

Why Best Execution matters

Fund managers that swiftly adopt Best Execution can save money for investors and boost performance, says MICHAEL CORCORAN.

Times of crisis in the financial markets often trigger a return to hackneyed phrases and folklore of the past. In this environment of widespread uncertainty and volatility in equities markets, you may find many fund managers muttering, "It's a jungle out there!"

It's true that along with market volatility, Australian super funds are under extreme competitive pressure to retain and attract funds. Meanwhile, fund managers must get creative in order to outperform. But, in these troubled times, they should all bear in mind another old proverb that has particular resonance: "The devil is in the detail".

In other words, the small things that are often overlooked can have a big impact over time. This is definitely true in the context of trading costs which, at an individual level can appear insignificant, but at a cumulative level can have a serious effect on the erosion of overall portfolio value. As a general rule, over

80 per cent of total trading costs come from only 20 per cent of the trades executed – by looking at the detail, funds can make significant cost savings.

This also means funds must look to Best Execution practices to limit the downside of trading in volatile markets, and ensure that unnecessary or disproportionate costs are not incurred.

The concept of Best Execution is becoming well entrenched around the world and in Australia IFSA has issued guidelines on the topic. However, if it is not well understood, it could become another over-used phrase that loses its true meaning.

Best Execution is not just another cliché. Research shows the average cost of an Australian equity trade is 66 basis points (bps). If these costs are reduced by only 25bps, a fund manager with a

\$3 billion dollar Australian equities portfolio turning over 75 per cent a year could save about \$11 million per annum. These are real savings – we're not just "talking up a storm" – and the good news is that traders now have access to the necessary trade cost analysis, management and trading technology tools to make Best Execution a reality for their businesses.

In fact, Best Execution is a neat explanation of conventional trading wisdom that is particularly relevant in volatile markets when costs become a key differentiator, and it also describes a process that adds value to the end portfolio under any market conditions.

At its simplest, Best Execution is the process of trading in the most efficient way to maximise portfolio value. The difficulty arises from trying to follow a series of identical, prescribed "Best Execution" steps to achieve a standardised outcome. The point, in fact, is not to do exactly the same thing every time a trade is executed, because every trade is different. Instead it is about having a process in place that takes into account the different factors of each trade, and then adjusts according to those variables (for example, order size, share liquidity, market volatility) to consistently get the best outcome.

In general, there are two types of cost a fund manager needs to manage: the obvious – normally, the relatively fixed brokerage fees and taxes on trading; and the hidden costs – those that are not immediately apparent, but that require special attention to manage.

ITG research based on an analysis of 47 fund managers trading Australian equities shows that average trading costs consist of 18 bps for tax and commission, but a far more significant 48bps for the "hidden" market impact and delay costs.



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Once these costs, and patterns of costs, are identified, advanced trading methods can help reduce these costs' impact on a portfolio's value.

When it comes to Best Execution, the rule definitely applies that "a stitch in time saves nine". By implementing a systematic, repeatable process that is tailored to the fund managers' business model, real and significant cost savings can be made. The earlier these are implemented, the quicker processes are improved, and the more protection there is to avoid unnecessary costs in future.

In our view, Australian fund managers' adoption of Best Execution is more a question of "how" and "when" as opposed to "if". They will have to more aggressively reduce the "hidden" costs within their portfolios if they want to stay in the game.

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