No hiding place

Robert Kay, MD of GSCS Information Services, explains that improved information flows and analysis reveal that some traders and algorithms do indeed perform much better than others, which may have far reaching consequences.

Proprietary traders are paid to make money from trading. Their daily profit and loss account quantifies their success or failure and much of their compensation. A typical hedge fund receives 20% of any profit it makes from trading within its performance fee structure. In contrast the rewards traditional asset managers earn from improved trading are typically worth less than one basis point.

The long-term qualitative results of these differing trading 'contexts' are starkly visible in trading rooms. Proprietary traders get to design and build sophisticated technology to aid productivity, integrate low-latency market data and enhance performance. Hedge fund traders are provided by brokers with their very latest and best 'client tools' for electronic trading. In contrast, buy-side traders at traditional asset managers often struggle to get approval for basic trading support tools and market data.

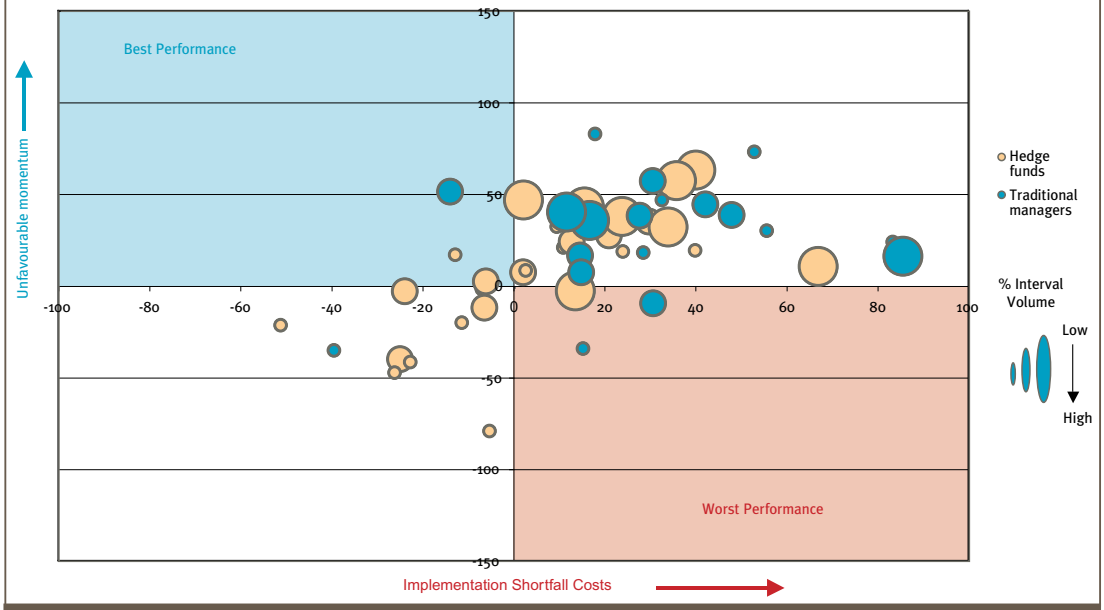
Trading results at traditional asset managers could be expected to be weaker than at hedge funds. The unanswered questions are how much worse is it; and does it really matter if all traditional asset managers are equally impacted? For many senior executives at these institutions, trading technology and salaries are always real and paid for by the firm, while trading improvements are hard to quantify and benefit clients. For most, average trading is good enough. If portfolio managers keep picking the right stocks, trading costs are considered an incidental distraction to overall performance. There seems no reason to invest in order to excel in trading.

Robert Kay

Recent research by GSCS Information Services suggests that these assumptions are wrong and dangerous. Analysis of the trading performance of hedge funds and traditional managers suggests that the difference in performance is substantial and may explain a material part of the superior average returns achieved by hedge funds. In other words, by regarding trading desks as 'cost centres' and failing to support them with the very best people and most sophisticated tools, senior management at traditional asset managers has presented hedge funds with an 'open goal' in terms of performance differentiation. Table 1 illustrates some summary results of the analysis, taking account of volatility, momentum, time in market and order size of different types of manager trading UK stocks.

Executives should also recognise that automation not only improves trader productivity, it means more, and more accurate, data is available about how trades are actually completed. This is true whether they are done manually; by human traders supported by algorithms and SORs; or simply by 'black boxes' completing trades with minimal, or even no, human intervention. Senior managers can and should compare the

TRADING PERFORMANCE



Source: GSCS Information Services

performance of traders, human or algorithmic, within their firm and against others. Measures of trading performance are statistically valid, quantification of differences accurate and conclusions harder to 'explain away'. Traders performing well have nothing to fear. Those who are not, whether people or computer programs, are now under threat.

