Transactions costs and trading performance

John A. Halligan, president, Global Trading Analytics explains why in these volatile market conditions, understanding the different components of transaction cost analysis has never been so important.

Transaction costs and trading performance are obviously not mutually exclusive. Identifying the components of transactions costs including poor implementation decisions and intermediary inefficiency, is a filtering process that requires structuring the correct analytical context to bring depth and clarity, through transparency, to a complicated, multi-level trading process.

The trading process encompasses much more than just the time a trader is working a trade. Trades and trading costs do not happen spontaneously. There is a process leading up to each trade, and trading costs are potentially encompassed in each part of the process. Each leg of the trade – starting with the analyst or portfolio manager to the trading desk, trading desk to the broker, broker to execution – has the potential to generate trading cost.

From a transaction cost perspective, the trading desk may not have the most impact on the trading process, but it is the most important mechanism. If, as described above, one of the other inevitable legs of a trade is mishandled, such as a delay in getting a trade to the trading desk in a timely manner, opportunity cost or slippage can equal and even exceed the potential cost generated from the trading desk component of the trade. However, the trading desk has the unique opportunity to do what the other components cannot. It has the opportunity to mitigate trading costs and, in the case of a well-run desk with talented traders, even generate benefit, or alpha, through the trading process.

Accurate time stamping is an important factor in correctly measuring trading desk execution costs. While accurate time stamping is very often an oxymoron, adjustments to existing time stamps and even artificial time stamps can also be used if necessary. Imperfect time stamps, handled properly, are better than no time stamps when the objective is to evaluate a time-slice of trading such as the trader component. Analytical context is the next essential aspect to effectively measuring trading performance. It includes three distinct components related to the process of trading, the benchmark, the universe and market conditions.

The benchmark, not necessarily the most important of the three, is not the sole determiner of trading costs. It is always the means to the end, and necessary when evaluating trading, but it is only a factor of the entire process. Benchmarks fall into two broad categories – static (i.e. implementation shortfall) and non-static (i.e. VWAP). Market conditions can weigh heavily on a non-static benchmark and influence its reliability, increasing the need for a context-based transaction cost model. The most important aspect of the benchmark is that it is relevant to
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the trading strategy. If the trading objective is to minimise slippage, necessitating the use of a static implementation shortfall benchmark, being evaluated using a non-static benchmark such as VWAP would not be the correct approach.

The second, and arguably the most important component of the trade measurement process is the universe, which brings greater clarity to the trade evaluation process if constructed properly. A universe should not only be relevant and have an apples-to-apples comparison approach, but it should also have great depth. Finally, a universe should, from a trading performance perspective, represent the same time frame in which a trader is working each trade in the market. A universe that encompasses all these factors is a meaningful representation of what institutional price was attainable in the market for each security traded. In addition, a well-constructed universe will reflect any market turmoil within the issues contained within the universe adding additional context to the analysis.

The third component of an accurate examination of the trading process is an assessment of the market conditions experienced when the trader was in the market. Market conditions that may affect a non-static benchmark such a VWAP must be identified and evaluated to maximise the accuracy of the analysis. In addition, adverse market conditions will increase the difficulty of executing a trade through increased volatility or extreme price shifts. For example, if just after a trader executes their trade but before they have closed it the price drops precipitously, heavy volume may enter the market to trade that security at the lower price levels. This scenario will affect the benchmark and the universe, and may cast this trade in a negative light. However, through transparency of the underlying market conditions, it is possible to deduce that this trade may have been executed efficiently when all factors are considered. When market conditions for a particular trade are normal, and yet transaction costs are high, these costs will be more difficult to justify and are more likely generated through poor implementation decisions.

To determine ineffective intermediaries, trends must be considered. By evaluating intermediaries over a significant time period using a statistically significant data set, it is possible to determine the least efficient intermediaries by market, instrument and trading strategy. However, it is difficult to segregate poor implementation decisions from less efficient intermediaries at aggregate reporting levels. It is possible that intermediaries are executing poorly due to poor implementation on the traders part. However, through well-constructed reporting it is possible to link trader, market, instrument and trading strategy such that it is possible to identify certain less efficient “pathways” to execution, and address these inefficient trading patterns through trading adjustments.

A trade evaluation structure as outlined above can clearly and accurately identify costs caused by poor implementation decisions, less efficient intermediaries or some combination of the two. Through a transaction cost measurement approach that includes accurate analytical context through benchmark, universe and market condition components, it is possible to determine the source and magnitude of trading costs as well as to identify any reasonable justifications for these costs.

The previous few quarters have been a dramatic reminder of why it is necessary to bring depth and clarity, but not complexity, to the transaction cost measurement process. The extraordinary market conditions traders have been experiencing have increased the probability of greater transaction costs. Through analytical and reporting transparency it is possible to determine if poor implementation, ineffective intermediaries, or a combination of both have contributed to high trading costs. In addition, when market conditions are taken into account it is possible to evaluate trading within a more informed analytical context.