EXECUTIVE SUMMARY

Transaction Cost Analysis (TCA) is the measurement of the costs to trade. Trading costs can be broken down into two sub-categories namely direct costs and indirect costs.

- Direct costs are explicit costs and include brokerage, taxes, levies and settlement charges.
- Indirect costs are implicit costs measured in opportunity cost, market impact cost and the delay between the trade decision and the implementation of the trade.

TCA is intended to measure the costs of trading at several points and then to compare those costs against a benchmark such as VWAP (Volume Weighted Average Price) or a peer average.

Investment managers should always seek best execution for their clients and where brokerage are used to purchase research and other services, such research and services should aid in the investment decision-making process.

WHY SHOULD TRUSTEES AND INVESTORS CARE ABOUT TRANSACTION COSTS?

It is increasingly recognised that the effective attribution of trading costs is an integral part of overall investment monitoring. In periods when investment returns provide low results in absolute terms, trading costs are even more important as it makes up a more significant portion of the returns. Investment managers are responsible for transactions just as they are responsible for investment decisions. Trustees and investors should therefore be cognisant of transaction costs which are often equal to or greater than investment management fees.

EN AVANT

A French ballet term describing a dance step requiring dancers to move forward and onwards.
DO REGULATORS CARE ABOUT TRANSACTION COSTS?

Circular PF130 of the Financial Services Board (FSB) serves as a guide to good governance of retirement funds. The Circular states that all costs should be transparent and quantifiable by stakeholders. Regulators therefore require that Trustees are informed about how members’ money is being spent within the investment management process.

According to the Ethical and Professional Standards of the CFA Institute, brokerage is an asset of the client and investment managers should therefore use brokerage solely to the benefit of that client. Investment managers are required to seek “best execution” which refers to a trading process that seeks to maximize the value of the client’s portfolio within the client’s stated investment objectives and constraints. Investment managers should therefore be prudent with the use of brokerage to pay for execution and where required for research.

HOW CAN TRUSTEES AND INVESTORS IMPLEMENT TRANSACTION COSTS ANALYSIS?

GraySwan has built proprietary technology which now provides comprehensive Transaction Cost Analysis (TCA) reports for our clients. The TCA process starts with GraySwan collecting detailed trade information from investment managers as well as from the custodian. The data from these two sources are compared for accuracy and missing or incorrect data are investigated and corrected. The data is then analysed and compared to various market and industry benchmarks in order to check good governance and prudent use of client transaction costs. The governance checklist as provided within the report provides a snapshot of key concerns (such as investment managers trading in their own shares through their internal broker) and the action item list details practical steps to monitor the trading process. The TCA report therefore serves as a governance and compliance tool to Trustees and investors.

This governance and compliance tool can then be used to draw up policies and procedures that should be adhered to by investment managers. Trustees and investors might want to limit the usage of internal brokers, require a portion of trades to be executed through empowerment brokers, limit the percentage allocation to a single broker and list what is deemed to be permissible research. There are many actions that can be taken and would be different per investor.

It might not be prudent to be too restrictive, however a broad directive to indicate what is expected from the application of transaction costs might provide a neutral ground for Trustees and investors to meet with investment managers.

CLOSING REMARKS

Ultimately the TCA report can be used as guide for the drafting of a Transaction Cost Policy (TCP) as part of the Investment Policy Statement (IPS) as well as adjusting Investment Management Agreements to reflect guidance as to how the Trustees wish their selected investment managers to implement trades.

MORE INFORMATION

If you have any question regarding our Research, Investment Consulting, Wealth Management or Reporting services please contact us today.
The core of our investment team has been working together for more than 10 years. Our collective investment experience exceeds a 100 years of advising to and managing most of the largest institutional client’s assets in South Africa. Since the inception of GraySwan have we not lost any investment consultants or senior members of the team making us one of the most stable and experienced investment teams in the industry.