Comparing performance is only the start. Gaining a sound understanding of those elements of the investment, trading and execution process with potential to improve results is now practical. Technology allows consultants at GSCS to identify and quantify key factors. Relatively 'simple' changes in approach can result in materially better performance, though these differences often challenge some of the long held assumptions of buy-side traders. Simply, the data shows it is possible to trade much smarter and better and some firms do, even as many do not.

Volatile markets make the consequences of poor trading more visible to senior executives as well as traders. Human traders and those providing algorithms should therefore expect more searching scrutiny of their trading results. The outcome will be lower overall costs of trading. With no place to hide there will be a fierce cull of indifferent traders and 'me too' algorithms but a commensurate growth in the number of genuine 'alpha' traders, delivering real benefits. ■

GSCS Information Services

Under the microscope

Poor investment returns and high trading costs mean traders could face some tough questions about the value they are adding.

Global equity markets remained unsettled and challenging during Q1 2009. The extremes of the latter part of 2008 may not have been revisited but their impact remains visible. Asset levels are still a long way down, trading levels are down even more and expense concerns are building up. Consolidation is already making its mark with associated job losses throughout the industry. In such a climate, buy-side traders are under increasing pressure to justify why they are necessary and whether they are a contributor to investment alpha or simply an administrative/compliance expense.

The latest country data suggests that traders' contribution to investment performance is not improving. Overall implementation shortfall costs were more than 50 basis points in all major European and North American markets. While the position in Asia was slightly better, the numbers remain disappointing. Average agency

> "The latest country data suggests that traders' contribution to investment performance is not improving."

The data provided by GSCS Information Services is based on its global equity transaction cost measurement universe. This universe incorporates representative transactions from more than 300 investment management companies, using more than 500 institutional brokers. The total number of transactions in the universe grows at a rate of around six million per annum across more than 50 countries.

COUNTRY ANALYSIS – DEFINITIONS

Market impact
Market impact, expressed in basis points, is calculated based on a comparison between the execution price and the price of the security immediately before the trade was put in the market by the buy-side trading desk. This is commonly known as Release Time price.

Cost of delay
Cost of delay expressed in basis points represents the costs incurred as a result of delays between the decision to trade being made and the trade being put into the market.

Implementation shortfall
Implementation shortfall, expressed in basis points, reflects the difference of a paper portfolio versus the actual portfolio purchased. This is calculated based on a comparison between the execution price and the price prevailing at the time the decision to trade is made (or where this is not known, the open price on the trade date).

Average commission
Commission, expressed in basis points, reflects all trades (including program trades) that bear commission. However, it excludes any principal or zero commission trading activity.

% zero commission
This shows the relatively low proportion of activity in most countries that is carried out by dealers acting as principal and not charging a commission to act as a broker on behalf of clients.

commissions of 10-15bps, depending on the markets involved, means that trading is removing 125bps from alpha a year, assuming normal levels of investment turnover. Highly-paid traders using expensive technology and market data are going to be pressed hard for explanations of this kind of cost to clients, particularly when it has increased by 60% in less than a year.

The main factors that will be cited are market volatility, lack and growing fragmentation of liquidity and the fact that traders have to execute what their portfolio managers decide. All of these reasons are as valid today as they have always been. The difference now is that senior executives may be less happy to accept 'average' performance. Though average relative performance has typically been good enough in investment management generally, this may no longer be sufficient to guarantee survival of the company or its employees. When it costs a portfolio manager more than 200bps to switch from one Dutch or Italian stock to another, everyone will probably start looking

