

Making the right choice

FlexTrade's Bertrand Rassat and Vikas Kedia describe the benefits of transaction cost analysis software in today's volatile equity markets

In a bear market characterised by volatility and fluctuating trade volumes every penny counts. Investors want to know how their money is being used by fund managers, fund managers need to achieve best execution in pursuit of improved trading performance and traders must prove they are doing a great job to secure their positions in the investment process.

Just a few years ago, when funds frequently showed returns of 10% to 20%, transaction costs of 2% or 3% were largely ignored. But time and financial circumstances have moved on, leaving funds with a 3% return and transaction costs of 2% showing little performance upside. Clearly, by pushing down transaction costs, performance should rise, but how is this best achieved?

One answer is pre-trade transaction cost analysis, which not only identifies costs in the investment process, but also the best venues for the execution of specific trades and the best, and worst, traders. Software solutions have been on the market for some years, even before the MiFID 2007 deadline for demonstrating best execution, and most large asset managers have implemented either vendor or in-house developed transaction cost analysis tools in their trading systems. For those that have not yet embraced the technology, today's markets have changed its status from a 'nice to have' add on to an essential element in the portfolio manager's tool set.

While transaction cost analysis has become an important part of the investment process

– making sure costs are appropriate to particular trades and allowing portfolio managers to account for transaction costs in their profit and loss forecasts – it is only valuable if it is measured correctly.

Here, benchmarks are crucial and need to be selected dependent on the reason for a trade, the style of the portfolio manager and the size of a trade. In the case of a small order of highly liquid stocks, the benchmark should be the arrival price. Using this benchmark, the price of the order can be compared to the price of the stock when the trader received the order. If the prices diverge significantly, the additional cost can usually be associated with the trader, suggesting, perhaps, that the trade was not made immediately after the order was received. Any time lapse also increases the risk attached to the order. At this level of trading, the transaction cost based on the arrival benchmark should be minimal, probably within one spread unit.

A higher volume order needs to be traded on the basis of a different benchmark. The aim here is to minimise market impact and the time it takes for the order to be executed. In this case, the market participation benchmark – or the average price of a stock through the trading duration – should be selected, as the best way to fill the order is by putting it into the market little by little as stock appears. The order should be complete in about 10 minutes, leaving it open to high volatility risk, but minimising market impact.

While different participation rates generate different market impact costs and trade durations determine different volatility risk costs, pre-trade transaction cost analysis tools can discover the point where the sum of these costs is minimal and trading is optimal.

As trading volumes increase to create orders that cannot be completed in one day, the benchmark changes again, this time to the volume weighted average price – or VWAP – benchmark. The strategy here is to ‘hide’ the order for as long as possible to avoid the costs of market impact.

Multiple trading venues, such as dark pools and multilateral trading facilities, may be used for a very large order, with pre-trade transaction cost analyses informing decisions made by the portfolio manager or trader on where and when to trade. For example, if an asset manager can trade in a dark pool of liquidity with another asset manager there are no transaction costs other than the fees paid to join the pool. A similar trade on the stock market is likely to attract transaction costs of 3% to 4%.

The costs of high volume VWAP orders can be difficult to analyse, but they can be averaged and asset managers are increasing their efforts to categorise orders – perhaps the purchase of 1% of a company’s stock – so that the transaction costs of orders of a similar type can be viewed against an historic trend.

At the moment, most asset managers maintain their own share trading data to use as a base for decision making, but many show an increasing willingness to share historic data with peers on the basis that the analysis of a wider scope of share trading information will deliver a more accurate picture of what the costs involved in different types of large orders should be. The interest in data sharing among asset managers to better understand costs is beginning to be acknowledged by software providers, although



Bertrand Rassat



Vikas Kedia

there is much work to be done before high quality tools for gathering and analysing large volumes of trading data will be widely available to the buy-side.

Transaction cost analysis is vital in making smart trading decisions, but also in helping asset managers to set accurate performance expectations and identify brokers that deliver the best execution costs for particular types of orders.

As well as providing portfolio managers with valuable insight into trading and best execution, transaction cost analysis software has reporting capabilities that can be used both internally and externally to show investors a breakdown of where in the investment process costs are incurred and how a change in the process, perhaps a switch in traders, affects costs.

As clients search for better returns on their investments, best execution strategies are under scrutiny – and without transaction cost analysis software it is difficult, if not impossible, to demonstrate that such strategies are being applied successfully.

Bertrand Rassat is managing director and Vikas Kedia is chief technology officer of FlexTrade Systems Europe.