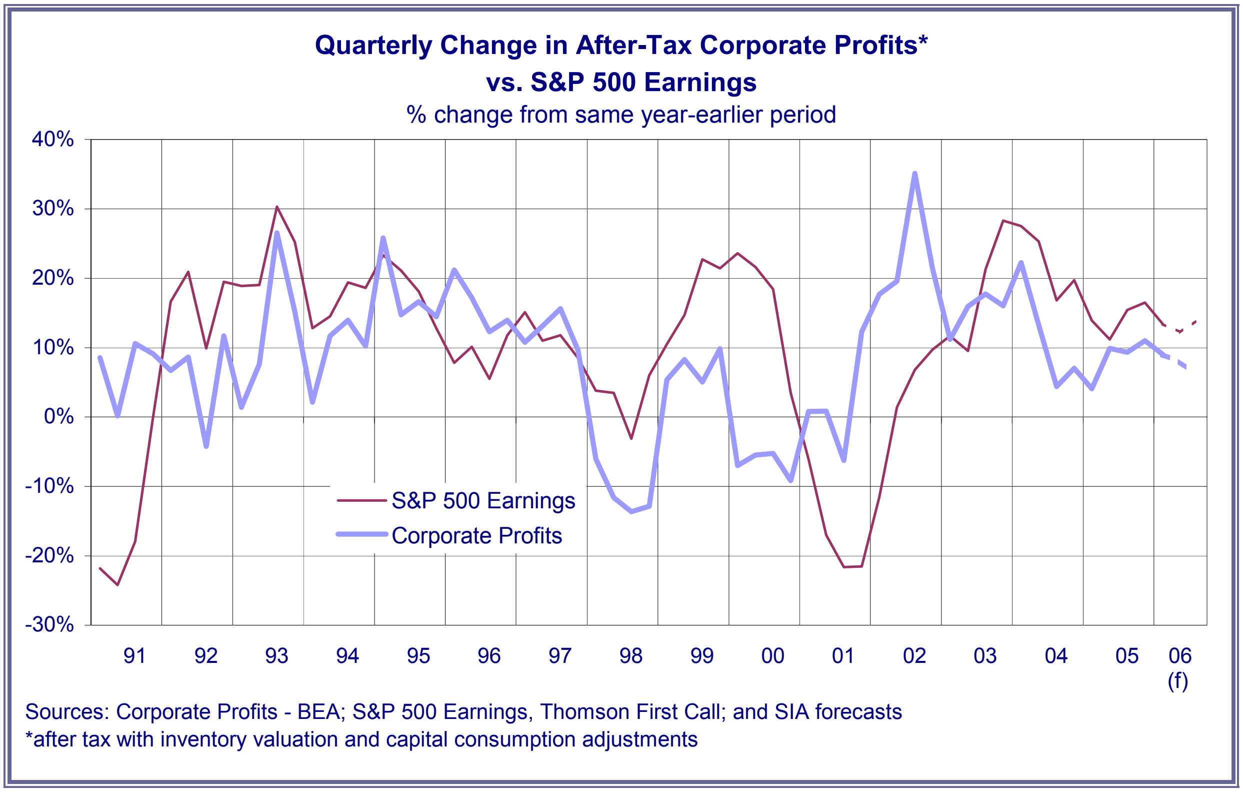
As the year came to a close, the securities industry was enjoying solid, broad-based growth, as nearly every product and service line showed positive, if not robust, prospects for 2006. Investment banking firms should continue to do well as the upswing in the M&A cycle continues (up another 15%-17%) and a rebound in equity underwriting offsets declines in issuance in debt capital markets. Prime brokerage revenues are expected to grow 10%-12% and similar growth is expected in derivatives and structured products. Retail brokerage activity, which has lagged in the industry recovery, appears to be on the rebound and revenues for this business line could expand 8%-10% in 2006.

The Economy

At end November, the growth rate for the U.S. economy for 3Q'05 was revised to an annual rate of 4.3%, up 0.5 percentage point from the "advance", or first estimate, released by the U.S. Bureau of Economic Analysis (BEA) in October, and a full percentage point above the 3.3% annual rate reported for 2Q'05. The upward revision was largely attributable to higher investment in equipment and software, non-residential structures and single-family homes, as well as stronger consumer spending on non-durable goods, which was partly offset by an upward revision in imports of goods. This surprisingly robust performance in 3Q'05 was the strongest since 1Q'04 and marked the tenth consecutive quarter of above average real growth recorded by the U.S. economy. Growth accelerated despite the impact of the hurricanes, higher interest rates and fuel prices, a period of weak consumer confidence, and a softening housing sector.

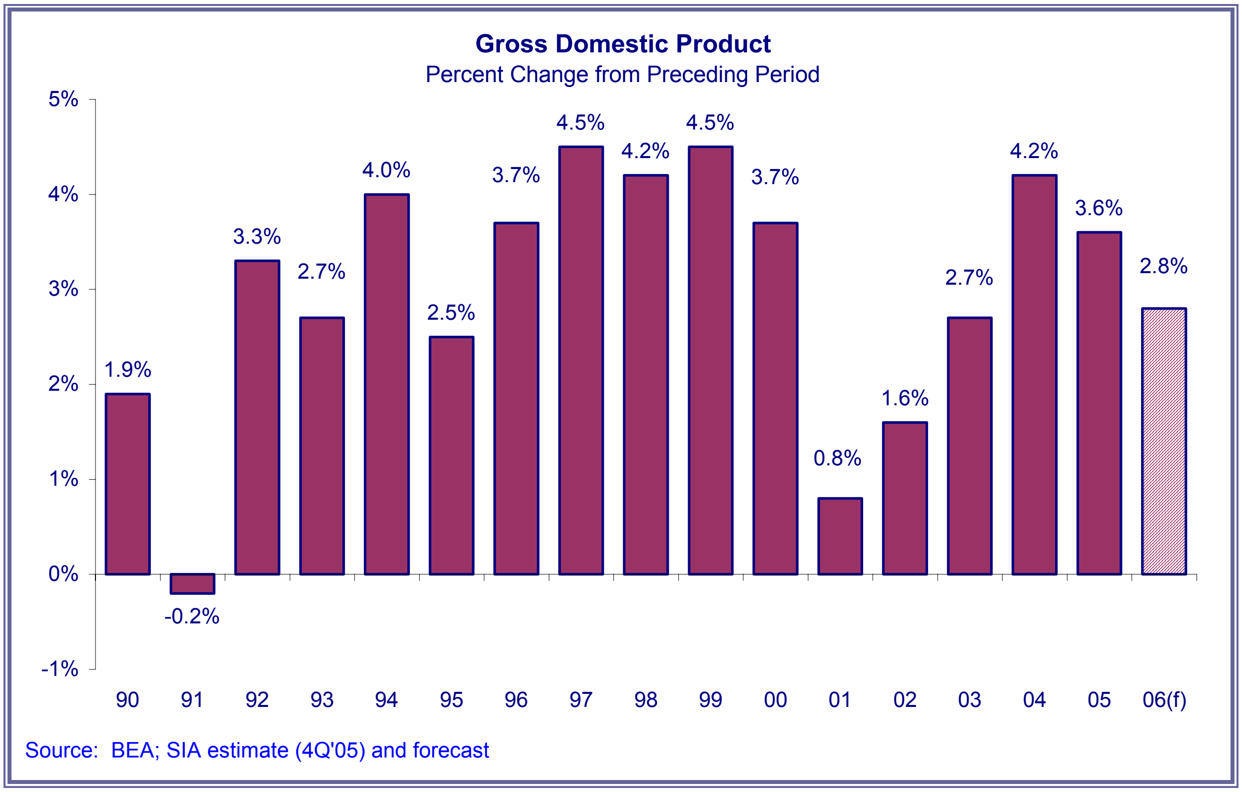


At the same time, the BEA released its first estimate of corporate profits for 3Q'05, which showed an increase of 16.5% from the same year-earlier period. Relative to 2Q'05, corporate profits from current production fell 3.4%, due to $151.2 billion of losses (the net benefits paid by domestic insurance companies and the uninsured losses of corporate property) caused by Hurricanes Katrina and Rita. Excluding hurricane-related losses, corporate profits in 3Q'05 were 30.1% higher than the same year-earlier period.



Although the economy entered 4Q'05 enjoying substantial momentum supporting above-trend growth, activity appeared to be decelerating rather than accelerating. Supporting positive prospects for 4Q'05 have been declines in fuel prices, as crude oil prices fell back to $60 per barrel and gasoline prices returned to the more normal levels prevailing before the hurricanes disrupted production and refining capacity, falling to $2.15 per gallon in early December from $3 per gallon at end-September.

On a less positive note, home heating costs remain high and temperatures in December across the U.S. have been well below normal. Preliminary indications for holiday retail sales are within the range of analysts' expectations, although they are hardly robust, despite signs of strengthening consumer confidence. More troubling, perhaps, were recently released international trade figures for October, which showed surprisingly strong import growth which prompted most analysts to cut their forecasts for 4Q'05 real GDP growth, many to 3.0% or less.



The Securities Industry Association's forecast for 4Q'05 and for 2006 as a whole, which was released at the start of November, remains unchanged.[1] We expect growth of 3.0% in 4Q'05 and further deceleration in 2006, as consumers retrench in lagged response to: steadily rising interest rates early in the year; sustained, high fuel costs; and, the end of the housing boom. The waning of strong fiscal stimuli and reduced net foreign inflows will further constrain growth in the U.S. economy, although it will remain above its long-run average of 2.6%. Expectations of deepening external and fiscal imbalances, rising inflation, higher volatility, and increased frequency and severity of extreme events could dampen consumer and investor confidence and pose risks to this benign forecast. Details of that forecast are summarized in the following table and can be seen in more detail in our November 1 *SIA Research Report*.

[1] Frank Fernandez, "U.S. Economic Update", *SIA Research Reports*, Vol. VI., No. 10, November 1, 2005 (www.sia.com/research/pdf/RsrchRprtVol6-10.pdf), pp. 3-14.

Real GDP: Percent Change from Preceding Period

at seasonally adjusted annual rates (s.a.a.r.)

						2004				2005				2006 (f)			
	2002	2003	2004	2005	06 (f)	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q(e)	1Q	2Q	3Q	4Q
GDP	1.6	2.7	4.2	3.6	2.8	4.3	3.5	4.0	3.3	3.8	3.3	3.8	3.0	2.5	2.2	2.8	3.2
Personal Consumption Expenditures (PCE)	2.7	2.9	3.9	3.7	2.4	4.7	1.9	4.4	4.3	3.5	3.4	3.9	2.5	1.7	2.1	2.6	2.5
—Durables	7.1	6.6	6.0	5.8	3.0	4.4	0.4	10.8	5.5	2.6	7.9	10.8	1.0	1.5	1.7	2.8	1.7
—Nondurables	2.5	3.2	4.7	4.3	2.2	6.6	2.6	3.9	5.5	5.3	3.6	2.6	2.6	1.4	2.0	2.5	2.7
—Services	1.9	2.0	3.0	2.9	2.4	3.8	1.8	3.4	3.6	2.8	2.3	3.2	2.8	1.8	2.3	2.8	2.7
Business Investment	-9.2	1.3	9.4	8.6	6.5	7.9	13.5	11.8	10.4	5.7	8.8	6.2	5.3	7.4	6.4	6.3	5.9
—Structures	-17.1	-4.2	2.2	2.0	2.3	-3.5	8.8	1.4	4.7	-2.0	2.7	-1.4	2.0	1.5	3.5	5.0	5.0
—Equipment and Software	-6.2	3.2	11.9	11.0	7.4	12.0	15.2	15.5	12.4	8.3	10.9	8.9	6.0	8.0	7.0	6.5	6.0
Housing	4.8	8.4	10.3	7.3	0.6	5.2	17.8	2.6	1.6	9.5	10.8	4.8	2.5	0.0	-5.0	-1.0	0.0
Exports	-2.3	1.8	8.4	6.5	4.6	5.0	6.9	5.5	7.1	7.5	10.7	0.8	2.0	5.0	6.0	5.0	7.0
Imports	3.4	4.6	10.7	5.8	4.2	12.0	14.5	4.7	11.3	7.4	-0.3	0.0	4.6	5.4	5.0	4.5	4.0
Government	4.4	2.8	2.2	2.1	3.8	3.3	2.3	1.8	0.9	1.9	2.5	3.2	4.1	5.7	2.5	2.8	3.2
—Federal	7.0	6.9	5.2	3.0	6.4	10.7	3.2	3.6	-0.6	2.4	2.4	7.7	7.0	12.0	2.5	3.2	3.6
—State and Local	3.1	0.6	0.4	1.6	2.2	-0.7	1.8	0.8	1.8	1.6	2.6	0.7	2.5	2.0	2.5	2.5	3.0

Inflation (percent change from preceding period, s.a.a.r.)