COUNTRY ANALYSIS

	Market impact (bp)	*Cost of delay* (bp)	*Implementation shortfall* (bp)	*Average agency commission* (bp)	*% zero commission* (%)
Europe – major					
Finland	27	91	118	11	2.5
France	9	43	52	7	3.0
Germany	19	54	73	10	2.5
Italy	31	63	94	10	2.4
Netherlands	22	72	94	11	2.0
Norway	39	36	75	13	1.3
Spain	21	28	49	10	3.2
Sweden	15	69	83	13	1.1
Switzerland	20	55	76	12	3.6
UK	28	33	61	13	1.6
North America					
Canada	15	41	56	12 (4.6 c/s)	4.0
US	18	54	71	12 (3.4 c/s)	2.3
Asia – major					
Australia	12	6	19	18	2.3
Hong Kong	50	19	69	16	1.1
Japan	36	4	40	11	1.2
Korea	75	13	89	22	0.0
Singapore	24	88	112	23	0.4
Taiwan	51	-2	49	24	0.0
Other – select					
Brazil	55	-15	28	20	4.0
Greece	41	59	100	16	2.9
Hungary	59	89	148	30	0.1
Ireland	46	-1	45	12	2.9
Malaysia	6	99	105	24	0.2
Mexico	67	74	140	21	5.0
Poland	14	61	75	24	0.7
Portugal	22	14	35	10	3.2
South Africa	15	71	86	16	1.3
Thailand	1	7	8	33	0.1

Leading stocks – Q1 2009

much harder for genuine performance improvement rather than being content with average.

As might be expected, trading costs in emerging markets were even more extreme. Implementation shortfall in Hungary and Mexico was almost 150bps and Malaysia and Greece saw costs of 100bps or more. While accepting that greater volatility is inevitable in these countries, the costs certainly undermine some of the portfolio management approaches that work well when costs are lower.

Survive and prosper

To some extent the market is beginning to settle down as it becomes clearer that the brokers who have survived this far are likely to stay in business. The 'flight to quality' that might be expected has not been especially material to date, with most brokers maintaining market shares in Q1 comparable with those in earlier periods.

However, the survivors will not necessarily all prosper and many may see temporary problems in

LEADING STOCKS

	Market impact (bp)	Cost of delay (bp)	IS* (bp)	Buy (%)	Sell (%)	Leading brokers
US						
Altria Group	51	-12	39	96.40	3.60	Cazenove/Merrill Lynch/Deutsche
Wells Fargo	-62	229	167	34.10	65.90	Deutsche/Merrill Lynch/Keefe
Apple Computer	40	75	116	78.50	21.50	Credit Suisse/Goldman/UBS
Canada						
Barrick Gold	43	107	150	33.10	66.90	Deutsche/UBS/Credit Suisse
Kinross Gold	15	-89	-74	37.00	63.00	UBS/Deutsche/Nesbitt
Goldcorp	59	37	96	9.10	90.90	Deutsche/UBS/CA Cheuvreux
Finland						
Nokia	16	118	134	56.60	43.40	CA Cheuvreux/UBS/Merrill Lynch
Sampo	55	82	137	43.00	57.00	Deutsche/Carnegie/UBS
UPM	53	38	91	43.10	56.90	CA Cheuvreux/Credit Suisse/Deutsche
France						
Total	21	18	39	56.60	43.40	Merrill Lynch/JPMorgan/CA Cheuvreux
Sanofi-Aventis	-4	7	2	65.90	34.10	Merrill Lynch/Morgan Stanley/ JPMorgan
Gaz de France	18	30	47	54.40	45.60	Merrill Lynch/CA Cheuvreux/JPMorgan
Germany						
Allianz	9	24	33	60.70	39.30	Deutsche/Merrill Lynch/CA Cheuvreux
Bayer	-27	31	4	49.70	50.30	UBS/Morgan Stanley/Deutsche
E.ON	5	26	31	52.70	47.30	Merrill Lynch/CA Cheuvreux/Morgan Stanley
Italy						
ENI	19	47	66	52.40	47.60	Exane BNP/Deutsche/Merrill Lynch
Banca Intesa	31	-9	22	47.10	52.90	Banca Leonardo/Deutsche/ Euromobiliare
Unicredito	17	216	234	45.90	54.10	Mediobanca/CA Cheuvreux/UBS
Netherlands						
ArcelorMittal	24	102	126	48.50	51.50	Merrill Lynch/Credit Suisse/Morgan Stanley
ING Groep	25	302	327	61.20	38.80	Deutsche/Merrill Lynch/Credit Suisse
Unilever	27	-15	13	65.40	34.60	Deutsche/Merrill Lynch/CA Cheuvreux
Norway						
Statoil	38	-8	30	32.00	68.00	Morgan Stanley/Goldman/Citation
Storebrand	45	85	130	45.90	54.10	Goldman/Danrek/UBS
Yara Intl	1	39	40	58.00	42.00	Credit Suisse/ABG/JPMorgan
Spain						
Telefonica	5	4	9	45.80	54.20	CA Cheuvreux/Deutsche/Merrill Lynch
Banco Santander	26	80	106	50.60	49.40	Merrill Lynch/CA Cheuvreux/Credit Suisse
BBVA	25	81	106	42.30	57.70	Merrill Lynch/Citi/CA Cheuvreux

