It isn’t just about equities

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It was not that long ago when people questioned the validity of equity transaction cost analysis (TCA). Not anymore. TCA for equities is now commonplace and accepted as standard practice. Today, people are on to questioning the validity of some of the more recent asset class additions to TCA, such as fixed income and foreign exchange. This is to be expected considering that we are currently at the start of the relative life-cycle for measuring these asset classes.

Fixed income traders are sometimes alarmed at the prospect of the efficiency of their trades being measured, and not without some justification. Once traders become more comfortable with the process, however, their concerns usually abate. To begin with, TCA is a new concept in the fixed income markets. While equity traders have had more than 20 years to acclimate to their trades being analysed, fixed income traders are not used to being measured and in many cases are not yet familiar with the TCA process. Secondly, fixed income is an inherently difficult asset class to measure.

Fixed income TCA encounters two important structural difficulties. The first is data. Although much better than even in the recent past, fixed income data still has its challenges. For example, fixed income data does not currently achieve the granularity found in the equity markets. The second inherent difficulty is the nature of the market. It tends to be a less liquid market than the equity market, and will continue to be. A far greater number of instruments, and far more types of instrument, trade within the fixed income markets than within the equity markets. Each instrument is designated by differing characteristics such as coupon and maturity, and is very often characterised by a relatively small issue size as measured in principal. In addition, the fixed income markets are characterised by direct transactions between parties as principals as opposed to transactions on centralised exchanges. Unlike the centralised equity markets, fixed-income markets are fragmented and often subject to limited transparency due to the aforementioned absence of a centralised reporting mechanism for completed transactions, as well as smaller issue size. Therefore, an issue of any given fixed income security will tend to be smaller and less liquid than a given equity issue. This is also true for high yield and mortgage-backed securities. These securities tend to be limited in scope and comprised of multiple issues with unique characteristics. Even as fixed income data improves and is more complete than it is today these liquidity problems will persist.

These conditions within the fixed income market make evaluation of trading efficiency more challenging than the equity market, but not any less effective when the correct TCA
methodology is employed. Any transaction cost analysis, including equity TCA, is a macro analysis which should evaluate the process of trading. The objective is to start the process at the trade level – the trades are the building blocks of the analysis – but aggregate results to observe trends and outliers. However, fixed income TCA needs to be viewed from an even more macro level than equity TCA to allow the inherent idiosyncratic aspects of fixed income to statistically flatten-out over a reasonable time period and with a sufficient data set.

Structuring TCA methodology to compensate for fixed income data shortcomings is an additional way to ensure the effectiveness of fixed income TCA. Illiquidity, insufficient data and benchmarking challenges can all be addressed through well constructed and creative TCA methodology and do not need to be an impediment to accurately evaluating fixed income trading efficiency.

It is clear that although much of the existing guidance regarding best execution has been developed within the context of the equity markets, the duty to seek best execution imposed on an asset manager is the same regardless of whether the manager is undertaking equity or fixed-income transactions. In addition to instrument differences, significant differences exist, however, between the trading structure of the equity and fixed-income markets. The definition of “best execution” in the fixed income market is very often choosing the best of three bids or offers and executing the trade. The fundamental differences between trading the fixed income and equity markets aside, this assessment of fixed income best execution may prove insufficient. Best execution encompasses more than just the perfunctory act of executing a trade at a ‘not-substandard’ rate. Best execution is a process. In the fixed income markets, where trading may be more circumstance driven then in other markets, a robust process of best execution must be employed demonstrating that every effort is made to ensure the best possible outcome for the trade.

Whereas equity TCA can be time-stamp sliced to better assess the components and process of the execution, due to the lack of liquidity in the fixed income markets, time slicing is more difficult and, as mentioned, fixed income must be analysed on a more macro basis. The members of the Asset Management Group (AMG) uniformly agree that best execution in the context of fixed income securities is appropriately defined as an asset manager’s duty to determine and evaluate the circumstances under which the overall value of investment decisions for its clients with respect to those securities will be maximised. The members

of the AMG believe that, in light of the special characteristics of the fixed-income markets, best execution be evaluated not on a transaction-by-transaction basis, but on an overall basis over an extended period of time.\textsuperscript{2}

With fixed income at one end of the TCA spectrum, and equity at the other end, foreign exchange TCA falls comfortably in-between. The foreign exchange market is the largest securities market in the world, and like the fixed income market is one that is not centralised. The over-the-counter nature of this market is the central challenge regarding trading efficiency and transparency. Well constructed foreign exchange TCA proves accurate and effective in measuring trading efficiency and gaining trading transparency. Much as with the fixed income markets, data challenges in the foreign exchange markets, although less restrictive than the fixed income markets, can be dealt with through insightful and creative methodological construction. The objective of TCA should be to evaluate the process of trading within the correct context, regardless of the asset class. To achieve this is to take the TCA methodology beyond the benchmark by incorporating meaningful, relevant information within the methodology, which permits insight into the analysis, data transparency and the ability to see what’s behind the numbers.

Foreign exchange TCA is more akin to equity TCA than fixed income TCA in that the FX market is liquid, with trade data that is more readily available and is more granular. Traders in the foreign exchange market are somewhat more comfortable with the concept of TCA due to the more liquid nature of the foreign exchange markets however FX traders can sometimes be as alarmed as fixed income traders at the prospect of having their trades measured. TCA is a new concept in this market as well as the fixed income market, and therefore again approached with some trepidation by market participants.

Recent questions regarding custodial foreign exchange trading for several state pension plans in the US are representative of the lack of transparency within the foreign exchange market, despite its size and liquidity. Several states are claiming that the foreign exchange rates they have received from their custodians are not representative of the time the trade was executed, and that they are receiving less-advantageous execution rates, very often reflecting the high rate of the day or the low rate of the day. It is very unlikely that an event such as this could occur in the equity market due to its level of transparency.

The objective of TCA should be to evaluate the process of trading, not just the trade, regardless of the asset class. Therefore, fixed income and foreign exchange TCA is accomplished much the same as traditional equity TCA. This may encompass incorporating several facets of the trade into the analysis, starting with the trade origination point, which may be with an analyst or portfolio manager. From there TCA can evaluate every aspect of the trade through the final execution. Breakdowns early in the trade process, such as with a portfolio manager or trader, can lead to significant hidden costs. Through evaluation of the process of trading, and not just the trade, TCA can establish where weaknesses may lie within the trading process.

As the SEC increasingly focuses on trading efficiency in all asset classes, transition cost analysis plays an increasingly important role in the ongoing efforts by firms to comply with the more comprehensive regulatory oversight being instituted with the advent of the Dodd-Frank legislation. TCA, however, including the newer asset class additions of fixed income and foreign exchange, need not be onerous. Transition cost analysis, properly implemented, can be an intuitive and productive tool which can meet the diverse best execution objectives of several areas of the firm, including management, compliance and trading, for multiple asset classes.