—GDP deflator	1.7	2.0	2.6	2.8	3.3	3.6	3.9	1.5	2.7	3.1	2.6	3.1	3.4	3.6	3.3	3.1	2.8
—PCE deflator	1.4	1.9	2.6	2.9	3.3	3.9	3.8	1.5	3.1	2.3	3.3	3.7	3.8	3.2	3.0	3.0	2.8
—PCE (excl. food & fuel) deflator	1.8	1.3	2.0	2.0	2.2	2.7	2.5	1.5	2.3	2.4	1.7	1.3	2.0	2.4	2.7	2.3	2.0

Other Indicators

Real change in Private Inventories*	12.5	15.5	52.0	10.0	0.0	41.9	65.6	50.4	50.1	58.2	-1.7	-16.6	5.0	0.0	0.0	0.0	0.0
Net Exports	-471.3	-521.4	-601.3	-629.2	-651.3	-563.0	-601.7	-606.5	-634.1	-645.4	-614.2	-611.8	-636.0	-654.4	-650.5	-656.1	-653.5

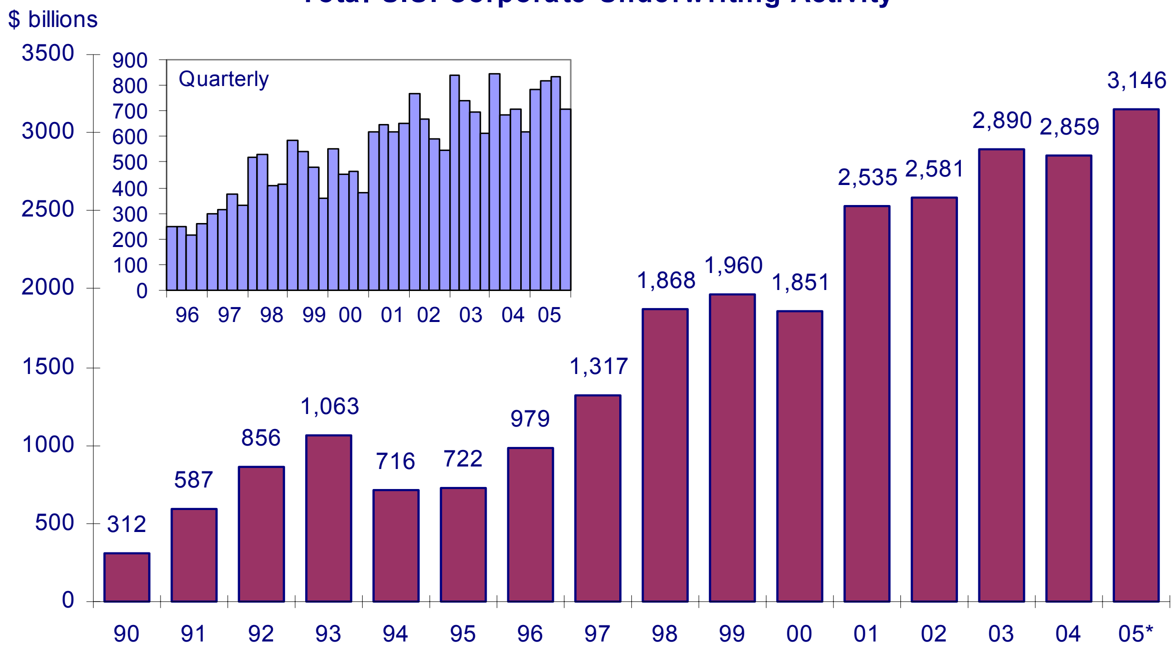
*billions of chained (2000) dollars

Source: BEA; SIA forecast

The Capital Markets

Total Underwriting Activity – The securities industry raised an estimated $3.15 trillion of capital for American businesses in 2005 through corporate underwriting activity in the U.S. market, up 10% from the $2.86 trillion raised in 2004, and surpassing the previous U.S. underwriting record of $2.89 trillion set in 2003. Underwriting activity slowed in 4Q'05 after an exceptionally strong third quarter. Total underwritings in 3Q'05 reached an unseasonably strong level of $835.3 billion, which was the fastest quarterly pace since the quarterly record of $846.5 billion registered in 1Q'04. During 4Q'05, underwritings dropped to an estimated $706.8 billion, down 15.4% from strong 3Q'05 results, but still 14.0% higher than in the same year-earlier quarter. During the last five years (2001-2005), the industry raised over $14.0 trillion for U.S. businesses, an amount that nearly matches the $14.2 trillion raised during the prior thirty-year period (1971-2000).

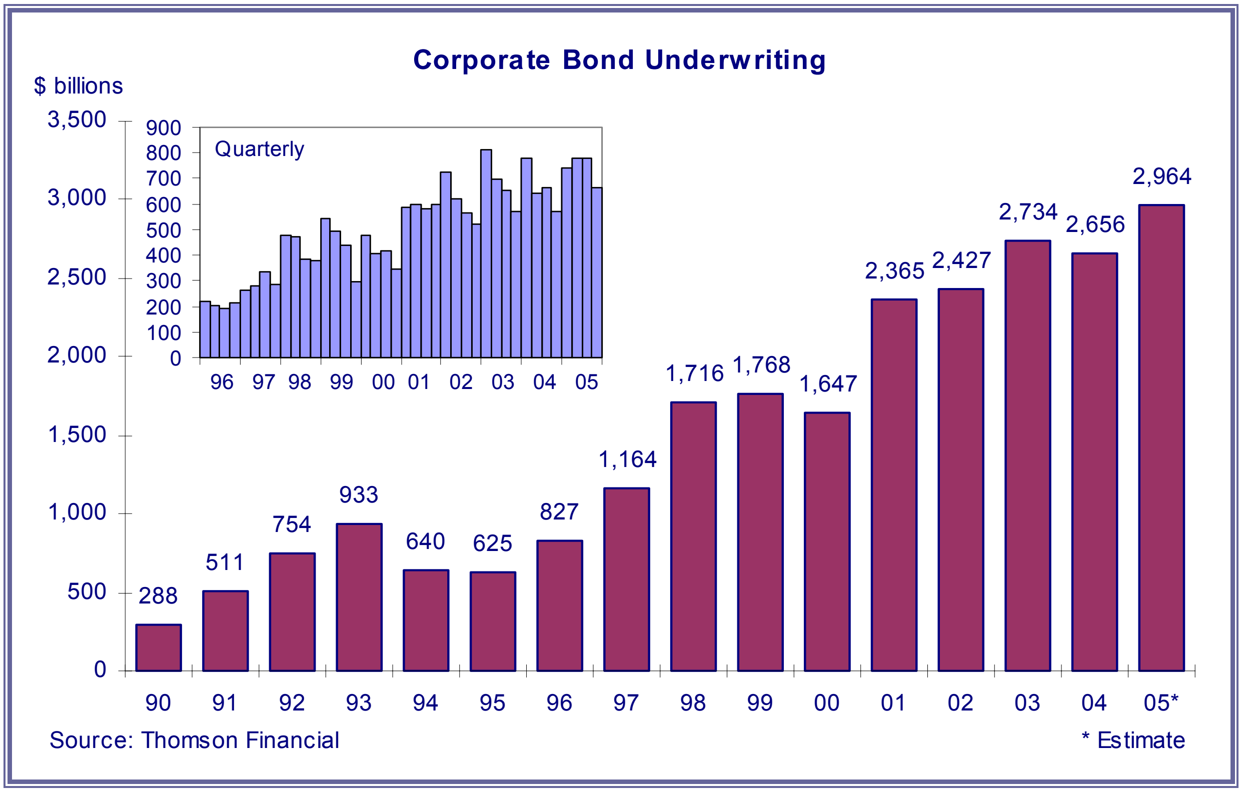
Total U.S. Corporate Underwriting Activity



Source: Thomson Financial

* Estimate

Corporate Bond Underwriting – Total corporate debt issuance reached record levels in 2005, estimated at $2.96 trillion, 11.6% higher than in 2004 and 8.4% above the previous record of $2.73 trillion set in 2003. The increase is attributable to a sharp 27.5% increase in placements of asset-backed securities (ABS), which rose to $1.75 trillion, and more than offset a 5.5% falloff in straight corporate debt issuance, which declined for the second straight year, falling sequentially in each quarter of 2005. By 4Q'05, issuance of straight corporate debt was 16.3% below the immediately preceding quarter and 3.4% below the same year-earlier period. ABS issuance, on the other hand, remained relatively strong throughout the year and volume during 4Q'05 was 32.5% higher than in the same year-earlier period. For 2005 as a whole, ABS volume surpassed that of straight corporate bonds for the second year in a row and for only the second time since 1993.

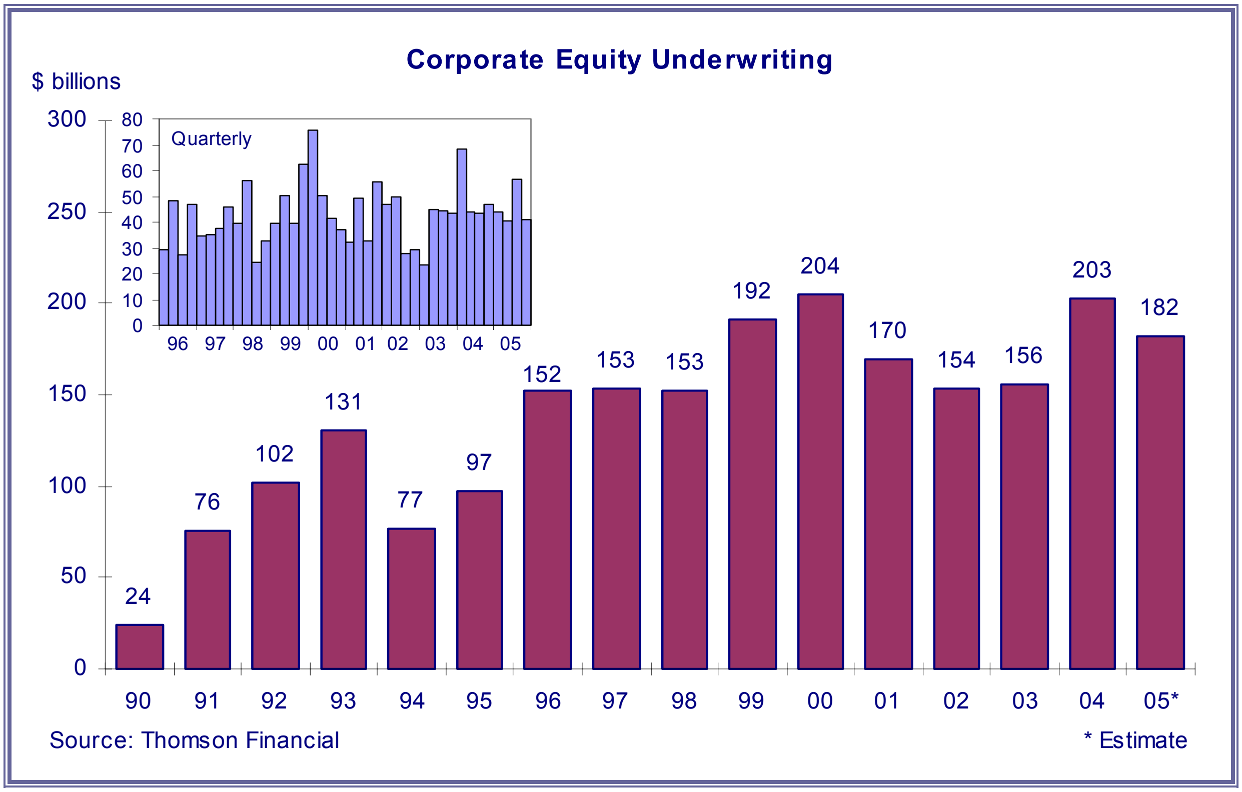


Slower growth in corporate bond underwriting is expected in 2006, particularly in the first half of the year, but not enough to avoid setting yet another annual record, topping a forecast level of $3 trillion for the first time. This view reflects expectations of higher interest rates, deteriorating credit quality (reflected in a widening of currently highly compressed credit spreads), slowing growth of non-residential investment, and continued ample liquidity on non-financial corporate balance sheets, as firms retain a higher proportion of still strong, but decelerating growth in profits.

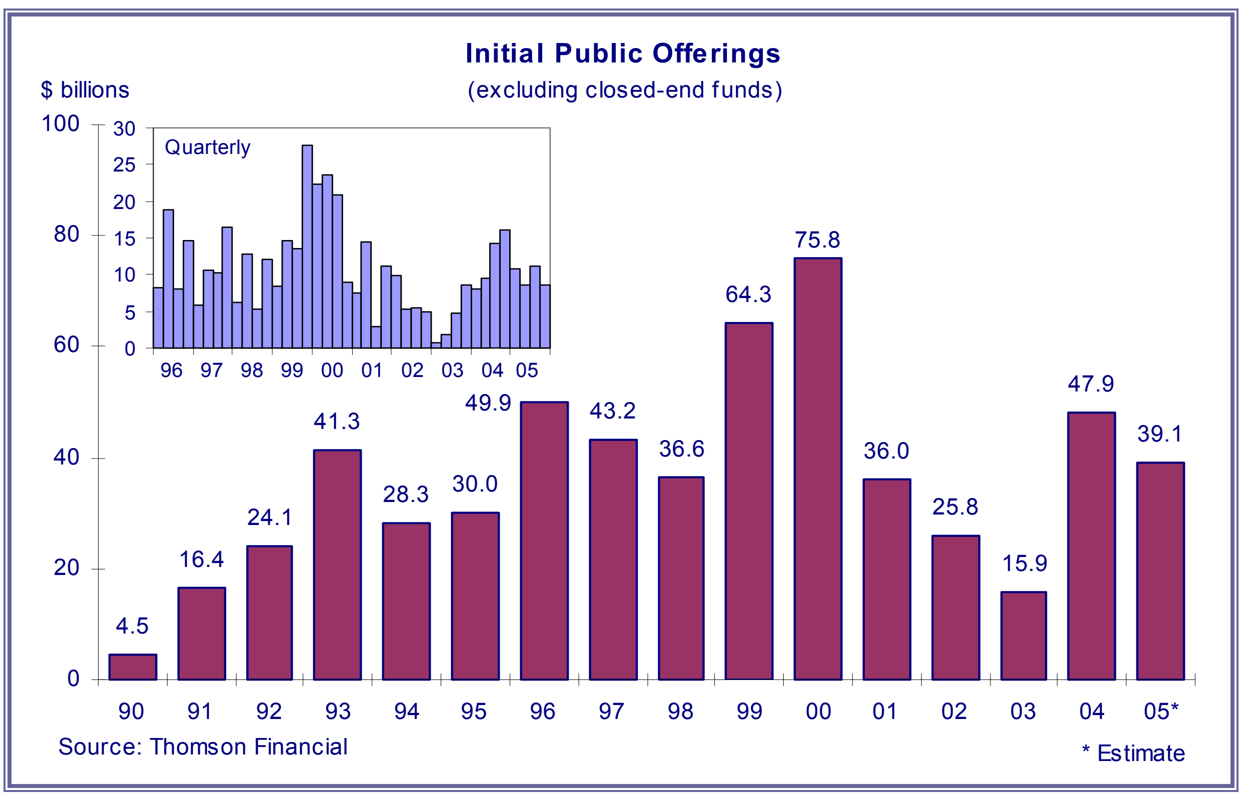
Municipal Bond Underwriting – The total value of U.S. long-term municipal bond underwriting[2] set a record in 2005, reaching an estimated value of $407.8 billion, 14.5% higher than last year, and 7.5% above the record level of $379.3 billion set in 2003. Despite a dip in placements of general obligation bonds in 4Q'05, the value of issuance of all municipal bonds in the final quarter of the year was still 10.2% higher than in the same year-earlier period, as the placement of revenue bonds in 4Q'05 rose 8.4% relative to 3Q'05 levels and 21.3% compared to 4Q'04. Another record year is expected in 2006, although growth is likely to slow to around 7%, half the increase seen this year, as stronger state and local tax revenue growth is expected to reduce municipal government financing needs.