**IS = Implementation shortfall*

Leading stocks – Q1 2009

LEADING STOCKS

	Market impact (bp)	Cost of delay (bp)	IS* (bp)	Buy (%)	Sell (%)	Leading brokers
Sweden						
LM Ericsson	12	79	91	46.00	54.00	Morgan Stanley/UBS/Merrill Lynch
Svenska Handelsbank	33	16	49	76.30	23.70	Goldman/Carnegie/Enskilda
Atlas Copco	21	108	129	46.40	53.60	Carnegie/UBS/Instinet
Switzerland						
Roche	4	27	31	56.90	43.10	UBS/Credit Suisse/Goldman
Nestle	0	20	20	48.90	51.10	Merrill Lynch/Deutsche/JPMorgan
Novartis	12	61	73	43.20	56.80	Merrill Lynch/UBS/Morgan Stanley
UK						
BP	-8	57	49	15.90	84.10	Deutsche/Merrill Lynch/Nomura
AstraZeneca	15	23	37	54.80	45.20	UBS/Deutsche/Citi
GSK	37	32	69	64.90	35.10	Deutsche/JPMorgan/Morgan Stanley
Australia						
BHP Billiton	-2	-5	-7	49.70	50.30	JPMorgan/Macquarie/UBS
Rio Tinto	32	-12	20	67.90	32.10	UBS/Credit Suisse/Goldman
Newcrest Moning	-26	38	11	62.60	37.40	South Cross/UBS/Credit Suisse
Hong Kong						
China Mobile	58	10	67	23.60	76.40	Morgan Stanley/JPMorgan/Credit Suisse
Bank of China	1	16	17	94.80	5.20	Morgan Stanley/Deutsche/Credit Suisse
China Construction Bank	38	45	83	45.70	54.30	Citi/JPMorgan/Credit Suisse
Japan						
Nomura Holdings	-30	-1	-31	70.30	29.70	Citi/UBS/CLSA
Nintendo	-8	30	22	55.30	44.70	CLSA/Nomura/UBS
Mitsubishi UJF	35	-12	23	69.70	30.30	Morgan Stanley/Nomura/UBS
Singapore						
Singapore Telecom	-9	127	118	60.70	39.30	JPMorgan/Morgan Stanley/Duetsche
DBS Group	15	27	42	64.30	35.70	UBS/Credit Suisse/Citi
UOB	-14	29	14	43.80	56.20	Deutsche/Merrill Lynch/Credit Suisse
South Korea						
Samsung	44	2	46	54.30	45.70	JPMorgan/Merrill Lynch/Deutsche
KB Financial	127	-8	120	32.80	67.20	Merrill Lynch/Citi/JPMorgan
Shinhan Financial	78	-15	63	44.80	55.20	Deutsche/Nomura/Exane BNP
Taiwan						
TSMC	35	-7	27	66.30	33.70	Exane BNP/CLSA/JPMorgan
Chunghwa Telecom	51	-14	37	32.80	67.20	JPMorgan/Merrill Lynch/Credit Suisse
Mediatek	6	-10	-3	78.70	21.30	Merrill Lynch/CLSA/Deutsche

**IS = Implementation shortfall*

LEADING STOCKS – DEFINITIONS

For each of 10 European major markets plus the US, the three most widely traded securities during the last quarter are identified. The 'Buy/Sell (%)' indicates the value of buys and sells as a percentage of the total value traded. It indicates the extent to which institutional investors as a whole were adding to their position during the period. The table identifies the three brokers that handled the highest proportion of trading activity in the stock.

"The 'flight to quality' that might be expected has not been especially material to date."

developing their business. Some traditional players, such as Citi, have faced significant challenges in other parts of their investment banking business. For firms that are under new ownership, such as Merrill Lynch, and those that have acquired businesses, such as J.P. Morgan, the challenge is to ensure the

