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WHOOOPS! SO THAT'S HOW MUCH SHARE TRADES COST?

They can make a big difference to fund performance. Jacobus Troveri, head of RisCura Transition, discusses the advantages of TCA.

Analysis of transaction costs is an often-underutilised tool for asset managers and pension fund trustees. It allows them to monitor share trades for cost efficiency and quality of execution:

- 'Performance drag', due to sloppy implementation of trades, can have a significant impact on the performance of portfolios;
- The increased level of monitoring that comes with transaction-cost analysis (TCA) should bring with it a refocus of resources and energy by asset managers to deal with the large performance drag within portfolios caused by inefficient trading and execution;
- A pension fund that uses TCA will be better equipped to manage performance and reduce the execution drag on that performance;
- This increased level of monitoring will ensure that better relationships will be cultivated between brokers, asset managers and pension funds.

How to keep track of transaction costs

At present the costs of the entire process of portfolio transactions lacks the transparency that other facets of pension fund management and investment processes enjoy. The Madoff scandal is a great example of nobody checking the underlying transactions.

At this point in the industry, the only way properly to monitor these costs is through TCA. Otherwise, asset managers merely report the costs of their activities as a direct transaction fee in a single line without a breakdown of the detail behind those fees while ignoring the indirect costs completely. So it's difficult for pension funds to track their transaction costs as they're unable to see where and when in the process specific costs are incurred.

TCA enables a fund to recognise and understand the best and most cost-effective execution for its particular investment strategy by providing a way to monitor the details on a transactional basis. It allows funds actively to monitor both the actual cost of transactions on an individual-cost level for their portfolios and the benefit or loss of performance through the actual trades.

How to ensure that portfolios aren't being excessively churned

Portfolio churn has proven difficult for funds to measure and manage. It's prohibitive for funds to incorporate a maximum limit on trading, as they do with tracking error or cash exposure, within the agreements they enter with investment managers.

This is because it would potentially hinder managers' ability to manage the portfolio to the best of their ability. Sometimes a large amount of trading is necessary.

There is some risk and compliance reporting that currently cover a small aspect of turnover issues. But this report does not provide a complete picture, particularly on the extent of trading that occurs within individual asset managers.

This issue becomes extremely important where an asset manager has its own brokerage firm in-house. Especially when managers trade through brokers within their own organisations, trustees should be able to see the costs of asset management and brokerage services separately accounted.

This provides pension funds an opportunity to work collaboratively with their managers to ensure the best possible solution for controlling portfolio costs.



Troveri . . . need to monitor

How to assess fund performance nett of transaction costs

Rates currently being charged by brokers, through affiliated asset managers, are not regulated. Managers have discretion around those rates. Although most managers operate in a way that keeps costs low for their clients, there are no limitations imposed by pension funds on those rates. They vary from manager to manager on the type of service they are receiving.

This makes it even more difficult for pension funds to assess broker transaction costs. Without a TCA for a fund, transaction costs for brokers fall into a single line on the statement. It might include all sorts of other charges, such as bank charges, making it hard to track overall expenses per category.

Although a fund's direct transaction costs are small relative to the asset manager's fees, it's the indirect costs of poorly-timed trades and inadequate executions that have a significant and detrimental effect on the asset manager's performance. Badly-timed executions can cost a fund upwards of 120 basis points monthly.

Once compounded, this can make a massive difference. It illustrates the potentially disastrous effects of these indirect transaction costs when they aren't properly monitored and managed.