

DIAMONDS & EXCHANGES

An overview - October 2009 memo

Diamonds & Exchanges

This article discusses the impacts and benefits of technology and e-exchanges (electronic exchanges) for global market places.

It identifies why the polished diamond market has lagged behind in this evolutionary progression.

The polished diamond market

The polished diamond market has historically been fragmented with individual bourses (exchanges) located in various hubs and diamond centres around the world. These bourses effectively act as a meeting place for industry members to work and carry out business in a secure and convenient environment. These fragmented centres have been particularly useful and helped drive trade. However, in recent times with the advent of technology and the progression of other global markets, the diamond industry has lagged in this area of development.

Various reasons have perhaps deterred industry leaders to follow the electronic market route, but many of the previous questions marks have been answered by the transformations shown in other markets.

Evolution of exchanges

An exchange is an organised market place where trade is centralised through a single mechanism allowing effective competition among buyers and sellers. This includes auction type exchanges, where trade effectively takes place through many non-related individual transactions between different permutations of buyers and sellers.

Its primary function is as a centre for facilitating physical trade and draws its strength from the capacity to act as a focal point for transactions, increasing security and ease of access. A well organised exchange forms natural reference points for physical trade which helps the price discovery process, allowing trade to take place more efficiently.

The shape of exchanges, including commodity exchanges, has changed drastically over years. The first big wave in their creation goes back to the late 19th century with the development of national and international marketplaces. Their initial role was to create a location where buyers and sellers could be sure of finding a ready market. This was the major factor that led to the creation of the Chicago Board of Trade in the 19th century as a solution for farmers who came to Chicago to sell their produce and at times found no buyers so often ended up having to dump their unsold cereals in Lake Michigan.

The next wave of exchanges came in the 1980s and 90s due to government withdrawal from direct intervention in the agriculture and the energy sectors. The liberalisation of trade and reduction of government support to the agricultural sector created fertile ground for the creation of new commodity exchanges, and the further development of existing ones. A third wave of exchange evolution began in the late 1990s, driven this time by technology rather than policy developments.

Due to the relatively recent growth of the internet, electronic trading has become a standard feature of exchanges (e-exchanges). This has permitted vast accessibility to various exchanges without requiring that a user be physically present within the exchange and without the necessity of 'paper trades'. Not only has the use of electronic trading greatly increased the ability to trade, but it has also increased the efficiency of the exchanges, with more users making easier, faster transactions.

Historical impact of technological advances in the financial markets

In financial markets, the Information Technology revolution began over 150 years ago. The telegraph, invented in 1838 by Morse and Vail, was used to transmit prices between New York, Philadelphia and New Orleans. This replaced horse and train journeys to accelerate market news from a week to half a day.

The Transatlantic cable, which in 1866 established telegraph communication between New York and London, affected pricing and changed trading practices in those cities' currency, stock, and bond markets. A time lag of 20 days was reduced to minutes, and the average absolute price differences for identical securities traded in the two cities' markets dropped 69 percent from their previous levels.

Thomas Edison's electromechanical stock ticker (1867), and Alexander Graham Bell's telephone (1876), were also rapidly adopted and enabled financial markets to extend their reach and importance in the economy. New York based brokerage houses that established a presence in other parts of the country became known as "wirehouses" for their reliance on telegraph communications.

E-marketplaces/E-exchanges

E-Marketplaces are virtual online markets where buyers, suppliers, distributors and sellers find and exchange information, conduct trade, and collaborate with each other via an aggregation of information portals, trading exchanges and collaboration tools.

For e-marketplaces to be truly successful they must exceed their purely technological roots and move beyond their single-minded focus on transactions to incorporate the human element. It is this human element that transforms them from impersonal trading arenas into collaborative commerce marketplaces based on lifetime relationship management, personalisation, marketing and trust.

The key to this transformation is best described using an alternative but appropriate version of the Four C's: commerce, content, collaboration and community. When all four of these critical components are combined the result is a collaborative marketplace in which buyers and sellers work together towards their mutual benefit. In the collaborative marketplace, transactions change from being isolated one-time affairs to becoming just another element in the interactive, ongoing exchange of goods and services.

