Tightening up trading costs

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Institutional investors must keep careful watch on trading costs, and take steps to minimize them, as recent research shows they rival investment management fees in their impact on portfolios.

Any front-running — buying or selling on advanced knowledge of trading orders to gain an advantage in price — such as by high-frequency traders, only adds to the high transaction costs.

Front-running has been a longtime concern of pension funds and other institutional investors; before the rise of high-frequency trading, they blamed hedge funds. Some pension funds have tried to address front-running by deferring disclosure of investment management changes until transitions are complete.

But trading costs, including front-running's effect, are harder to measure than management fees. They are less transparent, making it more challenging to see the significance of their impact on overall investment performance, and therefore harder to address and harder for regulators to detect improper activity.

Investment management fees, which are more transparent, have been shown to be an important factor in determining performance.


Three other academics — Roger Edelen, associate professor of finance, University of California, Davis; Richard Evans, assistant professor of business administration, Darden School of Business, University of Virginia; and Gregory Kadlec, the R.B. Pamplin professor of finance, Virginia Polytechnic Institute and State University — have shown transaction costs have a similar importance and present a similar hurdle to surmount for outperformance.

In their 2013 FAJ article, “Shedding Light on "Invisible' Costs: Trading Costs and Mutual Fund Performance,” they examined 1,758 domestic equity mutual funds over the 1995-2006 period, estimating trading cost by measuring a combination of brokerage commission, bid-ask spread and price impact.

They found the funds' annual expenditures on aggregate trading costs were comparable to, and even higher than, the funds' expense ratios, 1.44% vs. 1.19%. In addition, the trading costs showed
“considerably more” variation than expense ratios. “For example, the difference in average expense ratio for small-cap growth and large-cap value funds was 0.32 percentage point, or (1.39% vs. 1.07%), whereas the difference in average aggregate trading costs for the same funds was 2.33 percentage points. or 3.17% vs. 0.84%”.

They found “a strong negative relation between aggregate trading cost and fund return performance.” Funds were generally not able to recover trading costs by superior performance, they noted.

Better attention to trading is one reason for the use of transition managers, which have greater resources, including systems and experience, to devote to trying to minimize the impact of changing managers. The business faces challenges because of dynamics of clients and competitors, causing some transition managers to stop offering services. But the drive to minimize transition costs appears undiminished.

But everyday trading accounts for the bulk of institutional buying and selling and needs continued attention.

Fiduciaries should make as much of an effort to control trading costs as they do to control investment management fees.

Pension fund executives and other institutional investors have to keep up with the increasing complexity of trading. They need to demand more transparency on their trading costs from their money managers and securities brokers. They need to employ, or see that their vendors employ, strategies that minimize leakage of confidential trading orders, while measuring trading performance and addressing issues that might prevent the achievement of trading objectives.