Equity Underwriting – After enjoying a near record year in 2004, primary equity markets experienced a slower pace of issuance activity in 2005, and additional weakness is expected in 2006. After a surprisingly strong $56.8 billion in total equity issuance in 3Q'05, volume fell back to levels seen in the first two quarters of the year. During 4Q'05, total equity issuance was an estimated $41.1 billion, 27.6% below 3Q'05 and 12.4% below 4Q'04 levels. Although secondary or "follow-on" equity issuances in 4Q'05 were 2.1% higher than in the same year-earlier period, they were 31% below 3Q'05 levels.

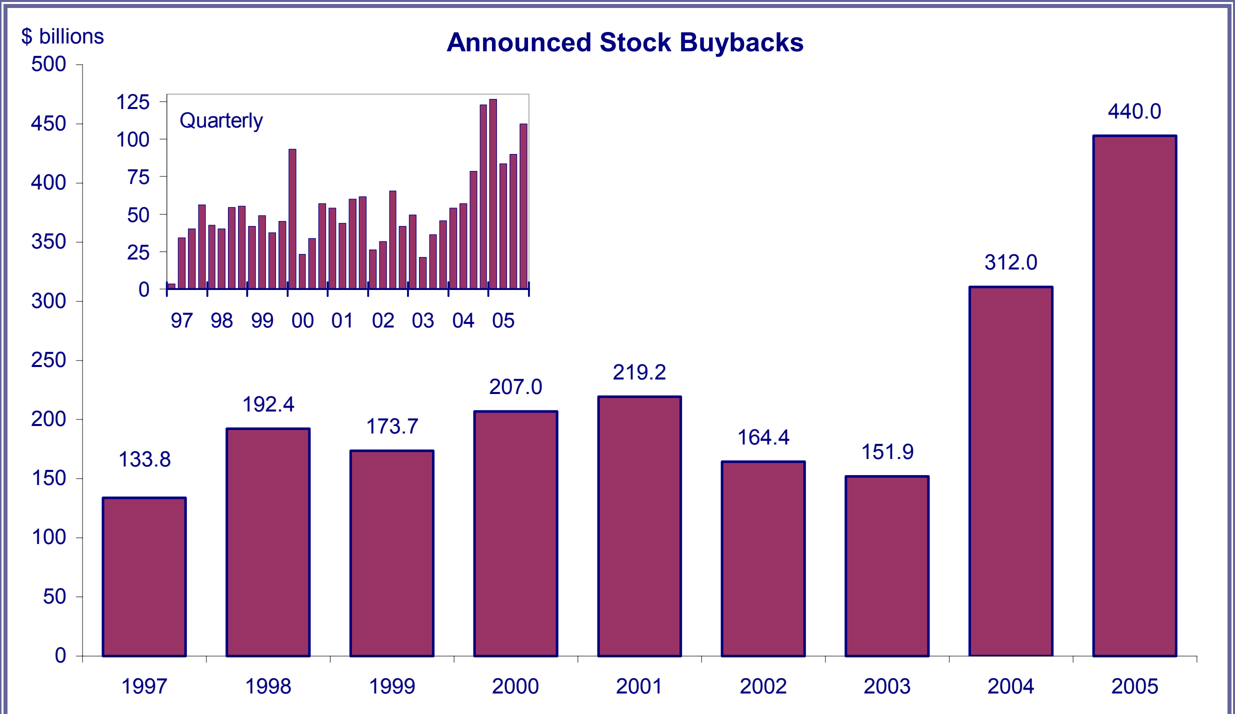
[2] Excludes taxable bonds and maturities under 13 months.



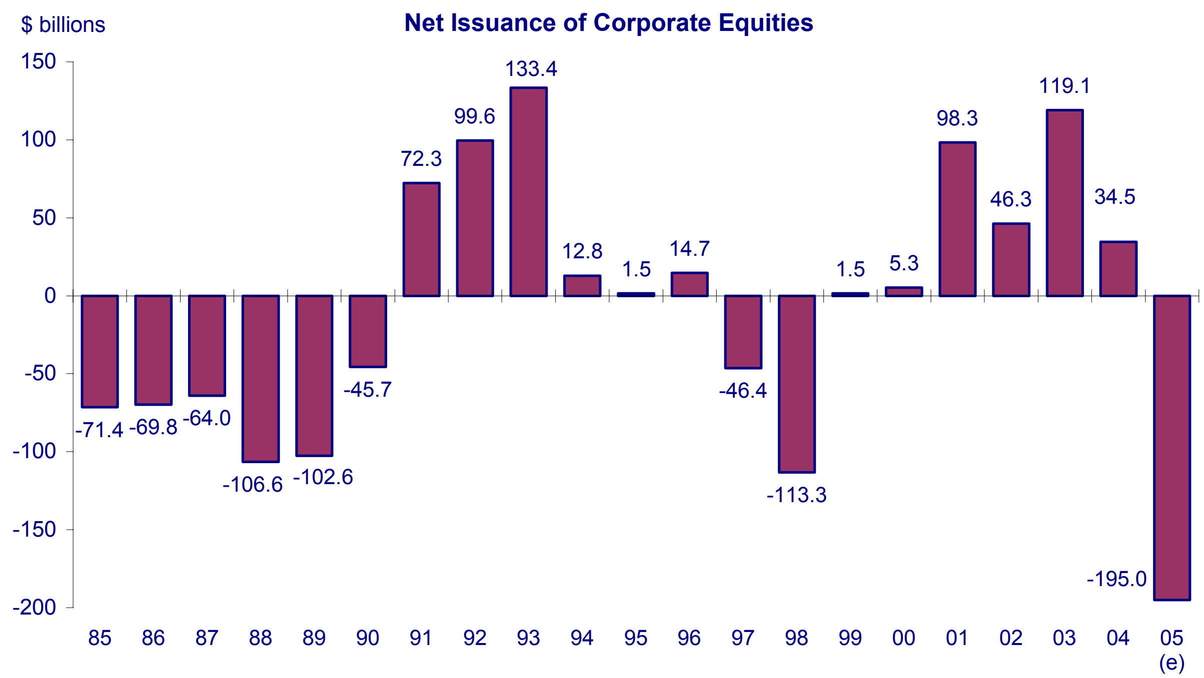
New issuance of common and preferred stock in 2005 totaling an estimated $182.2 billion was 10.1% below levels recorded in the preceding year and 10.9% below the record $204.5 billion set in 2000. The amount of equity raised in the U.S. market for new, start-up, and small businesses through the sale of initial public offerings (IPOs) fell 18.4% in 2005. This drop followed a rebound in 2004 after a three-year downturn that brought "true" IPO volume to a thirteen-year low in 2003. Secondary or follow-on issuance fared better, falling a lesser amount, 7.2%, in 2005.



Two years of double-digit growth in profits have left non-financial corporations with record levels of cash on hand, fueled a record pace of share buybacks and, along with tax cuts, supported continued growth in dividend payments. In fact, net issuance of corporate equities has been negative in 2005, reflecting the record level of share buybacks conducted so far this year by non-financial corporations and a slower pace of underwriting activity. While it is not the first year net issuance has been negative, 2005 far exceeds anything seen historically. Although growth of corporate profits is expected to slow to high single-digit rates during 2006, corporate liquidity is expected to remain high, as will the share of investment needs funded internally, providing little support for a rebound in equity underwriting and substantial incentive for continued buybacks.



Source: Trim Tabs; SIA estimate (4Q'05)

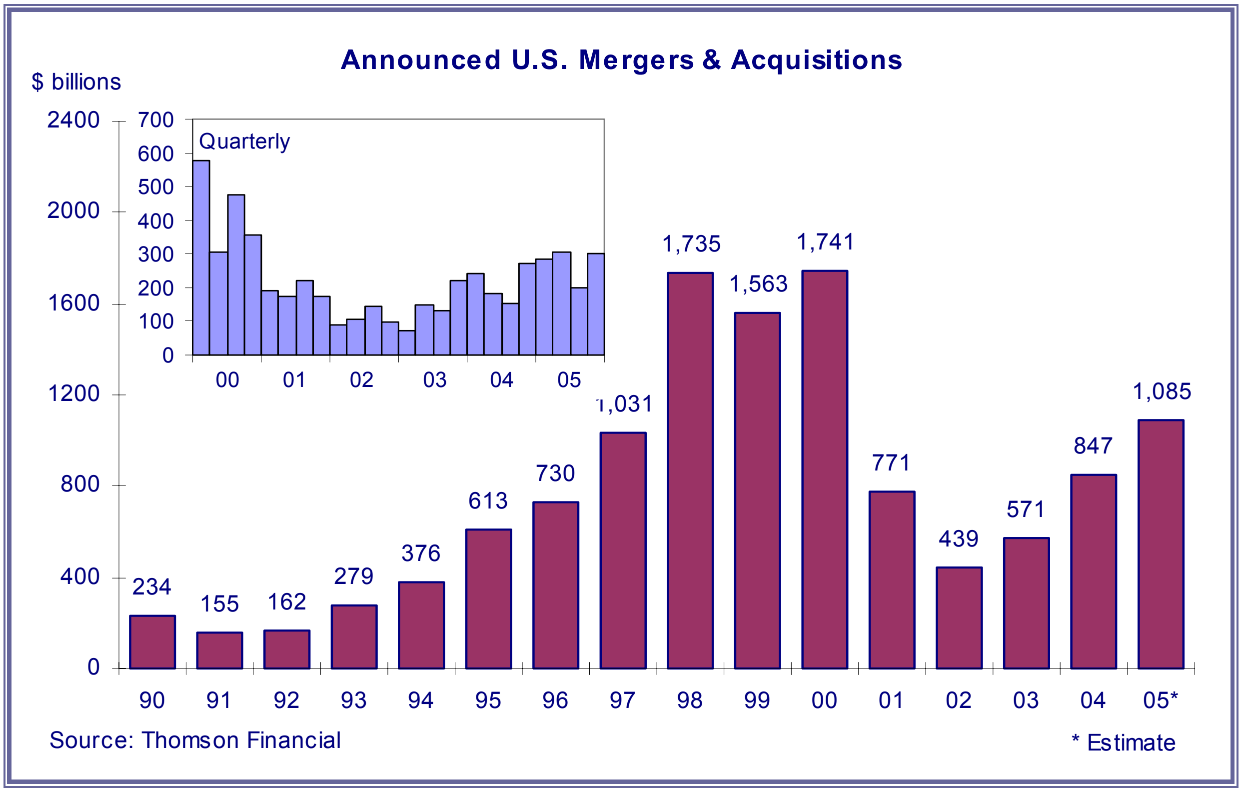


Source: Flow of Funds Accounts of the U.S., Board of Governors of the Federal Reserve System
Note: Excludes mutual fund shares

Private Placements – Private placements[3] are expected to reach $590 billion in 2005, up 8.4% from the $544.5 billion reported in 2004, when total private placements grew 5.1%. Although not easily tracked (and suffering from substantial lags in receipt of data) private placements appear to be continuing to grow in popularity, particularly with smaller, closely held companies and those seeking to spread the influence of outside investors, or as an alternative to venture capital.

Mergers and Acquisitions – The value of announced M&A deals involving U.S. target companies is expected to exceed $1.08 trillion during 2005, 28% higher than the total of $847.4 billion announced during all of 2004, while completed deals are likely to top $810 billion, an 8.2% rise. This makes 2005 the best year for the highly cyclical M&A business since 2000, when $1.74 billion of deals were announced and the best year in terms of completed M&A volume since 2001's $1.16 trillion total. A number of significant deals might well be announced in the final days of December, which could easily lift the 2005 total above $1.1 trillion. Even excluding possible December announcements, M&A activity in 2005 showed a strong finish, with $300 billion in announced deals in 4Q'05. This represented a 51.0% jump after a weaker third quarter and a 10.8% increase over 4Q'04.

[3] Private placement here refers to the placement of any security by a brokerage firm not involving a public offering (including Rule 144A transactions and private equity). Private offerings are not the subject of a registration statement filed with the U.S. Securities and Exchange Commission (SEC) under the *Securities Act of 1933*, but rather are done in reliance upon Sections 3(b) or 4(2) of the 1933 Act as construed or under Regulation D as promulgated by the SEC in 1982, or both. Regulation D sets forth certain guidelines for compliance with the Private Offering Exemption.



Announced global M&A activity was even stronger, as European M&A deals accelerated, outpacing growth in the U.S. market. The value of announced global M&A deals reached an estimated $2.55 trillion for all of 2005, 31.4% higher than the $1.94 trillion of deals announced in 2004. In 2006, we expect 15% to 20% growth in the value of U.S. M&A and 20% to 25% growth in the value of global M&A.

The current wave in the M&A cycle, which began with a recovery from cyclical lows at end-2002, has accelerated in line with our expectations at that time, but the industry 'clusters' that have led the upswing have been somewhat surprising.[4] "Merger waves have historically tended to 'cluster' in a single industry or a small number of industries. The fact that a large proportion of mergers in any given wave are accounted for by only a handful of industries, and that the identity of those industries changes over time, strongly suggests that mergers might occur as a reaction to unexpected shocks to industry or market structure. These shocks can be delivered by any number of unexpected events, such as a bout of deregulation, supply shocks (such as commodity price 'spikes') or the impact of rapid technological change."[5]

---

4 Frank Fernandez, "Mergers and Acquisitions: The Next Wave", *SIA Research Reports*, Vol. III, No. 10, November 29, 2002 (www.sia.com/research/pdf/RsrchRprtVol3-10.pdf), pp. 3-11.