Rather than being some kind of advanced futuristic phenomenon, collaborative commerce is really nothing more than a digitally enhanced throwback to the days when merchants and customers gathered together in a physical marketplace to barter over goods, discuss the events of their lives and conduct business as trusted partners.

Technological, legal, political, economic and organisational adjustments not only provide the potential for new types of contracts but can also allow a wider group of participants - who otherwise might have been unable to benefit from the services offered by the exchanges - to trade.

Benefits of centralised terminal markets

A global centralised market provides benefits that fragmented markets are not capable of. Importantly, true price discovery becomes a possibility rather than the reliance on a benchmark pricelist which has served the diamond industry well for the specific reason of its fragmentation. The price list helps traders gauge the value of their inventory and as there has been no direct communication channel it has been a particularly successful way of pricing.

However, it is undeniable that the best pricing mechanism come directly from market participants and generated through a bid-ask spread. This is where buyers individually decide what they are prepared to pay and sellers individually decide at what price they are prepared to sell. If all the buyers and sellers are grouped together it promotes competition in pricing and enables a true market price to be determined and ultimately a fair value which is the price at which a buyer and seller is prepared to meet. This is the basic principle of most commodity markets and has served their members well for hundreds of years.

Since the 90's all major commodity markets have moved their centralised markets from the traditional open outcry pits where members would gather and trade face-to-face, to electronic platforms which began with direct lines and has now moved to internet based connections. This has created substantial growth in these markets and enabled people from all corners of the world to trade with each other, overcoming distance, time zones and language. Therefore, trading volumes and liquidity have dramatically increased as access and entry has opened up. This has encouraged financial institutions and investors to become involved in markets in which they previously had no entry point for participation. In turn the new liquidity has brought in new revenue streams and provided increased wealth to these markets.

General business benefits

- There are greater opportunities for suppliers and buyers to establish new trading partnerships.
- E-marketplaces provide greater transparency in the trade process since true price discovery, availability and inventory levels are all accessible in an open environment.
- Time constraints and problems with different office hours for international trade are removed as it is possible to operate on a round-the-clock basis.

Benefits for the buyer

- Real-time information on price and availability makes it easier to secure the best price.
- E-marketplaces offer a convenient way to compare prices and products from a single source rather than spending time contacting each individual supplier.
- Established e-marketplaces provide a level of trust for the buyer as they are dealing exclusively with suppliers who are members.

Benefits for the seller

- Competing quotations from both new and current customers are possible and provides an additional sales and marketing channel.
- E-marketplaces can offer reduced marketing costs when compared with other sales channels.
- The use of international e-marketplaces can provide opportunities for overseas sales that you would not otherwise be aware of.

Impact of technology on other markets

The impact of the internet and computer technology has forever altered the climate of financial dealings around the world. Perhaps the most obvious example of the impact of emerging technologies on stock markets is the introduction in 1971 of the world's first 'virtual' stock market, NASDAQ. Owned and managed by the National Association of Securities Dealers, NASDAQ was extremely progressive. At the time, automated trading via computers was a much more cumbersome prospect than it is today.

Initially, NASDAQ trading relied heavily on the telephone to make the remote contacts to buy and sell stocks. Today, networked computers and the internet accomplish the task in a fraction of the time. The success of this exchange that has no real market 'floor' has been tremendous. In 1999 NASDAQ surpassed NYSE as the largest stock market in terms of the volume of issues traded daily.

When New York Board of Trade (NYBOT) began electronic trading soft commodities in 2007 the market share of electronically traded deals reached 36% just 13 days after launch. All commodity instruments including sugar, orange juice and cocoa saw growing electronic volumes with the switch particularly marked in coffee where over 50 per cent of contracts were traded electronically during the first month of trading.

Time for a centralised polished diamond exchange

There has never been a more pertinent time in the diamond industry for technological development to benefit the industry and its members. The wider global economic crisis and the failures of the credit markets have directly impacted the diamond industry and consequently caused severe problems for many within it.

