More prolific data systems, including order management systems, have not only led to better data availability, and but also to theoretical improvements in our ability to measure transaction costs. Theoretical because despite better data availability, our tendency is to still take the complicated, make it more complicated and in doing so to sacrifice transparency.

Five years ago responsibility for transaction cost evaluation fell to as few as one or two people within a given firm. Now, the discipline is usually the responsibility of a committee that can encompass departments ranging from upper management to compliance to trading. Therefore, as the demand for Transaction Cost Analysis broadens across firms, the need for clarity increases.

Regardless of the need for clearer and more communicable transaction cost assessment results, the process of trading has become more complex and difficult to measure. As methods of trading and trading venues have increased – from algorithms to dark pools to fragmentation – it is essential to employ transaction cost analysis (TCA) that accurately reflects this changing mode of trading.

Due to recent innovations, Transaction Cost Analysis can now provide better accessibility to more meaningful results through transparent and apples-to-apples analyses. This results in better value for the user, even in an increasingly complex environment.

Understanding the context within which trading and trading costs occur is an important aspect of a more meaningful, comprehensive TCA process. There are three components to the context of trading. They include the users net cost or benefit calculated using a relevant benchmark as well as their universe net cost or benefit calculated using the same benchmark. Finally, there is statistical information about the market conditions encountered when trading occurred. Within this framework the user can now derive a clear understanding of not only how their trade execution quality ranks among their peers but also what market conditions were encountered when trading occurred and how these conditions affected their trading.

A primary objective of Transaction Cost Analysis is to gain transparency into the trading process. Greater transparency leads to not only a better understanding of TCA results, but also to a better understanding of the process. This increases the user’s comfort level with the process and their ability to make more accurate assessments about their trading effectiveness. In other words, having a correct context within which to assess trading, and achieving a high level of transparency into the trading process, empowers the user of TCA to
make more confident and accurate assessments about their trading assessment results. This is better for all parties involved, and adds value.

TCA must assess the overall trading process and not just the “trading” part of the process. This is an important distinction. An asset manager is responsible for all facets of trading, from the timing of the portfolio manager placing the trade with the desk, to the desk managing the trade from that point forward. If an analysis only represents the time that the broker had the trade this is too narrow an assessment, and only reflects one part of the process. In many cases the broker may execute the trade effectively during the time that they are actively executing the trade. However, a broader analysis may indicate that a portfolio manager or desk was slow in getting the trade to the broker, and the most advantageous time to trade was missed. The entire execution process must be scrutinised in order to ensure that trading effectiveness is being maximised.

A broader reporting time frame is also an important aspect of effective TCA because it offers a more accurate assessment of trading effectiveness. One quarter of trading analysis is simply too short a time span to produce an accurate assessment of trading quality. A minimum of four individual quarters of analysis, and then a rolling four-quarter synopsis in each report is a good starting point. From this perspective the user has a statistically significant amount of trading data being analysed. In addition, idiosyncratic aspects of trading, an unusual and extreme price movement in a stock for example, may throw off a one-quarter analysis, but will be smoothed out in a four-quarter analysis.

Web-based reporting is an important aspect of a more efficient TCA process, replacing hard-copy reporting and its obvious limitations. Trading costs tend to reside in pockets and are comprised of a relatively small group of managers, brokers and trades that account for the lion’s share of a group’s trading costs. Therefore, much of the information that a TCA user needs to access is buried somewhere in the reporting. Web-based reporting allows the user quick, streamlined access to all the most pertinent information as well as direct access to the source(s) of their trading costs, through the ability to intuitively “drill-down” into the analysis from the macro level. Hard-copy reporting makes access to this information difficult, cumbersome and in some instances, not possible due to the level of detail and “optionality” available through a TCA. The ability to drill-down saves time, increases accuracy and brings a great degree of transparency to the process.

The advances outlined have begun to transform the TCA process into one that is more user-friendly, time efficient, accurate and one that produces results that are easier to convey to interested parties. In addition, in many cases, TCA has been like fitting a square user into a round analysis. Now TCA reporting can accurately reflect each individual user’s trading process, thereby making each analysis a “custom” analysis that represents a true measure of the effectiveness of each user’s trading. These advances are helping to overcome the complexity of measuring trading in an increasingly fragmented marketplace.