5 Ibid., p. 10.

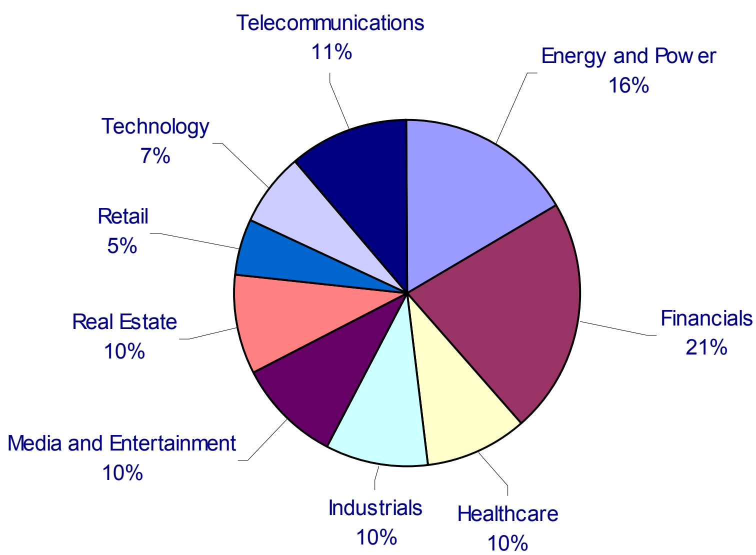
Top Five Industries
Based on Average Annual Merger Activity
in the United States

1970s	1980s	1990s	2000s
Metal Mining	Oil and Gas	Metal Mining	Financials
Real Estate	Textiles	Media and Telecom	Energy and Power
Oil and Gas	Misc. Manufacturing	Banking	Telecom
Apparel	Non-Depository Credit	Real Estate	Media and Entertainment
Machinery	Food	Hotels	High Technology

Source: Andrade, Mitchell and Stafford, "New Evidence and Perspectives on Mergers," *Journal of Economic Perspectives*, 15 (1), pp. 103-120, 2001, for 1970s – 1990s; for 2000s, data from *Investment Dealers Digest* (1/1/00 – 12/7/05) and SIA forecasts.

All of these drivers are evident in the current wave and, as a result, M&A activity is more dispersed across a broader range of industries. This decade's wave, like the preceding one which occurred in the 1990s, appears to be relatively dramatic and widespread, characterized by both a large number of deals (such as occurred in the 1960s) and high values on individual deals (as occurred in the 1980s). The financial, energy and power, and telecommunications industries are the leading target industries thus far in this wave, the composition of which is shown below for the last three years.

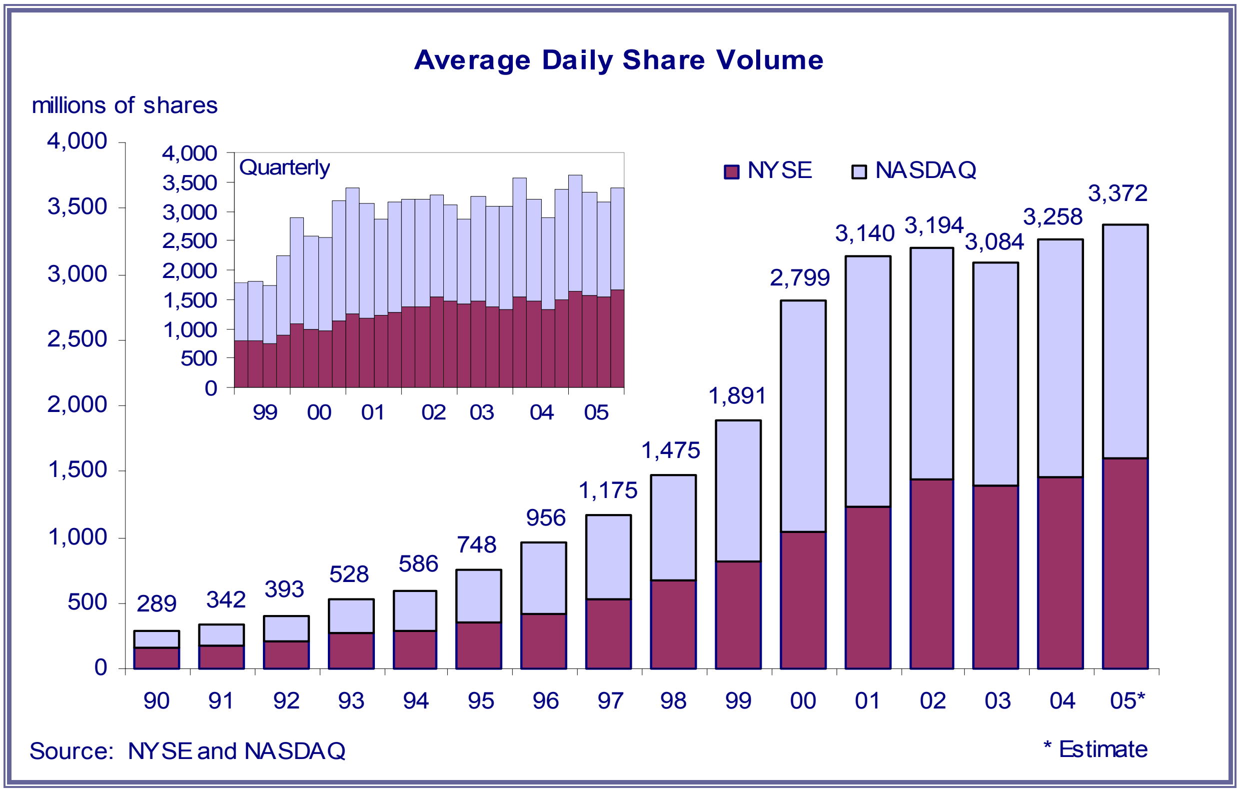
Global Mergers and Acquisitions
As a Percent of Total Value by Selected Industries
2003-2005



Source: *Investment Dealers Digest*

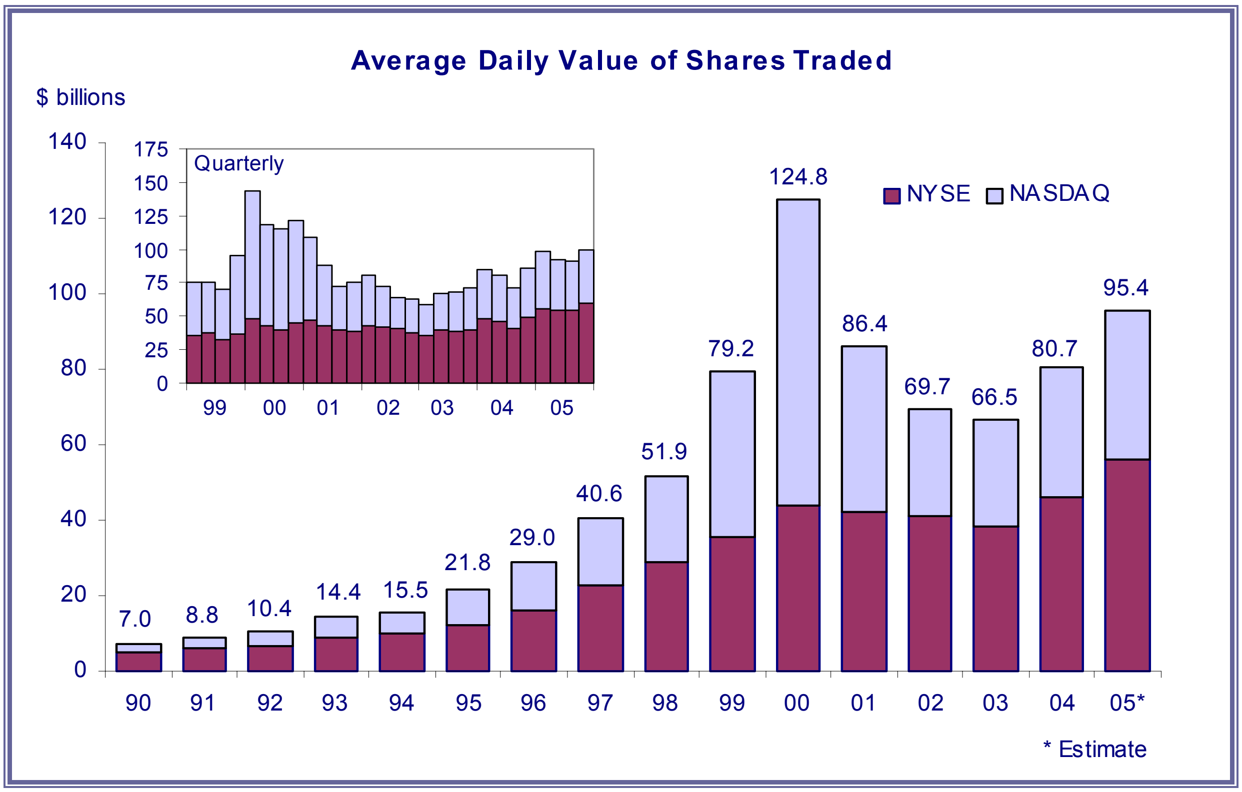
Secondary Market Activity

Equity Share Volume – After slumping in the late spring and summer, trading activity on the NYSE and the NASDAQ showed a significant pickup during September and October, before moderating somewhat in the final two months of the year. Net new flows from individual investors and hedge funds, conspicuously absent earlier in the year, returned to equity markets as autumn arrived. October 2005 proved to be the second best month ever for the NYSE (only 2.1% below the record set in July 2002) and, as a result, average daily share volume on the NYSE in 4Q'05 is estimated to have climbed to 1.67 billion shares, up 8.7% relative to 3Q'05 and 11.1% relative to the same year-earlier period. For 2005 as a whole, average daily share volume on the NYSE rose to an estimated 1.60 billion shares, up 9.7% from 2004 levels.



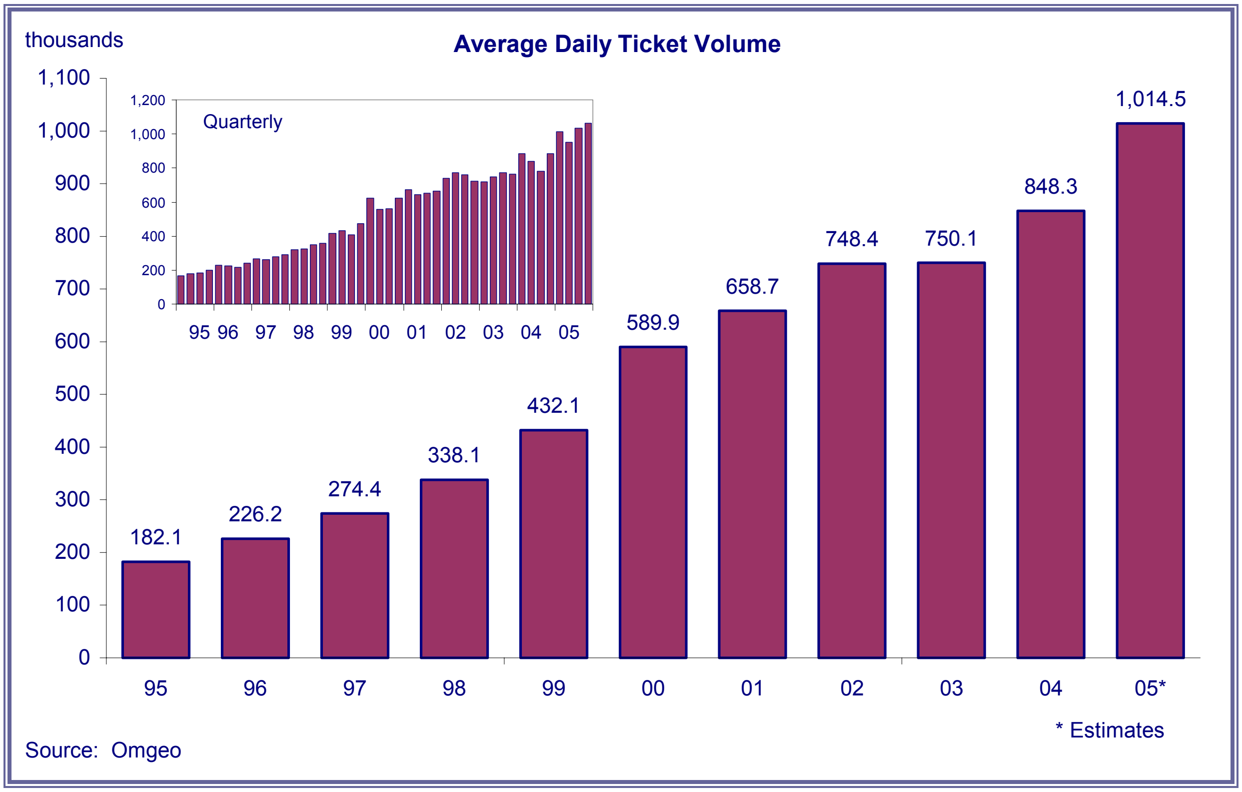
On NASDAQ, average daily share volume in 4Q'05 rose to an estimated 1.73 billion, up 6.8% relative to 3Q'05, but 7.3% below the same year-earlier period, and still well below the record volumes seen in early 2001. For 2005 as a whole, NASDAQ estimated average daily share volume was 1.77 billion, 1.6% below 2004 levels and still 6.7% below the record pace of 2001. American Stock Exchange (Amex) volumes continued to shrink, with the estimated average daily share volume declining to only 63.2 million in 2005, 4.3% below 2004 and 5.8% below 2003 levels.

Equity Dollar Volume – A strong rally in equity prices in October and November and higher share volume helped lift the total value of shares traded in 4Q'05. The average daily value of trading on the NYSE reached a monthly record in September ($60.6 billion), only to be surpassed in October ($64.6 billion). The value of trading slipped back to more normal levels, declining sequentially in November and December, but still produced strong results for the final quarter of 2005 as a whole, estimated to be the strongest quarter ever. During 4Q'05, the average daily value of trading on the NYSE reached an estimated $59.3 billion, up 8.0% from 3Q'05 and 21.1% higher than the same year-earlier period, setting a new quarterly record. Similarly, for 2005 as a whole the average daily value of trading set a record, reaching an estimated $56.0 billion, 21.6% higher than the previous record set just the year before.



