GSCS Global Securities Consulting Services Spring 2002

Prospects

The iceberg melts

Prompted by the Myners Report, transaction costs incurred by investment managers in the U.K. and Europe have become a focus of considerable interest and attention. Pension fund trustees in the U.K. have recently been bombarded with statistics suggesting that these costs are a significant influence on overall investment performance. One consultant suggests that transaction costs should be seen by pension clients as comparable to the unseen portion of an iceberg; representing eight-ninths of total costs, while commissions are the more visible one-ninth. Financial journals have happily reprinted statistics to the effect that these costs amount to anywhere from 75 to 250 basis points depending on the country. Some have also implied that transaction costs are not being effectively managed by many firms and if they were, they would be sharply lower.

As a consultant engaged in reviewing transaction costs, GSCS might be expected to welcome this increased public awareness of an important issue. In some respects we do. Trading is an integral part of the overall investment process; it is not well understood and many clients are understandably confused, not least because managers have traditionally not taken much time to explain the issues to them. But, however pleased we may be, we simply cannot ignore the fact that the statistics around which these stories and comments are based, are simply not supported by our own transaction cost analysis.

As our readers are aware we measure transaction costs according to some fifteen different benchmarks and assess opportunity costs of not trading, costs of delay in trading and market impact costs. Our review of 2001 data, which will be available in detail in June, covers 100 managers in more than 40 countries and includes two million transactions. It suggests that for our managers, and therefore their clients, trading costs are not as big an issue as they may be for others.

Table One (see over) highlights the performance of the ten largest equity markets where our clients invest and trade. Between them these markets account for more than 85% of activity of managers by number and value of transactions. As well as highlighting the proportion of activity accounted for by each country, the Table shows how each country ranks in terms of:

In reality for U.K. based pension funds and others using U.K. and Europe based, rather than U.S. based managers, the iceberg simply melts away in the light of a little data transparency

- The cost of delay (measured as a comparison of execution price with T-1 Close) and two widely used measures of market impact;
- Trade Date Volume Weighted Average Price;
- Average of Trade Date High, Low, Open and Close.

Of course everyone, including GSCS, agrees that none of these measures is perfect as an assessment of costs. However, they are all widely used and form the basis for much of the analysis that has been written about recently.

The message that they convey is clear. Costs incurred by our investment managers on client portfolios, whatever way they are measured, are typically less than 10 basis points, or around 50% of average agency commissions being paid. On no measurement basis whatsoever do costs exceed 30 basis points, and this level relates only to the Swiss market, not one of the largest areas of activity for most managers. In most cases therefore two-thirds of costs are visible (not one ninth) and only one-third somewhat hidden. In reality for U.K. based pension funds and others using U.K. and Europe based, rather than U.S. based managers, the iceberg simply melts away in the light of a little data transparency.

The conclusion is therefore simple, obvious and reassuring for U.K. pension funds and European clients. It is that U.K. and European managers are better at trading effectively in their "local markets" however that effectiveness is measured

Table One

Country	% of Value Traded	Cost of Delay (basis points)	Market Impact "VWAP" (basis points)	Market Impact "H/L/O/C" (basis points)
Australia	1.3	2	2	3
France	11.5	4	4	7
Germany	9.1	6	8	11
Hong Kong	3.2	7	2	5
Italy	3.9	19	9	13
Japan	14.6	9	3	5
Netherlands	2.8	7	0	0
Switzerland	2.0	30	4	7
U.K.	19.9	2	2	2
U.S.	22.5	15	7	11

There is clearly a large difference between the GSCS results and those of other consultants. Such differences raise two questions. First the reliability of the statistics and second the reason for the variance in results. GSCS reviews all its data for statistical validity looking at distribution patterns, "outliers" and standard deviation. Naturally the Trade Date VWAP information is the most statistically consistent measured by standard deviation. This is followed by the H/L/O/C data and the T-1 Close comparisons, where the standard deviation is higher but still typically small.

Given the statistical reliability of the GSCS data, and presuming the same for other consultants, the differences should be considered genuine and require explanation. In our view the primary reason for variation is that the investment managers incorporated into the GSCS database are principally based in the U.K. and Continental Europe. Those of other consultants (reflecting the nature of their clients) are predominantly U.S. based.

The conclusion is therefore simple, obvious and reassuring for U.K. pension funds and European clients. It is that U.K. and European managers are better at trading effectively in their "local markets" however that effectiveness is measured. Most U.K. pension funds naturally select U.K. based managers to look after their U.K. and European portfolios. As such the transaction costs they are bearing, in aggregate at least, are in fact accurately reflected in the GSCS statistics and are not nearly as high as studies relying on data from on U.S. based managers might suggest. That is not to say that everything is perfect and nothing needs to be done. Transaction costs can and should be measured by managers. Pension funds should know how their managers go about the measurement process, what the results are and how they compare with others, as was highlighted by the Myners Report. Not all managers, let alone all brokers, perform equally well and in some cases excess costs may be being incurred. However as this measurement and review process evolves, all parties should be aware that the problem and therefore the potential for savings, is not nearly as big as some self-interested parties might want to suggest.

Contacts

For further information about GSCS and its transaction cost measurement services please contact:

Robert W.A. Kay, Managing Director, Global Securities Consulting Services Ltd., 2 Station Road, Chertsey, Surrey KT16 8BE
Tel: 01932 568488. Fax: 01932 564290. e-mail: rkay@gscs.co.uk.