Guide to transaction costs
A primer for trustees and IGCs
When it comes to pension saving, even seemingly small costs can compound over decades to significantly affect the quality of an individual’s retirement. This means that value for money is a key concern for anyone charged with delivering the best outcomes for members.

This guide has been written to help trustees make informed decisions about value in their scheme, by explaining the key concepts of transaction costs.

We will cover three core areas: the regulatory framework, what transaction costs are, and how we manage and monitor costs at BlackRock.

**Michael Edey**

UK DC Investment Strategist, BlackRock
Three things to remember

01 Net performance already reflects all transaction costs

02 Transaction costs are not entry/exit costs, they are the recurring costs of buying and selling assets within a fund

03 UK and European regulations aim to provide a standard methodology for aggregate transaction costs
What is value for money?

The Better Workplace Pensions initiative introduced new requirements for pension schemes to ensure their members receive value for money. Assessing this involves considering key benefits such as investment performance and standards of administration.

Independent governance committees (IGCs) need sufficient data from asset managers to assess the balance of costs and benefits provided by a scheme.

Trustees and providers of contract-based schemes must provide headline information about management charges in the basic scheme information to new and prospective members, and disclose headline charges and costs to members as part of the annual benefit statement.

IGCs and trustees will need support from asset managers with the information they request to fulfil their duty of scrutinising the value for money delivered by the scheme.
The UK Government has put in place a number of new quality standards to apply across all defined contribution (DC) workplace pension schemes.

**Regulatory background**

**2014**

- Better Workplace Pensions: putting savers’ interests first.

**2015**

- Providers of contract-based schemes required to operate Independent Governance Committees (IGCs) to assess the value for money delivered by schemes.
- Trustees of trust-based schemes required to consider and report against the quality standards. New measures put in place to strengthen the governance in master trusts.
Better Workplace

Pensions: putting savers’ interests first.

Providers of contract-based schemes required to operate Independent Governance Committees (IGCs) to assess the value for money delivered by schemes.

Asset managers expected to report to trustees and IGCs on the costs incurred in managing schemes including underlying transaction costs.

The Government will examine whether some or all transaction costs should be included in the default fund 0.75% charges cap, and whether the level of the cap should be lowered.

Packaged retail and insurance-based investment products (PRIIPs) comes into force.

Trustees of trust-based schemes required to consider and report against the quality standards. New measures put in place to strengthen the governance in master trusts.

Financial Conduct Authority (FCA) Consultation Paper 16/30 on transaction cost disclosure. (Please see page 6).

Final FCA report on the asset management sector will determine whether and how asset managers will need to disclose an all-in fee including transaction costs, and/or impose further duties on trustees and IGCs.

Markets in Financial Instruments Directive 2 (MiFID II) comes into force.

Investment Association cost code of practice designed to complement FCA consultation. A parallel initiative is working on the disclosure of costs to local government pension schemes.
The FCA has released a consultation paper which proposes rules and guidance to improve the disclosure of transaction costs in workplace pensions.

Key to the FCA’s proposed methodology is the disclosure of transaction costs based on a comparison of actual prices with the value of the asset immediately before the order to transact entered the market, using the ‘slippage cost’ methodology. It needs two pieces of basic information for each transaction:

- the actual cost execution price
- the time an order enters the market

This time can then be used to identify the mid-market price of the asset, called the ‘arrival price’. This can then be compared to the execution price.

**Final rules are expected in the first half of 2017.**

**Asset management market study**

The FCA is assessing whether purchasers of asset management services obtain value for money and what changes to the current regulatory regime could assist them.

Among proposals for discussion is the introduction of an all-in fee including all transaction costs. Other proposals include requiring trustees and IGCs to periodically report on value for money using a prescribed template.
What are transaction costs?

Transaction costs are the costs incurred by portfolio managers buying or selling securities inside a fund.

This can be because of investor flow, index rebalances, new investment ideas, or ongoing risk management.

All of these activities result in trading, and the costs that arise because of that trading are transaction costs.

Some transaction costs are ‘explicit’ but others are ‘implicit’.

Transaction costs matter because they are a drag on net performance – what investors receive after fees, expenses and taxes.
Explicit costs

We know objectively what they are from internal or external data sources. An example is an equity trade, where the commission we’re charged is explicitly disclosed.

- **Broker commissions**
  Fees charged by intermediaries to buy or sell securities.
  We typically see these for equities.

- **Taxes and levies**
  Charges like stamp duty reserve tax, other levies charged by regulatory bodies and by the exchanges that we use.