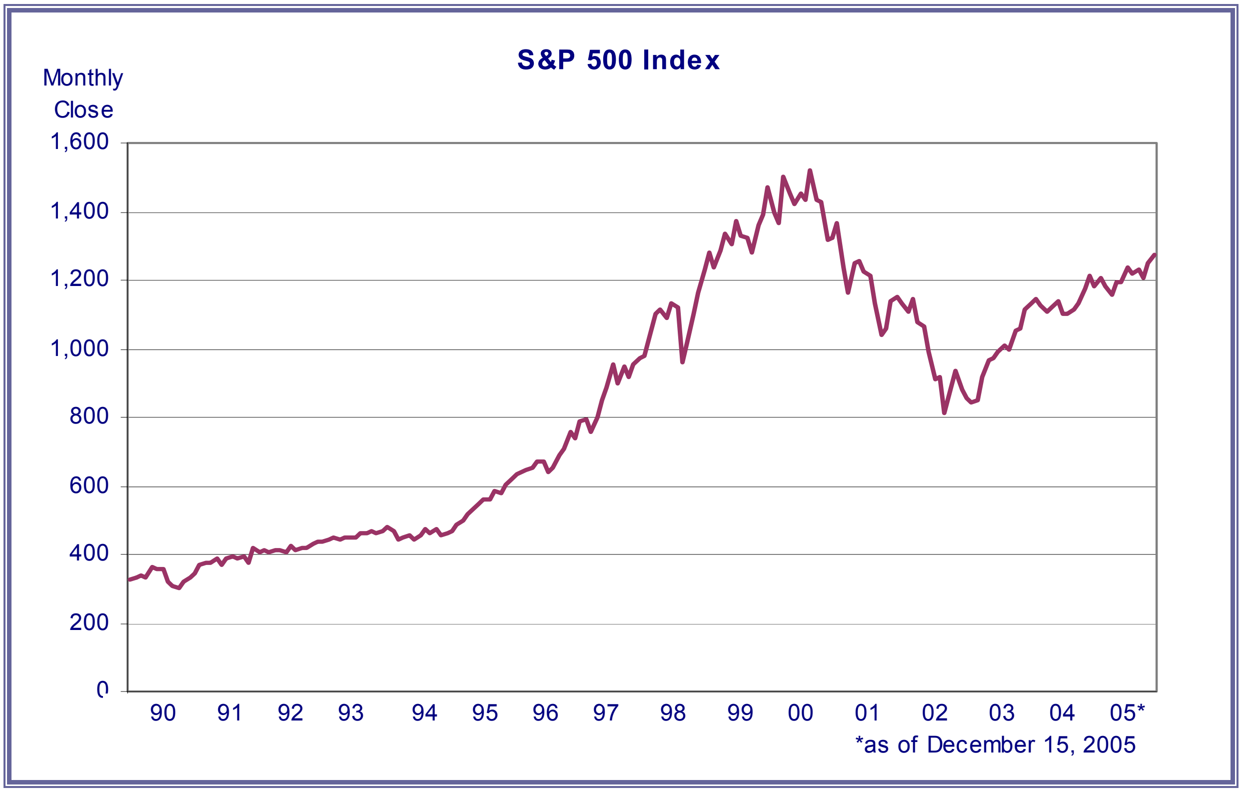
After slipping in August, the average daily value of shares traded on the NASDAQ rose solidly in each of the next three months, before falling back slightly in December. During 4Q'05 the average daily value of shares traded reached an estimated $40.5 billion, up 11.2% over 3Q'05 and 8.0% higher than in 4Q'04. For 2005 as a whole, the average daily value of shares traded reached an estimated $39.4 billion, up 13.8% from 2004 and 40.7% above 2003 levels, but still only half the record trading values reached in 2000.

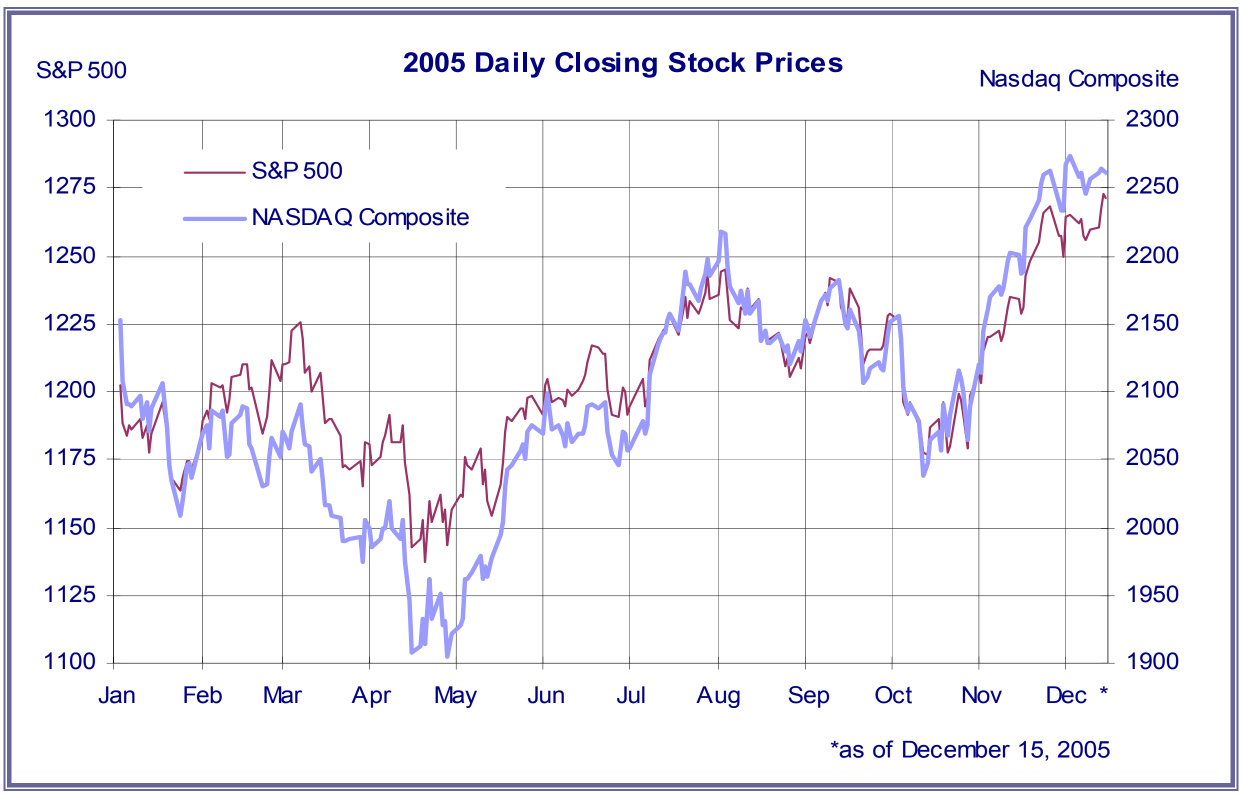
Equity Ticket Volume – The average daily number of institutional equity trades, or tickets, rose in line with growth in the other, more widely monitored indicators of equity market activity: the number and value of shares traded. Average ticket volume in 2005 has routinely stayed above 1 million per day, a doubling of trade processing volume over the past six years and a four-fold increase from levels seen in 1996. During 2005 average daily ticket volume rose to an estimated 1.014 million tickets, a 19.6% increase relative to 2004 processing volumes.

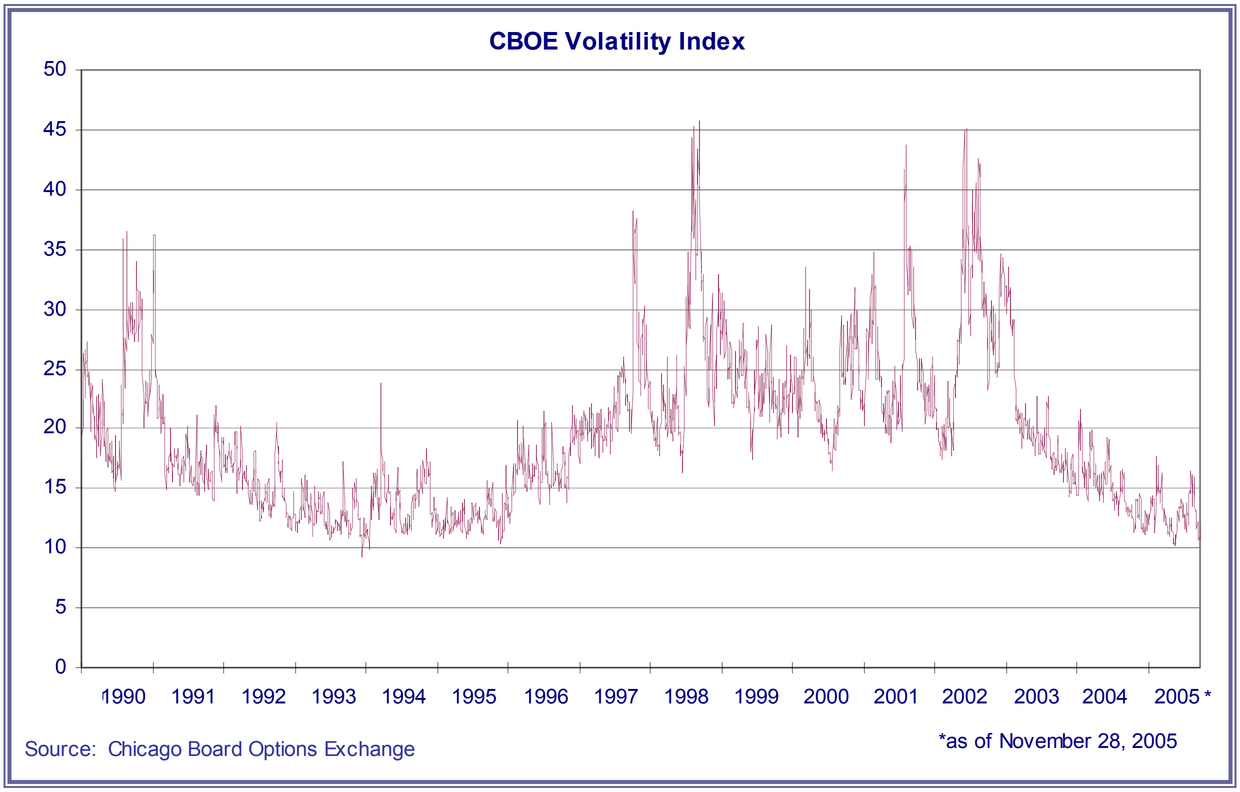


Stock Prices – The major stock price indices have been confined to a relatively narrow trading range throughout 2005. The stock markets posted moderate gains in 2004, thanks to a powerful rally in the fourth quarter that pushed the major market indices to new 3½-year highs by late December. Unfortunately, the rally was not sustained into 2005 and stock prices drifted lower during the first four months of the year as renewed concerns over slowing economic growth and rising inflation dampened investor confidence. The market advanced from near-term lows in late April until mid-June, driven up by lower long-term interest rates, solid corporate earnings growth and economic growth that exceeded expectations, and surprisingly subdued inflation.

The rally faltered in late June, however, in response to a spike in crude oil prices to $60 per barrel and the steady upward march of the Federal Funds rate. The three major market indices slumped across the third quarter to reach their lowest levels in five months during October, as energy prices "spiked" in the hurricanes' wake, inflation fears were reignited, longer-term interest rates moved briefly higher, certain mutual funds (those with a fiscal year ending in October 31) engaged in tax-related selling of money-losing stocks, and investor sentiment sagged.


S&P 500 Index
Monthly
Close
1,600
1,400
1,200
1,000
800
600
400
200
0
90
91
92
93
94
95
96
97
98
99
00
01
02
03
04
05*
*as of December 15, 2005

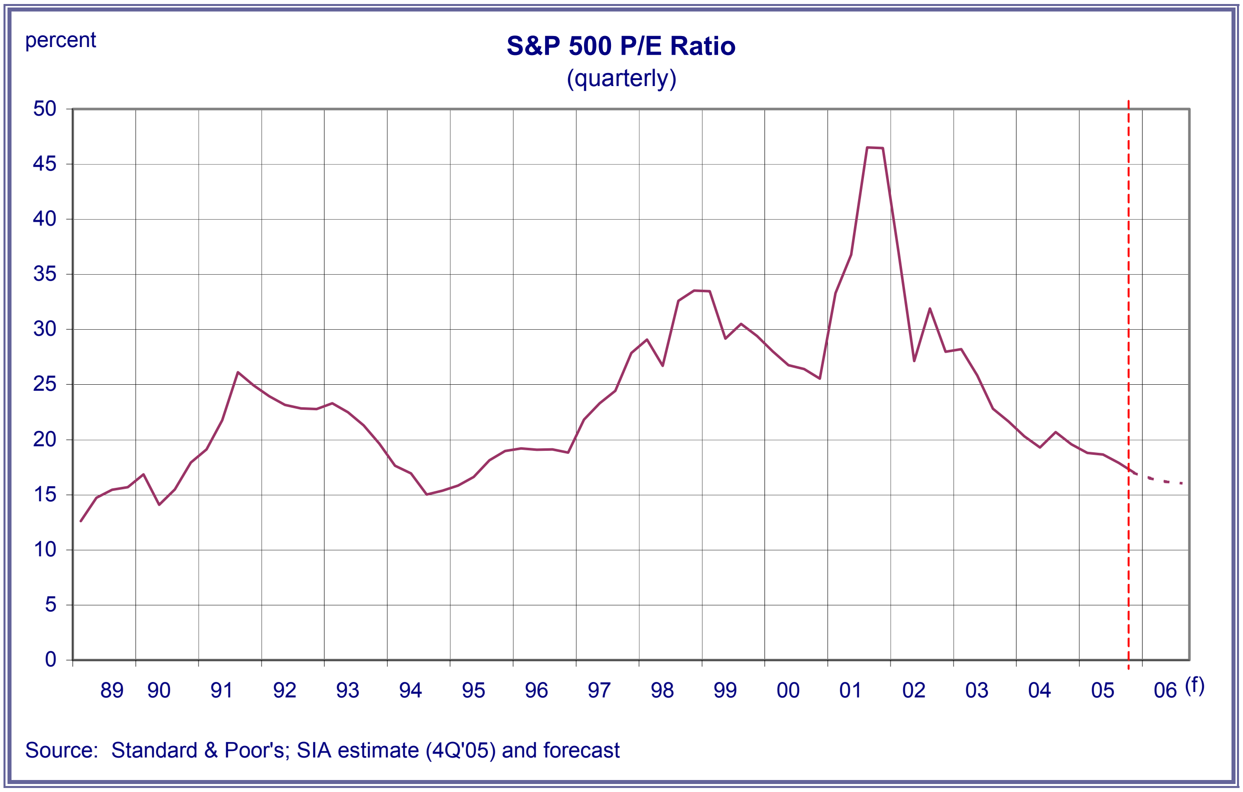

2005 Daily Closing Stock Prices
S&P 500
Nasdaq Composite
1300
1275
1250
1225
1200
1175
1150
1125
1100
2300
2250
2200
2150
2100
2050
2000
1950
1900
S&P 500
NASDAQ Composite
Jan
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
*
*as of December 15, 2005



The final rally of 2005 began in late October, as investors, particularly retail investors and hedge funds, positioned themselves in anticipation of a "Santa Claus" rally. Stronger-than-expected third-quarter results for economic activity and corporate profitability and the return of oil prices to levels seen at summer's end supported the upturn. Unfortunately, the move was so widely anticipated that there were too few investors left with uncommitted funds by end-November to lift the market higher, and the rally proved short-lived. In effect, "Santa Claus" came for Thanksgiving, and prices drifted lower across early December.