There are varying reasons as to why a centralised market environment has not been achieved within the polished diamond industry until now. This is mainly due to the issue of standardisation which is complex for diamonds. However, the past decade has seen the advent of certification for polished diamonds which has mitigated this issue.

Leading gemological laboratories have spearheaded the development of grading guidelines and the accuracy and consistency has improved so much that in the past few years the grading reports carried out by laboratories such as GIA, HRD and IGI have effectively standardised individual diamond categories. Coupled with this the industry has also widely adopted this grading process which has even filtered down to the consumer who now desires a reputable grading certificate when they purchase a diamond to qualify and quantify exactly what they are paying for.

These certificates now play a vital role in the industry as they provide necessary standardisation for individual categories. Therefore, diamonds are now being traded based on certificate which was once an impossible concept as the traditional physical examination was thought to be mandatory.

Effects

This fundamental development allows the diamond industry to generate much needed new liquidity and revenue streams as there is now a clear understanding of what is being purchased. A global exchange capitalising on this development transforms the industry, bringing it in line with all major significant commodity markets.

The argument that diamonds are in some way mysterious and unknown is an old fallacy. Diamonds hold intrinsic value. They are a form of currency and always have been. They will still exist far beyond the spectrum of our lives. Therefore, there is an appetite for investment in diamonds and only an organised, centralised marketplace can facilitate this.

It is for the benefit of the industry to provide the environment for investment and this means the existence of an exit channel or resale market. Again this leads to the necessity of functioning terminal marketplace based on a two-way auction mechanism and true price discovery.

It is understandable that there is opposition within the industry from traditional merchants who dislike the concept of extending the reach of the trade. The diamond industry has a prolific history and rich traditions which should not be overlooked. Trust and good business practices are fundamental to continued growth but technological evolution and progression must also be considered.

The diamond industry is missing out on the benefits enjoyed by similar industries such as gold where there is a greater range and variety of market participants.

There are other significant benefits of an electronic diamond exchange which also need to be considered. Firstly the cost for diamond manufacturers to market their production globally is immense and eats away at profit margins. The cost of sending a sales force around the world to seek new business and the insurance premiums associated are significant. A central marketplace dramatically reduces the need for extensive marketing and therefore reduces costs and increases margins. It also allows manufacturers to concentrate on their core business rather than marketing.

Competitive pricing greatly benefits for the jeweller as well. Additionally, they currently experience inventory control issues of sourcing and holding. Again a central market provides the best means for just-in-time inventory, meaning they purchase as and when needed rather than keeping large stocks which lead to expensive insurance premiums and unnecessary consignment commitments.

Diamond banks will also benefit from an electronic centralised terminal market for polished diamonds as a transparent, efficient and competitive environment creates a healthier and accessible industry which allows the banks to extend their reach to a new customer and investment base.

DODAQ profile

DODAQ is the first online cash market for certified polished diamonds. It creates a transparent pricing mechanism in which each category has its own market and order book. Within that is represented the volumes and values of the buyers and sellers. This gives a greater insight into the value of a particular diamond category and the most important factor to consider is that the market participants decide how the price moves according to the values of the bids and offers.

DODAQ provides a two-way auction as opposed to a seller driven auction and uniquely offers instantaneous settlement as every diamond must first be received into the vault before being published on the exchange so its authenticity and existence can be assured. Therefore, DODAQ is neither an inventory list nor a transaction initiator, but a real cash market and due to its simplicity within a complex market place it enables new investors and revenue streams to provide extra liquidity and increase the reach of diamonds not only globally, but between sectors.

DODAQ is open to all, both within and outside of the industry, but as an anonymous exchange participants compete with each other purely based on price. Whether it is dealers, wholesalers or the wider market DODAQ brings price transparency and the ability to create an efficient marketplace for polished diamonds.

DODAQ launched live trading in January 2009. It is the only global marketplace offering transparent pricing for individual polished diamond categories and a real time cash market with instantaneous settlement. For further information please visit www.dodaq.com

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