

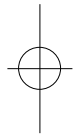
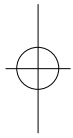
# TRANSACTION COST ANALYSIS

**T**ransaction costs are a significant and largely hidden charge on investment performance. Inalytics estimates that the overall UK institutional market is paying up to £8bn each year or around 0.75% per annum. The scale of the costs means that they are almost as significant to the eventual return as the investment process itself.

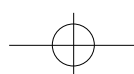
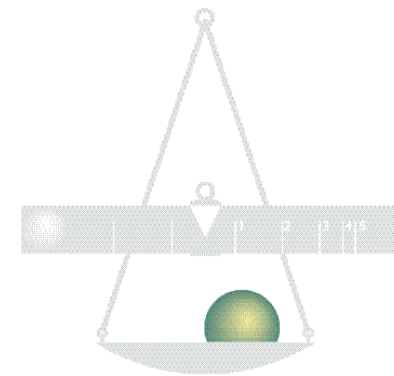
**// Transaction costs are an important cost to pension funds. For trustees to fulfil their duty... [they] must ensure that these costs are properly managed. //**

Myners Report 2001

Inalytics provides trustees with the means to manage these transaction costs through clear and concise reporting.



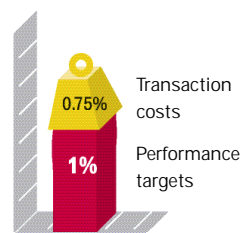
## INALYTICS TVA



## TRANSACTION COST ANALYSIS

### Why transaction costs need to be monitored

From a macroeconomic standpoint, the Myners Report refers to the need to minimize transaction costs so as to ensure efficient allocation of investible assets. However, trustees and administrators with responsibility for individual funds have other, equally compelling, reasons for introducing a monitoring programme.



Transaction costs are of the same order as many performance targets

- **Scale.** Transaction costs are significant. For the UK institutional market as a whole Inalytics estimates that total transaction costs are up to £8bn each year, or around 0.75% per annum. For individual funds this cost will vary depending on factors such as:-
  - Type of asset invested: bonds, equities, emerging markets
  - Investment remit/style: growth, value, momentum
  - Efficiency of execution: good, poor
- **The impact on fund performance.** At a time of increasing scrutiny of performance and with evidence of a trend towards a narrowing dispersion of returns between funds, the cost of inefficient execution is significant.
- **Investment manager selection.** Given the predictability of transaction costs relative to returns, it would be appropriate to attach greater significance to that element of a manager's performance during the selection process.
- **Broker selection.** Transaction cost monitoring provides a means for assessing soft commission and directed brokerage agreements, as recommended by Myners.
- **The need to be Myners compliant.** The report squarely places the responsibility for monitoring and managing transaction costs with the trustees. The Inalytics TVA service enables trustees to fulfil their responsibilities in this regard.

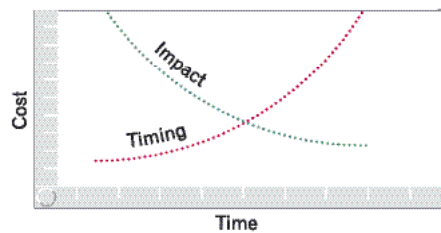
## Measuring transaction costs

### The dealing process

When executing a large order, one of the key decisions is whether to deal immediately at whatever price is offered in that size, or to effect a series of smaller deals at prices which reflect 'normal market size'. Such choices will drive the eventual cost, and how it is made up.

In this situation dealing immediately means 'paying up for size' and incurring higher spread and impact costs for the certainty of completion. The alternative of effecting a series of smaller deals reduces these spread and impact costs as each trade will be in the 'normal market size'. However there is the risk that over the period prices will move in the wrong direction, incurring 'timing' costs.

Dealers' dilemma

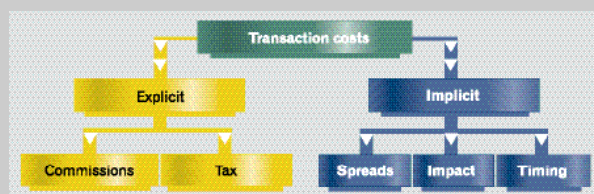


Clearly the choice of dealing route affects the total cost and how this cost is made up. The dealer's skill is in knowing which route to take.

### Measurement

The above demonstrates that transaction costs are not just commissions but comprise several items, many of which are not transparent. The components are interrelated, as the following model illustrates.

### Transaction costs model



**Explicit costs** of brokers' commission and taxes need no further explanation.

**Implicit costs** are less obvious.

**Spreads.** Defined as half the difference between the bid and ask price.

**Impact cost.** Defined as the difference between the dealing price and the volume weighted average price (VWAP).

**Timing cost.** Defined as the difference in price between executed trade and closing price. The closing price method is aligned to the way a fund's performance is measured; other approaches rely on price points.

These component parts of transaction costs are interlinked and any attempt to influence one is likely to have a knock on

effect on the others. This is starkly illustrated by the choice of whether to pay a commission to reduce spread and impact costs, or to deal 'net' at zero commission and rely on the skills of the dealer to keep the implicit costs low.

As well as demonstrating the linkages this illustrates that effective transaction cost management is not only about keeping commission costs low, but also about ensuring that rises in other costs do not outweigh these commission savings.

Whichever route is taken the objective is the same; juggle the various components of costs, commissions, spreads, impact and timing, to keep total transaction costs low.

Effective management ensures commission savings are not outweighed by rises in less transparent costs

## TRANSACTION COST ANALYSIS

### THE INALYTICS TRANSACTION COST SERVICE

Inalytics TVA meets the needs of pension funds for complete clarity and certainty in the calculation of transaction costs.

- Inalytics TVA recognises trustees' need for clear, concise and user friendly reports.
- The TVA reports enable clients to see, at a glance, all the key numbers, including total transaction costs and their breakdown into the main component parts.
- TVA reports provide detailed breakdowns of costs by asset class, investment manager and by broker.
- Inalytics' reports compare a pension fund's actual costs and the individual components to the other funds in the Inalytics TVA sample.
- Finally the Inalytics service to clients includes our availability to attend on-site meetings. These meetings will provide a forum for further explanation and analysis of the transaction cost reports.

**Inalytics Limited**  
1a Church Road  
Croydon CRO 1SG  
UK

Tel: + 44 (0)20 8401 7510  
E-mail: [info@tva.eu.com](mailto:info@tva.eu.com)  
Web: [www.tva.eu.com](http://www.tva.eu.com)