Investors viewed changes in the language accompanying the Federal Reserve's announcement[6] of its thirteenth consecutive quarter-point increase in the Fed Funds rate on December 13 optimistically, and sentiment shifted once again. Specifically, investors appear to believe it likely that the current round of increases, now stretching across 17 months, will come to a close at end-1Q'06 with the Fed Funds rate reaching 4.75%. In response to renewed investor interest, the major stock price indices once again tested, and appear to have breached, the top of the effective trading range that has contained them throughout 2005. The S&P 500 Index moved to a 4½-year high, while the much broader DJ Wilshire 5000 Index made a new 5-year high in mid-December.

6 See www.federalreserve.gov/boarddocs/press/monetary/2005/20051213



Further advances are expected in 2006 given prospects for still strong, albeit slowing, growth in corporate profits and the underlying economy, current valuations, and prospects for flows into the market. Currently, the price/earnings (P/E) ratio for the S&P 500 is around 17.0.[7] This is well below the average of 28.3 since 1996 and the average of 23.4 since 1988, but still above the long-run historical average (1935 – 2005) of 15.7. Stock prices are likely to move higher, in line with the expected growth in corporate profits in 2006 if the Federal Reserve meets market expectations concerning the end of the current tightening cycle and begins to cut interest rates during the second half of the year in response to slower growth and more subdued inflationary expectations expected to prevail at that time.

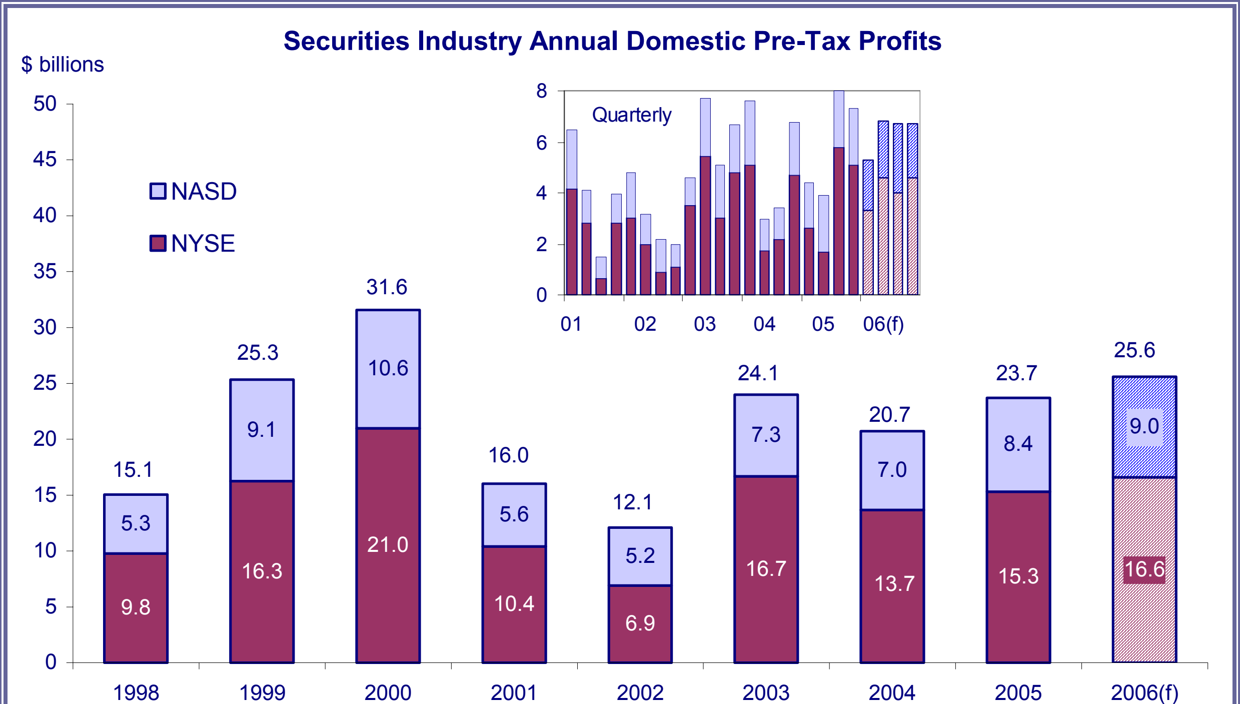
[7] Top-down estimates by S&P for reported operating earnings per share for 4Q'05 as of Dec. 7, 2005.

The Securities Industry

Summary

The U.S. securities industry enjoyed very good results in 2005 despite relatively weak performance in the first half of the year, as key sectors such as M&A and proprietary trading enjoyed tremendous growth. Third-quarter performance was unseasonably strong as both primary and secondary market volumes, which normally slump in the summer months, did the opposite, rising solidly in 3Q'05. This positive shift continued in the fourth quarter, driven by reinvigorated institutional and individual investor interest.

Securities industry profits (pre-tax net income) reached an estimated $7.3 billion in 4Q'05, boosting full-year 2005 results to an estimated $23.7 billion, 14.4% above the $20.7 billion result achieved in 2004. Gross revenues surged 38% to $326.7 billion, rising for the second year in a row after declining between 2001 and 2003. Growth of net revenues (revenues net of interest expense) increased by 8.1% in 2005, compared to a growth of 5.2% in 2004.



Source: SIA DataBank (4Q'05 estimate, 2006 forecast)
Subtotals may not add to totals due to independent rounding.

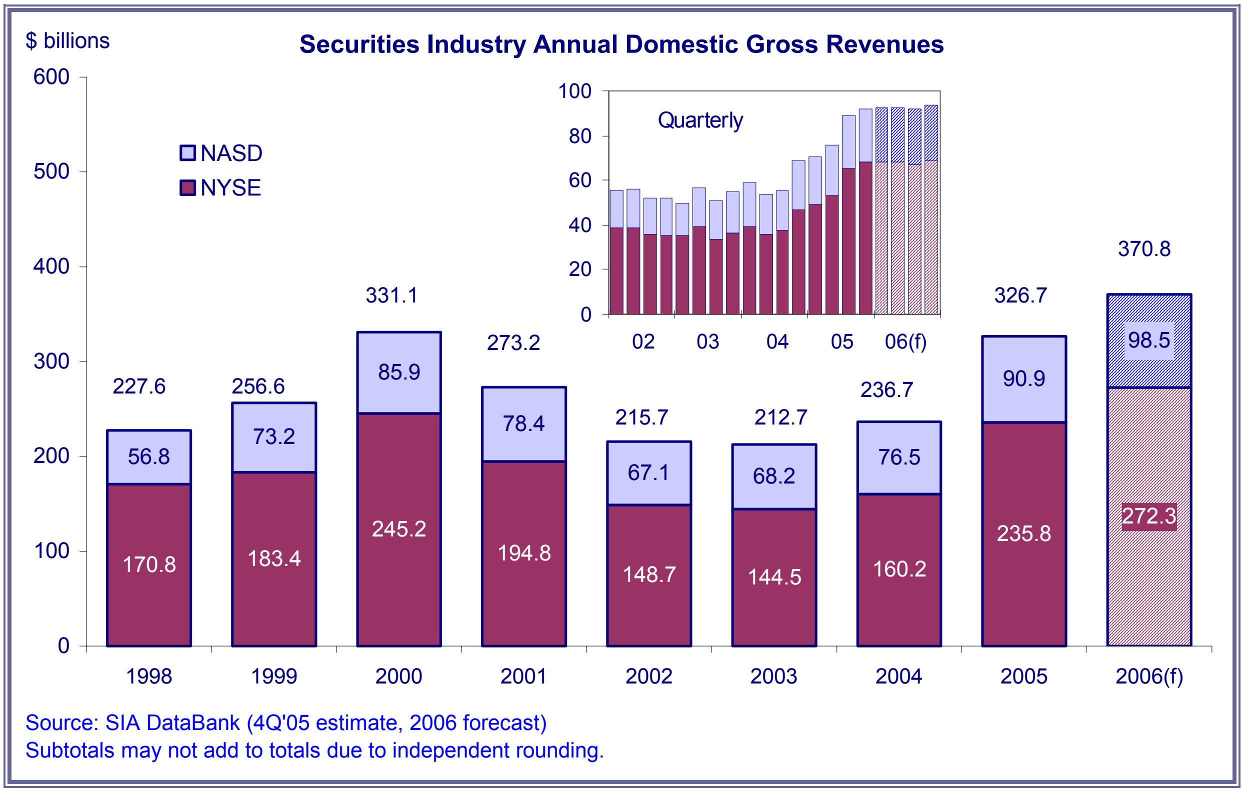
Relatively favorable prospects for the economy are expected to support solid revenue growth and higher profits for the securities industry in 2006. Still ample liquidity and an expected pickup in volatility from current low levels should support continued strong growth in investment banking revenues and in trading, both for customer accounts and for securities firms' own accounts. Trading is expected to expand in both traditional securities, such as stocks and bonds, as well as in faster-growing, higher-margin derivatives and structured products. Increased activity in full-service retail accounts and slower margin compression should support continued growth in commission and fee income. Investment banking will benefit from continued strong non-financial business investment spending and the ongoing upswing in the M&A cycle. More subdued, but still positive, prospects persist for growth in mutual fund sales revenues and asset management fees, despite increased pressure on margins in 2006. Margins should narrow further, reflecting both fee cutting by large fund complexes taking advantage of economies of scale to increase market share, as well as rising regulatory costs.

Even better industry results appear likely in 2006. We expect profits to reach $25.6 billion, an 8.1% increase over 2005 and the industry's second-best annual performance, after the record $31.6 billion in pre-tax net income earned in 2000. This forecast reflects expectations of slower, but still solid, growth in both gross and net revenues (up 13.5% and 6.2%, respectively, vis-à-vis 2005) and slower growth of non-interest expense (up 6.0%), as variable compensation, which surged in 2005, is held in check, along with other expenses. This solid performance is expected to support continued growth in industry employment within a range of 2.5% to 3%, following an estimated 3% increase in 2005.

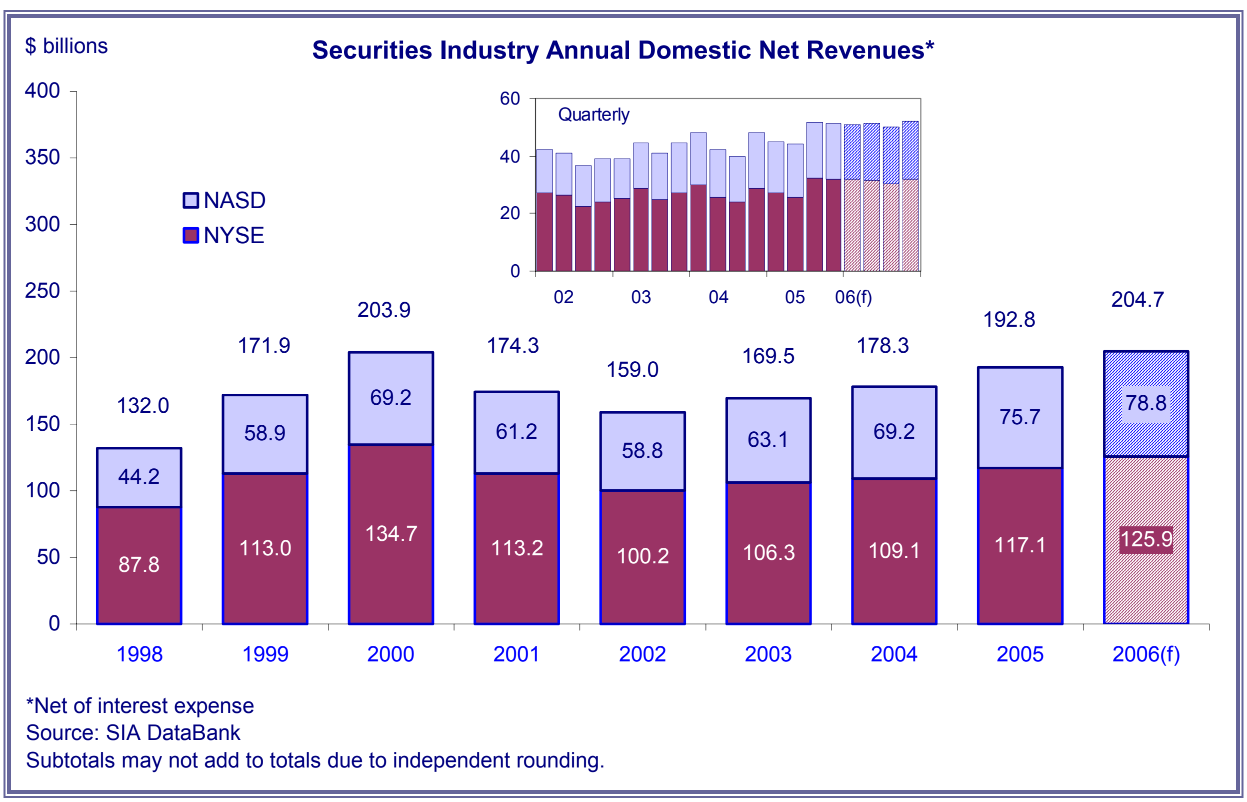
4Q 2005 Results

While it will be some time before final results are in and aggregate figures are available, with only a few days left in 2005 it appears that securities industry profits will reach roughly $7.3 billion in 4Q'05, 8.0% above results for the same year-earlier quarter, but 9.3% below the exceptional results in 3Q'05. These very strong results in 4Q'05 reflect a rebound in investor confidence and issuer activity beginning in September, which boosted revenue growth through year's end.

