

Expert opinion: Taking TCA beyond an equity only mindset

Robert Kay, managing director, GSCS Information Services, examines the factors that will ultimately drive development of fixed income TCA and assesses progress already made towards a working model.

While equity transaction cost analysis (TCA) has been reviewed and refined over the last 20 years, there has been almost no development of fixed income TCA. This is now changing as a result of a number of factors. First, there is a growing recognition that fixed income trading is complex and that trading expertise can have a significant impact on overall performance, just as in equities. Second is the fact that the quantity and quality of pricing information available has reached a point where reliable analysis can be completed and the technological support for such analysis does not have to be prohibitively expensive. Finally, the belief is gaining ground that inevitably trading of equities and fixed income cannot be kept separate as managers look at ever more integrated trading and investment strategies.

However, the challenges should not be underestimated. Pricing sources are frequently patchy, especially in corporate bonds. Often the way bonds are actually traded makes analysis of trading performance far from straightforward. As with equities traders believe they know best, and through competitive bidding of business at no commission, are confident they are certain to achieve best execution. Statistics compiled by GSCS Information Services as part of its fixed income analysis suggest that this is not necessarily the case. It is now quite possible to complete a post-trade analysis of how bonds were trading both at the time the decision to trade was made and at the time of execution.

This allows both implementation shortfall and market impact to be calculated accurately for each trade. Meanwhile, time weighted average prices throughout the day allow an assessment of the overall effectiveness of trading across multiple orders.

The results suggest that while trading performance is less volatile than equities, due to the generally lower volatility of price movement, the average performance is still variable by manager, security type and market. In addition the large average trade size, typically around 10 times the size of equity trades, means that the absolute financial impact of trading underperformance can be significant. It is also clear that in spite of the apparent transparency of pricing, best execution is not achieved with the consistency that clients may have been led to believe. As the volume of activity being analysed grows and the conclusions become harder to ignore, it seems inevitable that clients, regulators and compliance officers will expect to see more, and more sophisticated fixed income transaction cost analysis. This will present serious challenges to some of the major TCA providers if they fail to develop out of an equity only mindset.

