POLAR CAPITAL

Transaction Costs

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Background

Good active managers provide their clients with value for money from their investments. This does not mean offering them the cheapest products but providing value for money from the investment returns generated, after costs.

Two recent pieces of EU legislation, MiFID II and PRIIPS, set out to make investment funds' transaction costs transparent and comparable for all institutional, intermediary and retail investors. They do not introduce any new costs, simply a different way of expressing existing costs. What is new is that active managers are being asked to disclose these costs and to express them in monetary and percentage terms.

The overall aim is to give investors transparency and help them to compare investment funds' total costs. While this objective is right, in practice the mandated transaction cost disclosures are at risk of becoming too complicated, and possibly misleading.

Types of transaction cost

The new regulation requires fund managers to show transaction costs in two categories – explicit costs and implicit costs.

Explicit costs: These cover direct transaction costs, such as trading commission and any local taxes such as stamp duty.

Implicit costs: Under MiFID II, the implicit cost is the difference between the price of a stock when an order is sent to a broker (the arrival price) and the price at which the order is executed (the execution price). It is often called 'implementation shortfall' or 'IS'. No money changes hands; the implicit cost is simply an illustration of the difference between arrival price and execution price.

Both the explicit and implicit transaction cost figures can be affected by the level of turnover in portfolios (in turn influenced by idea generation and by client investment flows), but the implicit cost can be much more variable as it is subject to a variety of factors, which we outline below.

Implicit transaction costs: influences and imprecisions

In addition to turnover, implicit transaction costs are affected by investment style (momentum or contrarian) and by the size and liquidity of the security being bought or sold. This introduces a number of imprecisions which means that low implicit costs are not always a good thing for clients and fund investors.

- The implementation shortfall method for calculating implicit costs penalises managers with a momentum style, as momentum managers tend to buy into strength and sell into weakness. By contrast, contrarian managers do the opposite, typically buying into weakness and selling into strength.
- Implementation shortfall tends to attribute higher costs to a fund buying less liquid (often smaller) stocks, rather than more liquid larger names.
- Implementation shortfall analysis will tend to show higher costs for higher turnover managers (particularly if they also have a momentum style), including those experiencing a high level of subscriptions and redemptions.
- Implementation shortfall is an absolute, not market-relative measure; it can be significant when a fund is buying a share whose price is rising, even if the share price is rising by less than the market.

Investors who are looking at implicit transaction costs need to bear in mind these issues, as some of the factors above may in fact result in a higher chance of outperforming. High implementation shortfall costs do not predict nor necessarily correlate with poor fund performance.

Our position

The transaction cost illustrations introduced by MiFID II and PRIIPS are based on good intentions, to provide clarity and transparency for clients; we feel they have had the opposite effect.

Explicit transaction costs are already reflected in net fund performance numbers; there is no additional payment involved.

Implicit costs are never a cash cost; they simply provide an illustration of the transaction price at which an investor may have bought or sold, had an order to buy or sell shares been implemented in full as soon as it was received by a trader.

It is possible for implicit transaction 'costs' to be negative. This happens if a share is being bought while the price is consistently falling or sold while it is rising. While superficially attractive, this may not be a good outcome for investors; the price of the purchased security may continue to fall, or the security sold may continue to rise, in which case the investor would have been better not to sell at all.

We remain committed to keeping all transaction costs to a minimum where we can but believe transaction cost disclosures should be used with care and are potentially misleading.

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