In the year's final quarter, gross revenues for all broker-dealers doing a public business in the U.S. rose to an estimated $92.0 billion, up 34.1% over the same year-earlier period, as higher short-term interest rates boost both total revenues and total expenses. Total expenses, including interest expenses, in 4Q'05 were estimated at $84.7 billion, 4.9% higher than in 3Q'05 and 36.9% above the same year-earlier period. Expenses net of interest expenses in 4Q'05 are estimated to have increased only 6.7% relative to 4Q'04, as some variable compensation normally paid in December was delayed until January. Estimated net revenues were 0.7% below 3Q'05 levels, but up 6.9% from the final quarter of 2004.

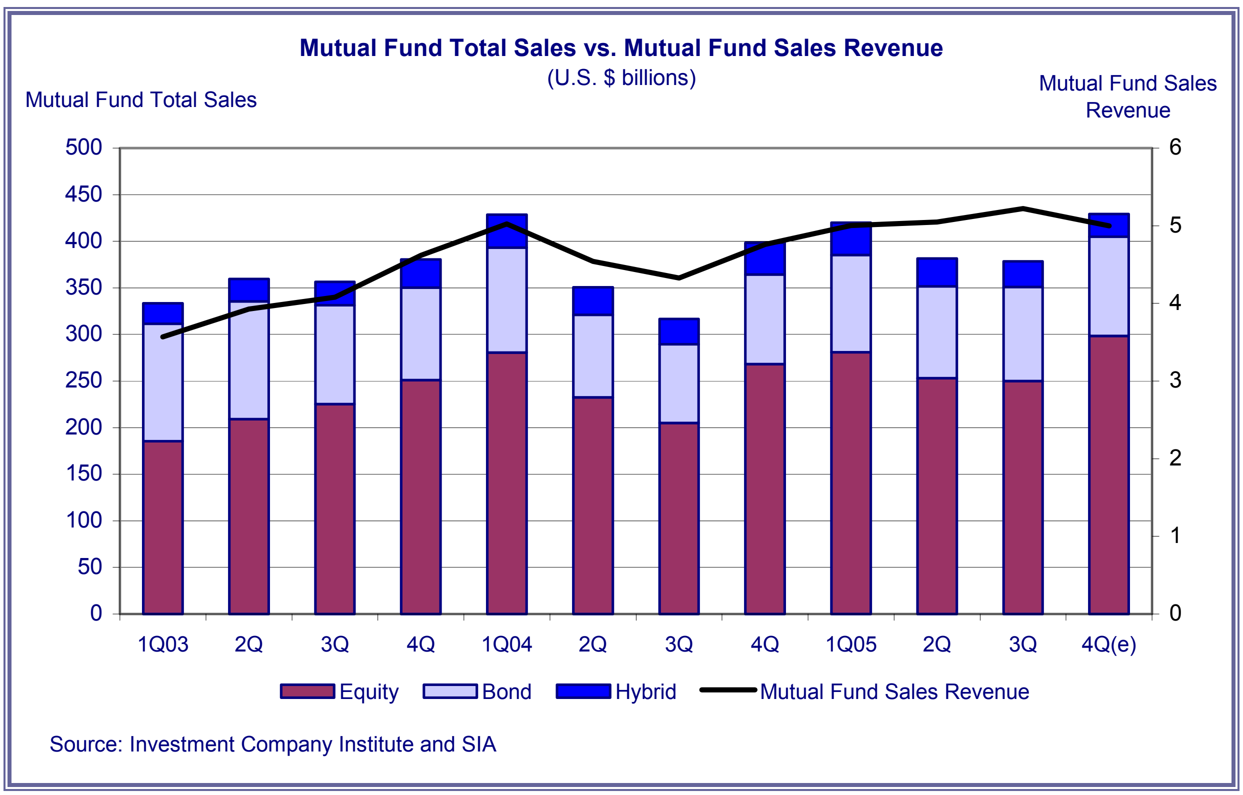


The industry enjoyed unseasonably strong results in 3Q'05, after two disappointing quarters, before posting solid, although slightly less spectacular, results in 4Q'05. With the exception of declines in stock and corporate debt underwriting, virtually every product and service line showed better-than-expected growth, particularly M&A, structured finance, credit derivatives and commodities trading.

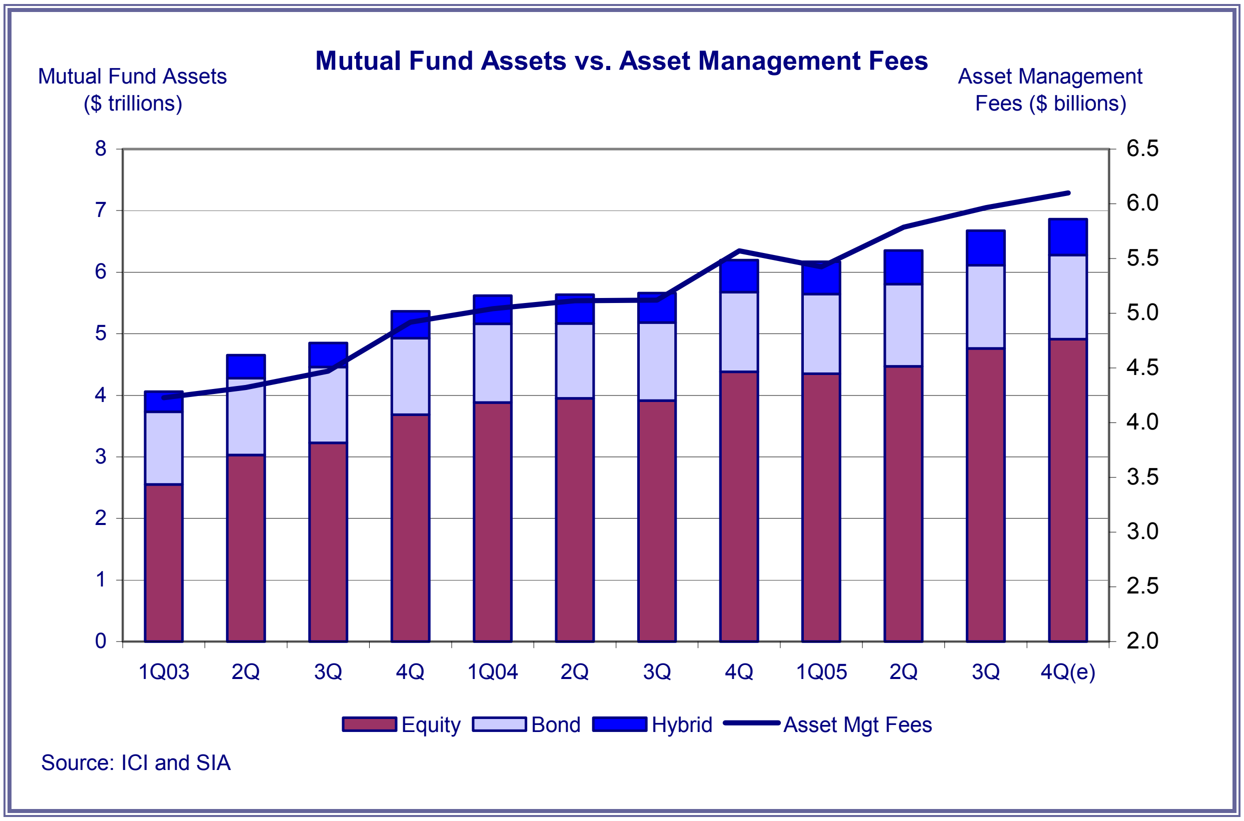


Commission and fee income jumped an estimated 6% from 3Q'05 to reach $12.4 billion, reflecting increased activity in both institutional and retail equity trading as well as a surge in derivative products transactions. Throughout 4Q'05 strong net inflows into mutual funds and a surge in purchases of individual securities by both domestic and foreign customer accounts translated into higher equity market prices and commission and fee income. NASDAQ and NYSE total trading volume increased 8% relative to 3Q'05 levels, led by a jump in full-service, retail brokerage activity. Retails' share of total trading rose and institutional margin compression slowed, helping to limit the fall in average per-trade margins, which have been relentlessly squeezed in recent years by the growth of program trading and fierce competition.

Mutual fund sales revenues and **asset management fees** benefited from investors' bullish outlook during the last quarter of 2005. Mutual fund sales revenue was an estimated $5.1 billion in 4Q'05, 2.3% below the prior quarter, but still 7.1% above the same year-earlier period. Net new cash inflows into all types of funds reached an estimated $130 billion during 4Q'05, but were led by inflows into money market mutual funds (MMMFs) which took in $72.2 billion as higher short-term interest rates increased their relative attractiveness. Inflows into long-term mutual funds, which command higher management fees and sales charges than MMMFs, rose thanks to a surge in interest in December. The $58 billion estimated inflow into long-term funds was 22.7% higher than net new cash flows in 3Q'05 and 5.9% above inflows reported in the same year-earlier period, as sales of bond funds partially offset higher net inflows into equity and hybrid funds.

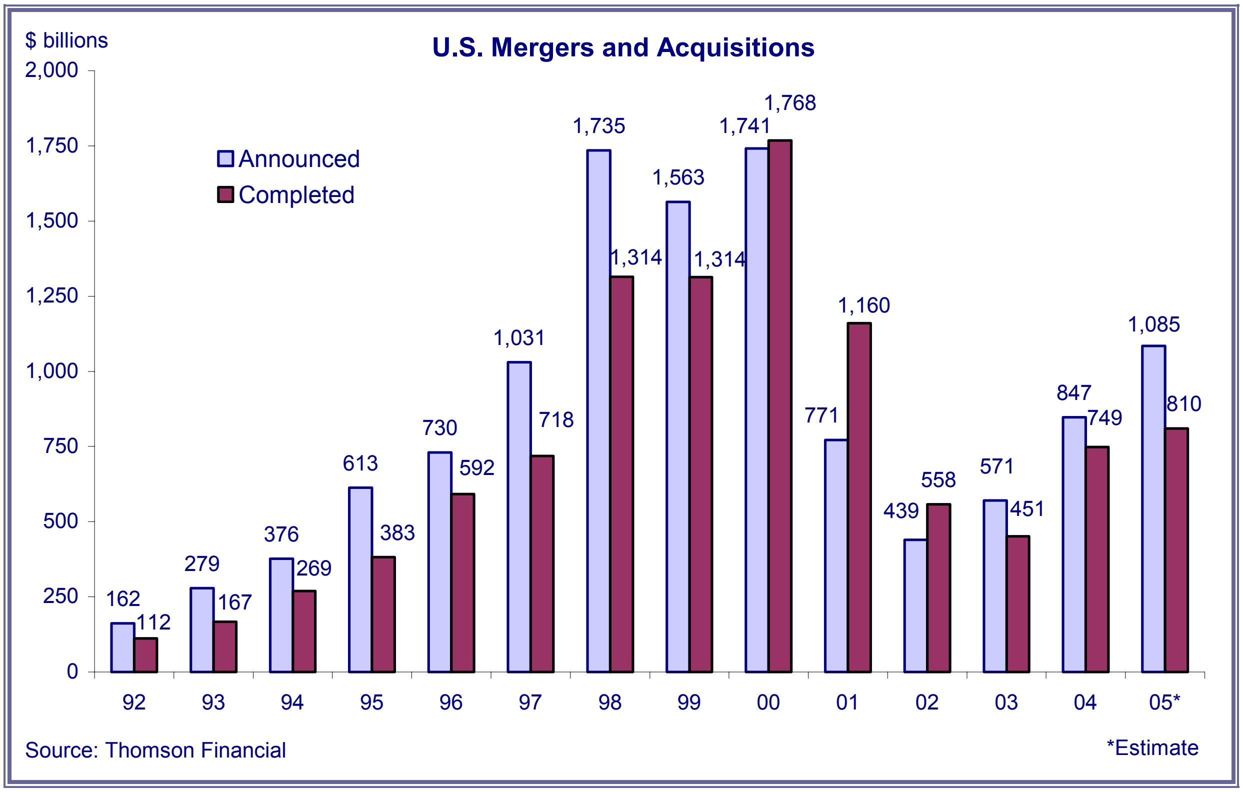


Asset management fees reached an estimated $6.1 billion in 4Q'05, an increase of 2.3% relative to 3Q'05 and 9.5% from 4Q'04 levels. Growth was constrained by the impact of fee cutting by large fund complexes and faster growth of funds with relatively lower fees. This largely offset the benefits of higher levels of assets under management on which fees are calculated.