Leading brokers – Q1 2009

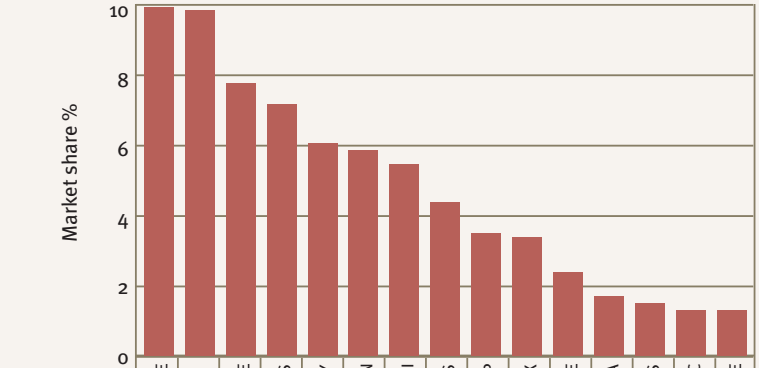
integration process does not distract them from maintaining market share and making necessary investment in the underlying business.

Among the global dealers, Merrill Lynch and Deutsche have maintained the top two places in the value traded and commissions earned rankings. UBS has dropped to fifth from third in terms of value traded while Citi has fallen to eighth from fourth.

Somewhat surprisingly, Goldman Sachs continues to rank rather poorly on both commission and value traded, only just in the top 10, even while Morgan Stanley has shown improvement in the latest period. Cheuvreux, BNP Paribas and Société Générale now all seem well established in the rankings, though still, in terms of continental dealers, well behind Deutsche, UBS and Credit Suisse.

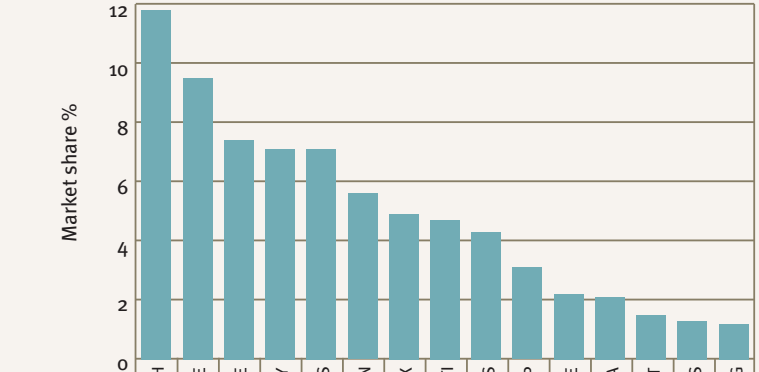
In the US, Merrill Lynch continues to dominate the commissions earned rankings with 12.7% of the total. It also moved to first from third in the value traded table. Goldman Sachs, although yielding top spot in the value traded ranking, remains firmly in the top

Q1 2009 LEADING GLOBAL BROKERS – TOP 15 RANKED BY COMMISSION



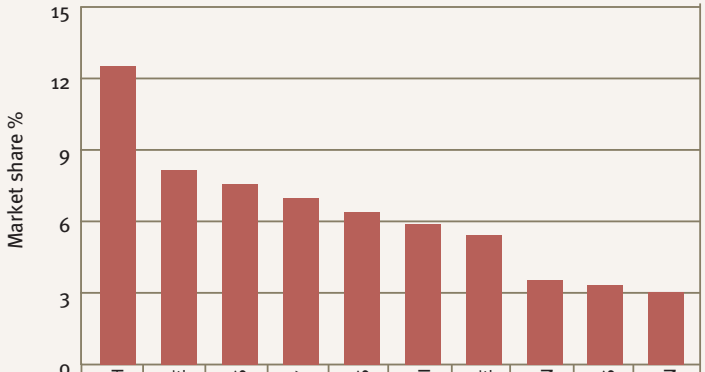
Rank Q1 2009	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Rank Q4 2008	2	1	3	5	7	6	4	8	11	9	10	14	13	12	–

Q1 2009 LEADING GLOBAL BROKERS – TOP 15 RANKED BY VALUE TRADED



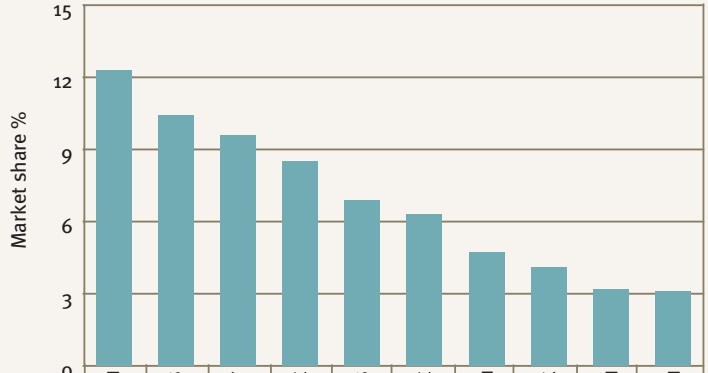
Rank Q1 2009	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Rank Q4 2008	1	2	5	6	3	7	11	4	8	10	9	13	12	14	15

