

# Prospects

## Transaction Trading

Institutional investment managers have always recognised that the trades in executed as part of the creation of a portfolio for a new client have special characteristics and are the focus of much attention. Periodic fundamental “rebalancing” of portfolios also leads to the execution of large numbers of trades within a very short period of time. Effective execution of these “transition” or “program” trades, whatever their underlying origin, has long been the focus of some of the world’s leading global broker/dealers. Technology has been used, both to reduce operational costs and to provide pre and post-trade analysis of performance.

Pension funds have more recently begun to appreciate just how important these kinds of trades can be. Hiring and terminating managers, whether for performance reasons or a desire to rebalance between asset classes, has become more common as pension funds mature. Broker/dealers, consultants and custodians have all developed or are trying to develop services to offer directly to the pension funds, taking responsibility for completion of these transactions away from investment managers.

In this issue of Prospects, we consider some of the important elements of transition trades and what pension funds should really be looking for as they evaluate the competing claims of all the interested parties.

### What costs should a plan sponsor be analysing in a transition trade?

There are three elements of cost in any transition trade. First is the movement in value of the target portfolio and the liquidation portfolio between the date on which the decision is made to complete the transition and the actual execution. In some circumstances (depending on the expected delay and the nature of the portfolios) the risk may be hedged using derivatives. This part of the process may be considered to result in **management cost**. The management cost should be

calculated using the relative performance of the target and liquidation portfolios over the relevant period, taking into account both the results and costs of any hedging that might have taken place.

Once an execution broker is selected and all the paperwork is complete the broker has a short term trading “window” in which to complete the transition. By assessing the liquidity of different stocks, crossing opportunities, market trends and so on, the executing broker will seek to ensure that the trades are completed on the day(s) most advantageous to maximising the fund value. The cost of this part of the process may be considered to result in **short term trading cost**. It should be measured by looking at the performance relative to the position from five days prior to five days post execution date, though this period may be shortened if required by the pension fund, because of particular execution instructions they or their transition manager have given the executing broker.

The third cost is the **daily trading cost**. This may be assessed by looking at actual execution prices including commission (if any), in the context of bid/offer spread, volume weighted average price, high, low open and closing prices on trade date and, if available prices and activity relative to the actual precise time at which the trade was made. This may be considered as market impact cost.

Combined, these three costs determine the difference between the starting value of the fund as represented by the liquidation portfolio on the date the decision to effect a transition is made and the ending value of the target portfolio on the day it is finally completely purchased. This is the **implementation cost** of the transition (i.e. what it cost in total to implement the transition between portfolios). Measuring implementation cost is therefore easy, but without an understanding of the different components, largely of no value to the pension fund.

## Why do plan sponsors need a “certification” process for transition trades?

Within the overall investment process, money managers are the institutions who have the greatest impact on performance of a pension fund. Consultants, who advise on asset allocation, manager selection and performance review, would also hope to add value to the fund by their recommendations. Custodians by contrast have traditionally played the role of “scorekeeper”. They are involved “after the fact” in determining how managers have performed and in some cases, what factors have affected performance. Custodians are paid only small amounts, relative to the other “players” because their impact on fund performance is negligible.

Transition trades have given custodians an opportunity to provide a range of different services some of which are more valuable. As executing brokers, the preferred role of many custodians in transitions, they have an opportunity to compete for the most lucrative part of the action. If they cannot be executing brokers, they at least want to take on a “management” role, within the transition, competing directly with Russell and Plexus (or in some cases owning or merging with these companies). For the most part custodians have given up on the natural “independent scorekeeper” role that they play elsewhere. This creates a problem for pension funds. Quite simply, how can they get an objective, disinterested assessment of performance on these very important transition trades.

As pension funds are increasingly discovering, the absence of an ability to provide independent benchmarks of performance expectation (similar to MSCI and S&P), coupled with a lack of clearly agreed measures of transition trading effectiveness, make it almost impossible to determine whether a transition trade was “well done”. Typically the institutions providing the assessment are either involved in setting expectations and evaluating the outcome against these expectations, or executing the transition trade itself, or both.

The position of GSCS in transition trading is to fulfil the role of the disinterested, independent, professional and experienced third party in assessing transition trades. In our view, pension funds need someone to undertake this role. It is critical that the institution involved is not in the business of managing transitions or executing them. They must however have sufficient experience in transaction cost measurement generally, as well as being able and willing to perform the role for a fee commensurate with the work done. In this context GSCS is unique, with ten years experience in TCA, technology that supports a low cost base and a size that makes “small fee” business attractive.

## What services does GSCS provide?

GSCS currently provides three principal services in the area of transition management. These are;

- 1) expectation assessment
- 2) post-execution transition analysis and assessment
- 3) certification and rating for pension funds or investment managers of their completed transitions

## What do these services incorporate?

Expectation Assessment is the way in which interested parties can assess the likely **short term trading** and **daily trading costs**. It takes account of all transactions (differentiated between buys and sells as appropriate) in the GSCS BECS-mb Universe for a period of three months before a transition trade is completed. It provides an expected outcome and a statistical analysis of the range of likely outcomes based on the actual component securities in the target and liquidation portfolios. To facilitate understanding and use of this data, GSCS is now publishing monthly an assessment of the likely **short term trading** and **daily trading costs** for leading market indexes such as S&P 500, FTSE 100, DAX and CAC 40.

Post-Execution analysis reviews actual performance of the transition in terms of **management cost** (taking into account any hedging), **short term trading** and **daily trading costs**. These are presented graphically and numerically as both composite information and individual security level detail available to all interested parties on-line.

The Certification and Rating is an assessment in simply stated composite terms of the performance of the transition in terms of each of the three cost elements, taking into account expectations as well as the absolute costs involved. The ratings are presented on a scale from AAA to B with A representing satisfactory performance. This enables staff to present a simple, easy to use certification to trustees of the performance of the transition and its impact.

## Reports

Reports can be provided to any level of detail. At the highest level, illustrated on the Charts and Tables, the information concentrates on the overall performance. However interested parties (pension funds, transition managers and broker/dealers) can have access to more detailed information down to an individual security level. This can be available in hard-copy or via the GSCS Hypercube web-site.

## Contacts

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