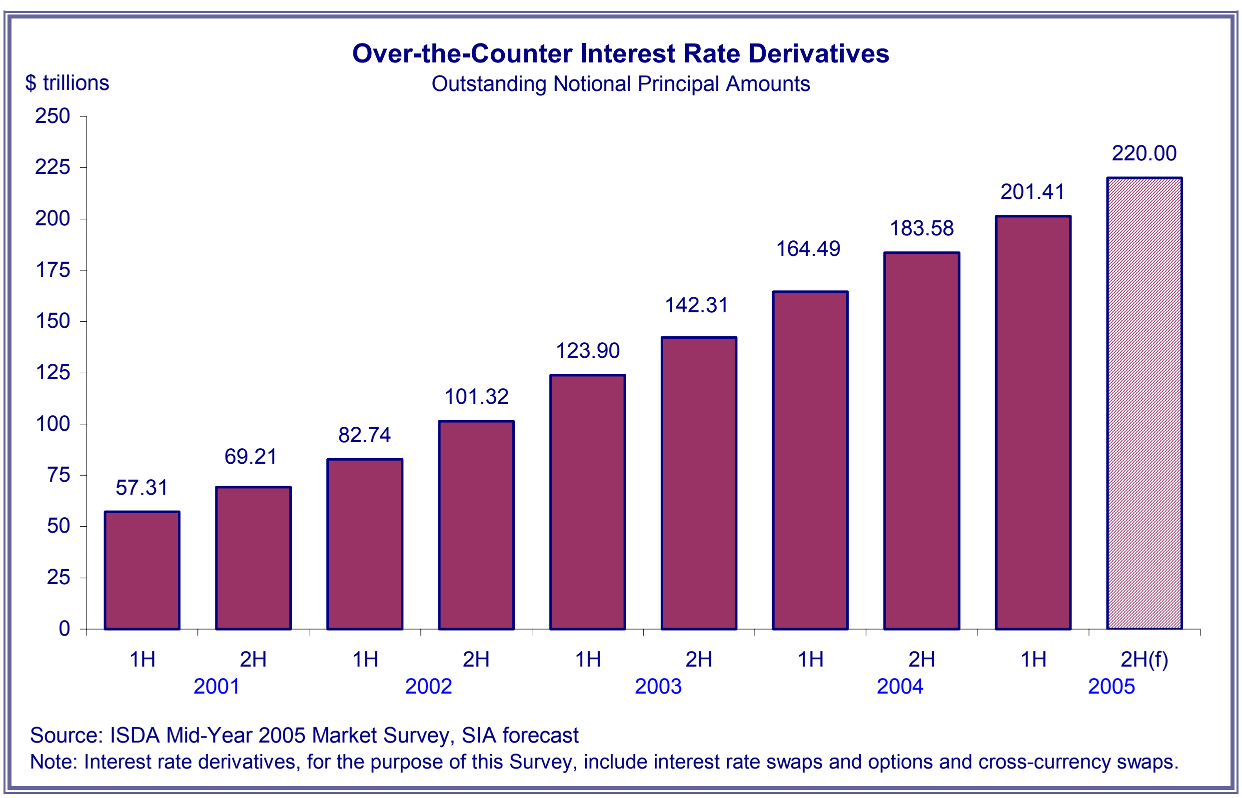


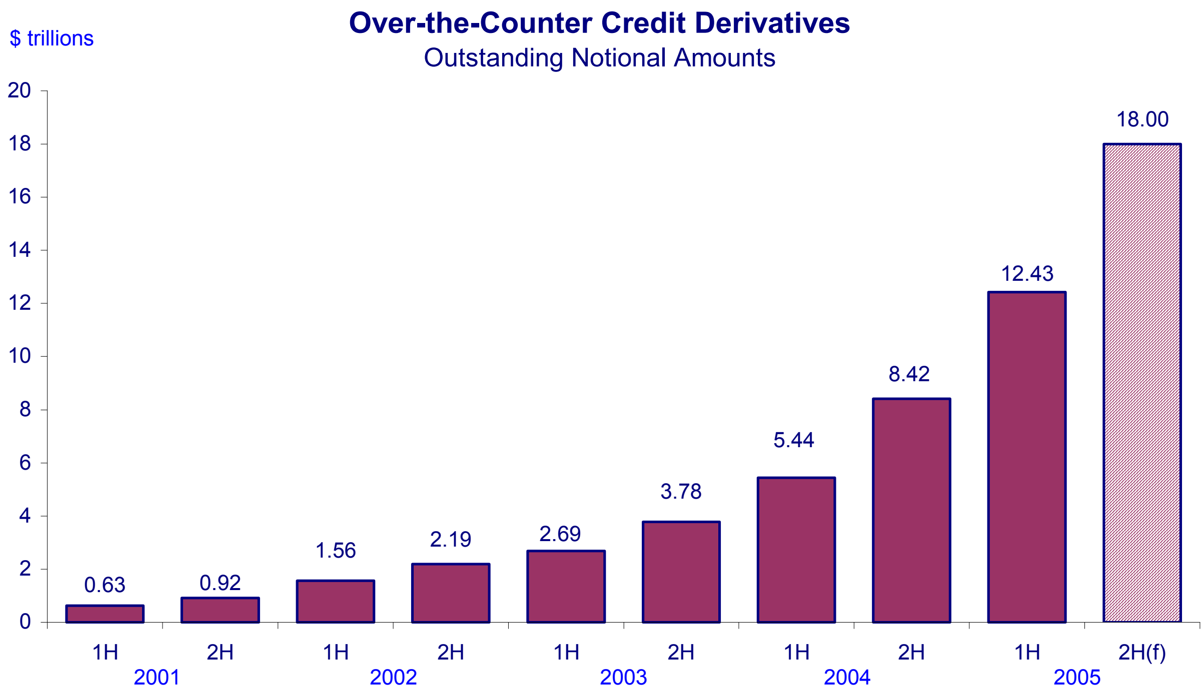
Trading gains rose an estimated 10.5% in 4Q'05 from 3Q'05 levels to reach $6.9 billion, reflecting a small uptick in market volatility and increased trading of commodities, precious metals and energy contracts.

Underwriting revenue reached an estimated $5.7 billion, down 2.0% from 3Q'05, but 8.3% above 4Q'04, reflecting changes in issuance volumes relative to these two earlier periods and slightly lower average fees. Revenues from debt underwriting fell as total debt issuance of $665.6 billion was down 14.5% relative to 3Q'05, but up 16.1% when compared to 4Q'04, due to the solid performance of asset-backed debt underwriting. Total equity issuance decreased 27.6% relative to 3Q'05 in spite of the notable increase in follow-on issuance during the month of December.

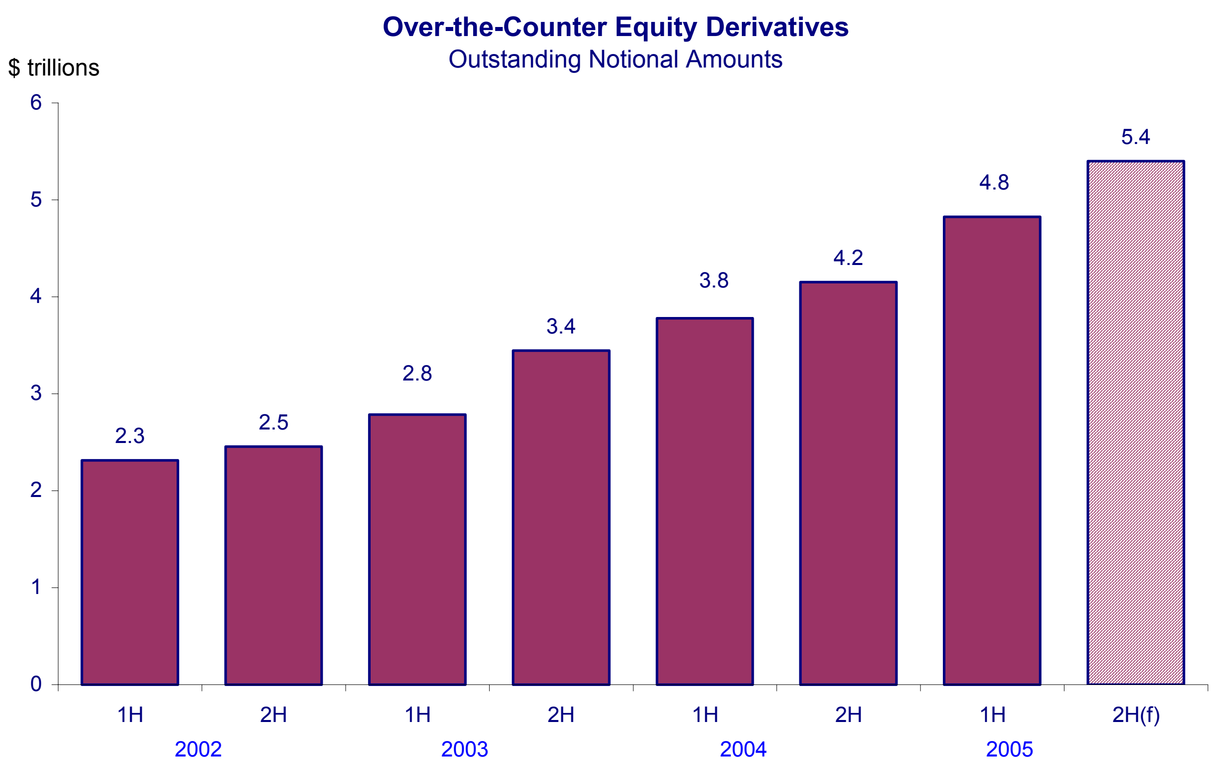


Other revenues related to the securities industry, including income derived from prime brokerage activity (spurred by still surging hedge fund activity), M&A, financial structuring, and other corporate finance activities, continued to rise solidly in the fourth quarter. November was an exceptional month for M&A, and it was followed by an unexpected jump in December. Deals in the pipeline suggest that M&A revenues will be even stronger in 2006. There is also an increasing appetite for high-yield investments, over-the-counter interest rate, credit and equity derivatives and structured products.



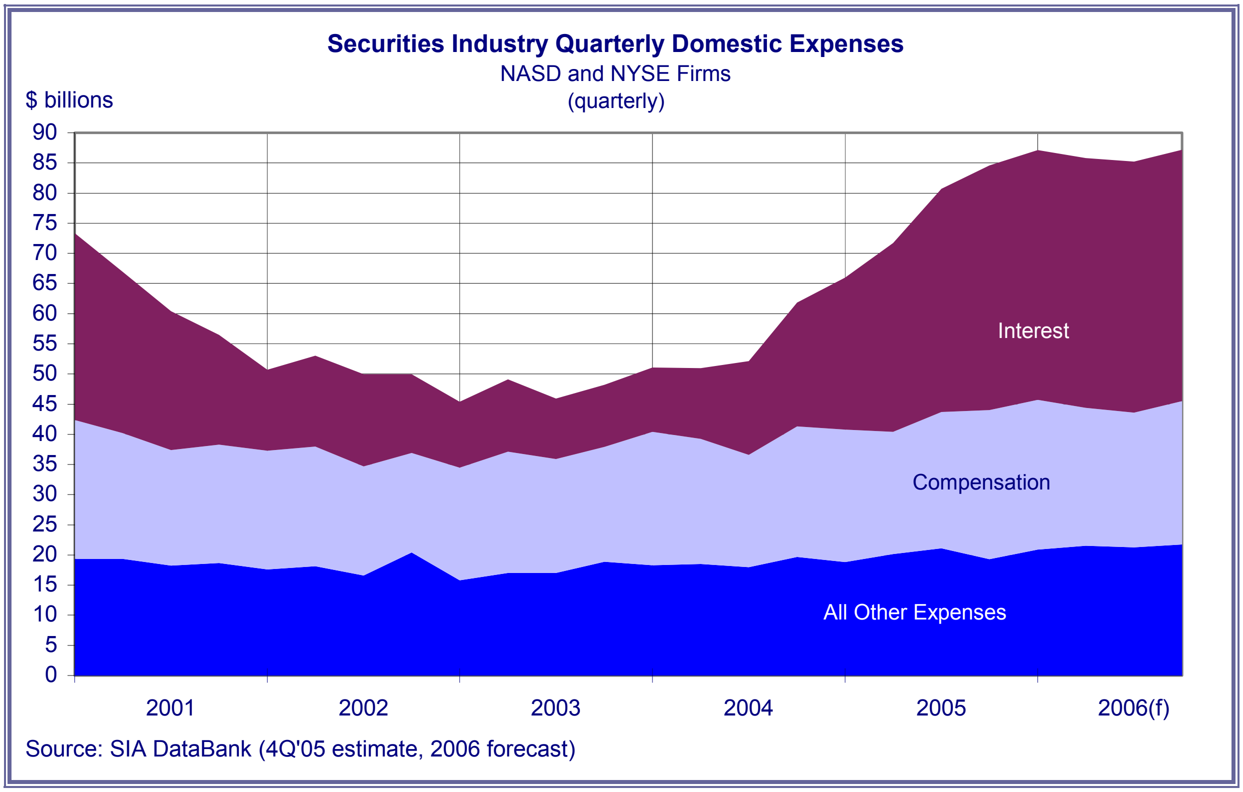


Source: ISDA Mid-Year 2005 Market Survey, SIA forecast
Note: Credit derivatives, for the purpose of the Survey, include credit default swaps, baskets and portfolio transactions indexed to single names, indexes, baskets, and portfolios.



Source: ISDA Mid-Year 2005 Market Survey, SIA forecast
Note: Equity derivatives, for the purpose of this Survey, include equity swaps, options and forwards.

Total expenses in 4Q'05 were an estimated $84.71 billion, 4.9% higher than in 3Q'05 and 37% above the same year-earlier period, largely reflecting higher short-term interest rates. Compensation expense rose 9.1% relative to 3Q'05 and 13.9% compared to 4Q'04, reflecting the securities industry's healthy revenue base and its interest in retaining top performers. Total floor costs rose 3% from 3Q'05 levels. All other expense items remained relatively stable, as the industry continued to focus on minimizing its fixed costs while increasing its productivity.



The Outlook for 2006

Our preliminary industry profits forecast for 2006 is for an 8% increase to $25.6 billion, which, if obtained, would be the best year since the record profits of $31.6 billion earned in 2000. Reflected in the outlook are expectations of slower growth in both revenues (13.5% increase in gross revenues and 6.2% rise in net revenues) and non-interest expenses (an increase of 6%). This outlook is expected to support continued job growth, with total industry employment forecast to rise between 2.5% and 3.0% after an increase of 3% in 2005. Growth in total compensation will also slow, due to a more constrained growth in variable compensation in calendar 2006 after a sharp increase in 2005.

The commoditization of trading and financial services as a whole will continue to put pressure on revenues, encouraging firms to continue to innovate, refocus and develop their activities in higher margin business lines and niche markets, while trimming resources dedicated to lower margin businesses. In this context, firms offering prime brokerage services will continue doing well, as the hedge fund industry matures. M&A and corporate advisory business will also continue enjoying solid double-digit growth riding a wave of consolidations. Interest rate, credit and equity derivative trading are also expected to enjoy strong, sustained growth. Rising credit concerns and the possibility that a relatively flat yield curve could invert, could constrain fixed-income origination. Regulatory changes and the unbundling of fees are expected to dampen revenues and offset some of the benefits of stronger expected secondary market volumes. With substantial liquidity on corporate balance sheets and expectations of high single-digit growth in earnings, we expect solid results for underwriting and equity trading markets. Mutual fund sales and asset management revenues growth is forecast to plateau, as the impact of ongoing declines in fees and sales charges are expected to be offset by the increase of investors' interest in retirement funds.

Frank A. Fernandez
Senior Vice President, Chief Economist and Director, Research

Isabelle Delalex
Vice President and Director, Industry Research

Grace Toto
Vice President and Director, Statistics

Securities Industry Association
120 Broadway, New York, NY 10271-0080
(212) 608-1500, Fax (212) 608-1604
info@sia.com, www.sia.com