Q1 2009 LEADING US BROKERS – TOP 10 RANKED BY COMMISSION



Rank Q1 2009	1	2	3	4	5	6	7	8	9	10
Rank Q4 2008	1	8	3	7	5	6	4	2	–	9

Q1 2009 LEADING US BROKERS – TOP 10 RANKED BY VALUE TRADED



Rank Q1 2009	1	2	3	4	5	6	7	8	9	10
Rank Q4 2008	3	1	2	4	6	5	8	–	7	10

> "The dominance of the top brokers has been weakened slightly."

three on both measures. In general the dominance of the top brokers has been weakened slightly. In the same quarter a year ago the top 10 brokers accounted for 74% of commissions earned and more than 80% of value traded. In the latest period the comparable figures are 64% and 69%. Whether this represents a secular shift away from the previous trend towards consolidation remains to be seen.

LEADING BROKERS – DEFINITIONS

Market share 'by value traded' is calculated based on the level of trading completed across all global equity markets. The share 'by commission' reflects the combination of both the value traded and the average commission rates charged. It is reasonable to assume that where market share by commission exceeds market share by value, above-average levels of commission are generally being charged.

Trading momentum – Q1 2009

Cold comfort

The first quarter of 2009 saw continued volatility of markets generally and of the securities traded more specifically. However there was at least some respite from the extreme position at the end of 2008. The GSCS Degree of Difficulty Index declined substantially to 300.0 from 393.1. However this was still the second-highest reading on record and means that the level of difficulty that buy-side traders are dealing with is still three times that seen in early 2007.

Given the obvious impact on trading costs, it is surprising how many portfolio managers seem intent on trading when stocks are at their most volatile. While managers of 'open-ended' funds may be required to realise cash to cover daily redemptions, such a limitation does not apply to investment of cash, nor to funds with separate account mandates from large pension funds. However, even managers who enjoy such flexibility appear just as vulnerable to following short-term market movements.

The GSCS Momentum Index again saw only limited change overall, increasing to 39.4 in Q1 2009 from 36.3 in Q4 2008. However, once again, when managers had to sell, they were doing so into falling markets. The Momentum Index for sells was up at 101.0, compared with the previous record of 83.9. Momentum on buys was much lower, however, at 21.6 – no doubt in part because markets were generally in decline.

MOMENTUM TABLE

ALL	*Q1 2009*	*Q4 2008*	*Q3 2008*	*Q2 2008*	*Q1 2008*	*Q4 2007*	*Q3 2007*	*Q2 2007*	*Q1 2007*
Very unfavourable	27.1	33.8	23.4	16.8	21.9	17.1	13.9	7.7	8.5
Quite unfavourable	11.0	8.7	11.7	12.9	12.4	12.7	12.7	11.6	12.1
Somewhat unfavourable	13.8	9.7	15.2	18.9	15.7	19.1	19.8	25.2	25.9
Neutral	11.4	8.7	12.5	18.1	12.8	17.4	18.9	23.1	21.9
Somewhat favourable	11.7	9.0	12.7	15.2	13.6	15.7	16.5	20.4	19.1
Quite favourable	8.9	7.3	10.2	9.2	9.0	8.4	9.1	7.6	7.4
Very favourable	16.1	22.8	14.2	8.9	14.6	9.5	9.1	4.5	5.1
GSCS Momentum Index	39.4	36.3	32.8	34.9	30.9	34.7	25.0	22.4	26.4

MOMENTUM TABLE DEFINITION

To compile the 'Momentum table' GSCS considered price changes in each security being traded on the date the trade was completed and compared closing and opening prices. To the extent that the difference was less than + or – 0.33%, the market was considered neutral in terms of its impact on trading. A movement of between 0.33 and 1.33% was considered somewhat favourable (if the manager was buying a stock whose price fell by an amount in that range) or somewhat unfavourable (if the manager was buying a stock whose price rose). A daily movement in the range of 1.33% to 2.33% was considered quite favourable or unfavourable, while if the movement was greater than 2.33% then the momentum was considered as very favourable or unfavourable.

The chart shows the results in terms of the value of trades falling into each category.