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Different times, different measures

In a trading environment prone to sudden shifts in price and volume, how are traders using transaction cost analysis and related tools to optimise performance?

Richard Schwartz

In November last year, Elkins McSherry, the execution analysis subsidiary of State Street, released a report that, in the normal course of events, would have alarmed the trading community. In the 12 months through June 2008, average costs of trade execution rose in 31 of the 47 countries surveyed by the firm. This contrasts with just one country in 42 during the previous year.

"Massive price swings are causing huge challenges for global equity trading," the report suggested. "Fierce market movements create huge savings and costs on a trade-by-trade basis, but the overall result is clearly higher delay and spread cost across the board."

Elkins McSherry may well be tempted to cut and paste this conclusion should they repeat the comparison in 2009.

In assessing the impact of this volatility on trading performance, it is useful to separate out trends in trading from trends in the analysis of the resulting costs. What role do measures of execution performance play in decision making in times of turmoil? How far is trading behaviour informed by cost analysis?

"Going back a few years, people used TCA in a fairly mechanistic way," says Michael Sparkes, director and managing consultant of analytical products and research for ITG in Europe. "But the more information we get about the conditions that were placed on an order, the more we can analyse the impact of those conditions on the results achieved."

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The notion of transaction cost is open to variation. "The definition of trade costs goes beyond the mere explicit execution cost; that is, the cost paid to a broker or to a trading venue," says Stephane Loiseau, deputy global head of execution services, Société Générale. "Implicit costs can represent the biggest portion of the overall transaction costs, but they can be complex to measure, particularly in fragmented markets."

How one measures is as important as what, especially when the market is febrile. "When I was looking at trading in Vodafone recently, there were 72 price changes and 90 trades in one second," says Richard Balarkas, CEO, Instinet Europe, an agency broker. In such circumstances, the methodology being used to gather trade data can have a material impact on the results. "With that speed of price and quote changes, how do you know if the data is representative if you snap the beginning of every second?" he asks.

Many on the buy-side do their own analysis and then use either third-party or broker-provided analytics almost as a control group. "Trading cost is a function of liquidity and will always be at the top of my list of priorities," says Bertil Meijer, head of equity trading at Dutch pension asset manager APG Investments. "Liquidity has certainly dropped, which has had a detrimental effect on costs. This only makes our job more important."

Meijer is cautious about the uses of externally provided measures. Like Balarkas, he points to TCA providers' differing data-gathering processes. "Some use all tick data, some only from exchanges, some include crossing data and some don't," he says. In addition, Meijer observes, most TCA providers also look at data on real trades provided by their clients. "Given that it is usually the traders themselves who provide the data in a free format excel spreadsheet, I don't really pay too much heed to the resulting trader rankings since data can be omitted."

Not all of the challenges involved in making sense of trade data are a result of recent market conditions. "Frankly, I would say that in Europe we're still some way behind the US in terms of overall penetration of transaction cost analysis across the whole industry," says Sparkes. "Some of that is about the take-up of order and execution management systems. And with additional drivers such as MiFID and fragmentation, a lot of our clients have been looking for both more information and more frequent information, leaving aside market volatility and big price falls."

Choppy waters

Trends in TCA usage and methodology notwithstanding, how seriously traders are applying the analysis of data to trading decisions in choppy waters? "To many buy-side traders, the best indicator of a good trade is that they found the liquidity," notes Balarkas. "That may have cost 50bps more in market impact, but if you've got customers banging on the door for redemptions, you want to get the trade done."

On the surface, says Loiseau, increased price volatility has reduced the relative importance of trading cost. "Most traders understandably won't care so much about a one basis point saving on trading costs, when the market can move 5-10% intraday and liquidity has become fragmented across several execution venues and broker-dealer systems, both displayed and non-displayed," he says.

The challenge of finding liquidity has led to a shift in choice of algorithms, with a number of brokers pointing to a growing preference for implementation shortfall, even if it results in greater market impact and transaction cost.

Vikas Kedia, CTO, FlexTrade, a supplier of algorithmic trading platforms and execution systems, understands the sense of urgency that traders feel. Nevertheless, he observes, while the use of implementation shortfall has increased, it is not necessarily the right thing to do with certain types of large trades. "If your order is more than 5% of average daily volume and you try to do it in an hour, you'll affect the price so much that your trade costs will soar," he says. A VWAP algo in principle allows the trader to spread the order and measure it against something that is more realistically achievable. The problem, however, is that in a volatile market a VWAP strategy exposes an order to the danger of a much greater price swing. Choice of both benchmark and strategy can therefore depend on judgements of real-time trading conditions.

Real-time benefits?

Opinion is divided on how useful transaction cost analysis is in helping traders choose between strategies and venues in real time when the market is jumpy. "Most people tend to look at trends. They don't necessarily look at individual trades," says Balarkas. Kedia acknowledges that increased volatility can significantly skew the results for any single transaction. "We average out the data across a large number of trades over time and over broker," he explains. "That allows the client to get a more realistic idea of performance."

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Sparkes concurs. "The majority of clients are not really looking at what you could loosely describe as real-time TCA, but at the bigger picture and the longer term." Until fairly recently, he says, the most widely-used frequency of transaction cost analysis was quarterly. "While a lot of people have moved from that down to monthly, weekly or daily, intraday is still not something that very many people do in a systematic way, though we do offer it."

Advocates of real-time use of TCA, meanwhile, point to the need to help traders in tough situations

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where they need support. UBS recently launched a real-time TCA service through UBS Fusion, the firm's equity trading analytics platform, which enables clients to have live, continuous analysis of their orders while they are still executing. "Times of volatility show you the limitations of historical analysis," says Mark Goodman, managing director, direct execution services, Europe, at UBS. "Every day is unique so you really can't rely on historical data to the same extent as before. In times of volatility, people need to focus on 'what's happening to my trade now'."

One of the aims of the service, says Goodman, is to give clients a comprehensive real-time idea of where their liquidity is coming from, including the ability to distinguish between light and dark venues.

Whether a decision made in real time proves to have been the correct one will to some extent depend on information beyond the moment. "It's partly about degree of urgency and partly about timing," says Sparkes. "What happened next?" To answer that question, ITG's Alpha Capture Service looks not just at the execution costs but also at the post-trade returns for 30 trading days after execution.

The human touch

With many buy-side dealers responding to sustained market uncertainty by relying more heavily on sell-side sales traders, TABB Group research analyst Matt Simon suggests any realistic metric should take into account more than trade costs. A holistic 'execution cost management' approach should involve variable costs – execution fees, messaging charges and clearing and settlement – as well as fixed costs such as exchange memberships, hardware, bandwidth and support staff. However, with resource constraints already tight, says Simon, "few small- and mid-size brokers have the internal resources to build systems to capture, aggregate and analyse all of the needed data."

For Loiseau, it is not so much volatility that penalises the analytics provided to buy-side traders as shortfalls in the trading products they have access to. "You have to remember that many traders still do not have real-time access to a pan-European order book, for example, or to prints from all execution venues," he points out. Since liquidity is no longer concentrated on legacy exchanges, the reporting of transactions has also been fragmented, making it more difficult to analyse the data.

"Ideally," says Loiseau, "you want real-time analytics to be able to make the right trading decisions: whether to trade on one venue versus another; whether implementation shortfall is better than VWAP in certain market conditions. But at the current stage, just getting basic trading information remains the key challenge for many traders."