- **Securities lending**
  In securities lending transactions, funds make short-term loans of stocks or bonds to incrementally increase returns to investors.
  In BlackRock’s model, a fee is charged as a percentage of the gross revenue generated from lending the securities. BlackRock covers all costs associated with the activity.
Implicit costs

We don’t know objectively what they are, so we typically estimate them using proprietary models. An example is a bond trade, where exact cost information cannot be objectively obtained using public market data.

**Opportunity cost**
Sometimes it is not possible to execute a trade of a certain size all at once. Executing the remaining trades can create a gain or loss to the fund, depending on how the market moves.

**Market impact**
Executing a large order in one go (e.g. after a big flow in or out of a fund) can move the market, meaning the price obtained is different from what was expected.

**Bid-ask spread**
The buy price (‘ask’) of a security is higher than the sell price (‘bid’). The spread is the difference between them.

**Delay cost**
A portfolio manager wanted to execute a trade at 14:00, but couldn’t do it until 14:01. If the market moves in that period, that causes an impact to fund performance, which could be a cost.
## Cost categories

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-off costs</td>
<td>e.g. entry and exit costs (Share class dealing price spread/swing)</td>
</tr>
<tr>
<td>Recurring costs</td>
<td>Trading costs</td>
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<tr>
<td></td>
<td>Ongoing fund charges and expenses</td>
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<td></td>
<td>e.g. AMC, custody fees</td>
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<tr>
<td>Incidental costs</td>
<td>e.g. performance fees</td>
</tr>
</tbody>
</table>

Source: BlackRock, 2016

**One-off costs** are the costs an investor pays to buy or sell units in a fund. These are sometimes known as anti-dilution levies because they prevent the fund’s net asset value being diluted through transaction costs from client order flow.

**Recurring costs** cover the day-to-day costs of running a fund. The ongoing transaction activity, management of risk, volatility, cash, and active management, all cause costs. Transaction costs sit here.

**Incidental costs** cover other ad hoc costs which do not recur periodically.
<table>
<thead>
<tr>
<th>Cost Category</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market impact</td>
<td>Large market trade leading to asset price movement/spread widening</td>
</tr>
<tr>
<td>Opportunity cost</td>
<td>Loss or gain from not being able to fully complete the trade</td>
</tr>
<tr>
<td>Broker commissions and fees</td>
<td>Explicit fees charged by the broker for on-exchange asset trades</td>
</tr>
<tr>
<td>Bid-Ask Spread</td>
<td>Implicit fee charged by the market maker in the bid/ask spread e.g. for FX and bonds</td>
</tr>
<tr>
<td>Delay cost</td>
<td>Loss or gain from delay in executing the trade</td>
</tr>
<tr>
<td>Taxes and levies</td>
<td>Taxes and fees payable to the regulatory agencies and security exchanges e.g. stamp duty</td>
</tr>
<tr>
<td>Securities lending fees</td>
<td>Percentage of profit generated by securities lending activities</td>
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</tbody>
</table>
Aren’t transaction costs covered by the spread?

It’s important to distinguish between a DC scheme buying or selling a fund (‘transacting’) and the investment activity undertaken by the portfolio manager inside the fund in pursuit of the investment objective of the scheme (‘trading’).

When a DC scheme transacts there is a ‘spread’ that protects existing investors or those remaining in a fund (depending on the type of transaction) of potential dilution of their assets caused by this activity. All funds need to consider how to mitigate or prevent this dilution through their dealing mechanism.

What causes confusion is that transaction cost analysis does not specifically relate to transacting described above. Instead it refers to the trading undertaken by the portfolio manager.

Because of this, transaction costs must be viewed alongside a fund’s investment approach. A buy-and-hold strategy will usually have a lower turnover and therefore a lower cost than a very active investment strategy within the same asset class.

Remember that different types of investments cost different amounts to trade. For example, large-cap US equities typically cost less to trade than emerging market bonds.

That’s why you need to compare apples with apples, both in terms of investment strategy and asset class, when approaching this topic and benchmarking the costs your scheme has incurred.
Transacting versus trading

Different asset classes cost different amounts to trade, so some strategies with outcomes which best meet a scheme’s needs are more expensive to access.
How BlackRock measures and monitors costs

BlackRock’s global transaction costs team:

- Provides models that determine the best way to trade before executing, to optimise net performance
- Assists trading decisions by finding the best tactic for any trade, to be cost-efficient
- Are the in-house experts for liquidity analysis and transaction costs at BlackRock
- Uses BlackRock’s global scale to help clients reduce costs
Our process

Proprietary technology captures all BlackRock trades across regions

- Identify performance opportunities
- Analyse ‘realised cost’ and ‘should-have-cost’
- Share data with portfolio managers and traders

Improved performance
Case studies

How does our transaction cost analysis drive decisions?

1. Trading decision

Some trades are particularly time-critical for a portfolio manager. Others may be executed for risk reasons or to balance the portfolio, or may be based on a really long-term insight. The motivation to trade can be very different.

A portfolio manager’s strategy may require the use of urgent trades to capitalise on a short-term opportunity or protect clients from losing money. That means a higher transaction cost but can also offer the potential for improved performance. If a manager does not need to trade quickly, he or she can be very patient and reduce the costs. One method to do this is algorithmic trading, where patience can lead to almost costless trades.

The key point here is that a higher transaction cost is not always a bad outcome. It’s all about performance.
Achieving value for money

High urgency trade
Pay more to capture short-term opportunity or cushion downside

Low urgency trade
Optimise order to minimise costs

Value for money
2. Investment process decision

When there is a change to a benchmark index (such as the FTSE 100 changing its constituents), everyone finds out that information at the same time, as well as when the change will occur.

With higher activity concentrated at the same point, managers may optimise trades – or intentionally not trade at that time – to seek to reduce costs that may impact the tracking performance.

In this case, we are trying to use our experience in trading techniques to minimise transaction costs before they arise.

A 2016 market execution case study

![Graph showing transaction costs in Fixed income, Equity, and FX](image)

**What BlackRock saved you versus the market**

- **40%** in Fixed income
- **29%** in Equity
- **33%** in FX

Source: BlackRock, 2016. BlackRock analysis of all Fixed Income High Yield and IG Credit, FX, and Equity trades excluding derivatives from Q1 to Q2 2016. BlackRock Execution Cost is the average difference between A) the actual price achieved on the trade and B) the benchmark price. For Equity and FX, benchmark price is the market price, based on exchange data, at the time when the PM submitted the order; for Fixed Income, the benchmark price is the previous day’s closing price. The Market Half Spread / Expected Cost is an estimate of the average execution cost of a market participant. In Fixed Income, the Market Half Spread is estimated quarterly for each sector and maturity bucket based on a consensus opinion of BlackRock traders as well as a set of over 10 broker dealers. In FX, similarly, brokers provide the Market Half Spread quarterly on a consensus basis for each currency pair and size range. In Equities, BlackRock calculates the Market Expected Cost using an independent broker model.
“Transaction cost analysis is a great measurement and monitoring tool, but it really develops value when you use it for informing your decisions and investment processes.

My team works with the trading desk and portfolio managers, across the asset classes, to ensure that we don’t just record this information, but use it actively to help improve performance for clients.”

Daniel Mayston
Global Head of Trading Research and Transaction Cost Modelling
Final thought

from Claire Finn,
Head of UK DC and Strategic Partnerships

We believe that we have led the market on this discipline for over a decade and that’s why we welcome the UK authorities’ efforts to improve the meaningful disclosure of costs.

Here are three key questions that any governance body should ask themselves when asking for transaction cost data:

1. **Does it help?**
   How will we use the additional information requested and how can we put it to use in a meaningful way when assessing value for money?

2. **Is market data available?**
   Until recently, much transaction cost data has been based on estimates. The slippage cost methodology proposed by the FCA has the advantage of using actual data but doesn’t break down implicit costs into their various component parts. For example, managers may not know objectively what the bid-ask spread is on a particular bond trade at any point until more standardised market data becomes available as market infrastructure is modernised.

3. **Is that data comparable across managers?**
   Additional data requested may rely on estimates and managers’ own observations of the market. This is likely to mean that every manager you talk to will give you a different set of disclaimers and caveats on their data provided. BlackRock is working hard to provide you with the information you need, and how to make sense of it.

Please get in touch if you want to learn more about this topic, or for a discussion about how our approach impacts your investments with us.
Contact the team

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Why BlackRock

BlackRock helps people around the world, as well as the world’s largest institutions and governments, pursue their investing goals. We offer:

• A comprehensive set of innovative solutions, including mutual funds, separately managed accounts, alternatives and iShares® ETFs

• Global market and investment insights

• Sophisticated risk and portfolio analytics

We work only for our clients, who have entrusted us with managing $5.1 trillion*, earning BlackRock the distinction of being trusted to manage more money than any other investment firm in the world.

*AUM as at 30 September 2016.