THIRD QUARTER 2014

ZENO'S TRADE PROCESS
PEER GROUP UNIVERSES & LEAGUE TABLES

LARGE CAP VALUE MANAGERS

Earlier this year, Zeno Consulting Group introduced its trade cost Peer Group Universes and League Tables. The costs tracked in the universes include not just broker-related costs, but also the trading costs incurred by asset managers "working" their orders over multiple days. Equally important, the universes rank managers against other managers charged with the same investment mandate (e.g. Small Cap Growth, Large Cap Value, EAFE etc.).

As such, Zeno views these universes as the next step in the evolution of trade cost analysis; and an important tool in evaluating the degree to which a manager's trading process helps or hurts bottom-line returns. Just as Fund fiduciaries use Peer Group Universes to help identify managers with superior stock picking ability, Zeno's Peer Group Universes and League Tables help evaluate the skill and efficiency with which managers implement those stock picks.

This quarter's Newsletter highlights the range of trading costs, commissions, and impact to performance incurred by managers in Zeno's **Large Cap Value Peer Group Universe**. It also highlights those Large Cap Value managers who incurred the lowest total trading costs, lowest commission rates, highest turnover rates, and lowest turnover rates.

Large Cap Value - Peer Group Universe

Asset manager trading processes often significantly impact overall investment performance. To this end, managers have a fiduciary obligation to both obtain best execution (so as to minimize the impact their trading has on their clients' portfolio returns), and avoid paying excessive commissions. Asset owners, in turn, have a fiduciary obligation to monitor their managers to ensure these legal requirements are achieved.

As shown in the table below, the range of trading costs, commissions, and impact to performance experienced by Large Cap Value managers (for the four-quarter period ending June 30, 2014), ranged from less than +36bp to more than -101bp. The median Large Cap Value manager had total trading costs of -23bp, and a spread of 53bp separate those managers that ranked in the top quartile and bottom quartile of their Peer Group.

About Us

Zeno Consulting Group, LLC, offers plan sponsors, mutual funds, insurance companies and fund-of-fund managers an objective way to examine the entire trading process, from stock selection through implementation, devoid of conflicts or associations with any broker/ dealer. As part of that commitment, we have also developed a proprietary benchmark that goes beyond measuring costs to encompass trade characteristics, existing market conditions and delay costs, giving you a fuller, more accurate picture of a manager's trading execution efficiency.

In this issue:

- **Zeno's 3Q14 Trade Process Peer Group Universes and Manager League Tables**
  - **Large Cap Value Peer Group Universe**
  - **Large Cap Value League Table**
- **Feature Article:** ***Enhancing your Manager Search process – by using Trade Cost Analysis prospectively***

While less expensive and volatile than other asset classes, the costs to trade Large Cap Value securities can still be significant. This is evidenced by the almost 140bp that separate the 5% and 95% managers (noted above). This underscores the importance of having a systematic and efficient trading process. This volatility also heightens the risks associated with using VWAP-based formulas to measure costs. VWAP-based formulas, by definition, tend to mask the true cost to trade; and as detailed in the table below, suggest that the median cost to trade Large Cap Value was only -7bp; with only 9bp separating the top quartile and bottom quartile managers.

Given the less demanding nature of most "value-type" trades (in terms of execution requirements) we would normally expect relatively low commission rates. This is, in fact, what we see. The median Large Cap Value commission rate was 2.3¢, with the top quartile and top 5th percentile rates being 1.7¢ and 0.6¢, respectively. Since most Large Cap Value trades don't require particularly "high touch" services from broker/dealers, rates in excess of these amounts are most likely due to either soft-dollar research needs or less rigorous commission oversight policies.

Large Cap Value				
Ranking	Total Costs (bp)	Performance Impact (bp)	Commissions (¢)	Execution Price vs. VWAP (bp)
Top (25%)	+2	0	-1.7	-2
Median (50%)	-23	-14	-2.3	-7
Bottom (75%)	-51	-45	-2.8	-11

To review all of Zeno's *Peer Group Universes*, key trends, and Glossary click here.

Large Cap Value - Universe League Tables

An asset manager's trade process is a function of both the Total Trading Costs incurred to build/unwind portfolio positions, and the amount of trading the manager engages in (turnover). "Total Trading Costs" x "Turnover" defines the impact a manager's trade process has on overall investment performance.

As shown in the table above, when taking into consideration the amount of trade volume each manager executed, the median bottom-line impact to performance (due to trading costs) equated to an annualized return of -14bp. The difference between top quartile and bottom quartile managers was approximately 45bp! In essence, this means the stock picks of bottom quartile firms needed to outperform their peers by 45bp, in order for their net returns to break even. Given historic returns for Large Cap Value strategies, this can represent a significant hurdle for long-term superior performance.

Conversely, managers with efficient trade processes, enjoy a systematic advantage over firms with more costly processes. The table below shows the **Large Cap Value Manager League Tables** for: "Total Trading Costs" (calculated on an implementation shortfall basis), "Commissions", and "Turnover" for the four-quarter period ending June 30, 2014. The rankings are based on trading conducted by those managers reviewed in Zeno's Large Cap Value Peer Group Universe.

Large Cap Value Managers			
Efficient Total Costs		Efficient Commissions	
Rank	Manager	Rank	Manager
1	Quantum Capital Management	1	Glovista Investments
2	Wells Capital Management	2	Structured Portfolio Management
3	Dimensional Fund Advisors	3	LSV Asset Management
4	Hamon	4	BlackRock
5	Fama Investments	5	Schroders
High Turnover		Low Turnover	
Rank	Manager	Rank	Manager
1	Glovista Investments	1	Lazard Freres Gestion
2	RS Investments	2	State Street Global Advisors
3	Harding Loevner	3	Dimensional Fund Advisors
4	Batterymarch Financial Management	4	Westwood Global Investments
5	Hamon	5	Structured Portfolio Management

To review all of Zeno's *Universe League Tables* and a Glossary of key terms, click here.

FEATURE ARTICLE - ABSTRACT

Enhancing your Manager Search process – by using Trade Cost Analysis prospectively

In our inaugural quarterly Newsletter, we presented a Case Study on how one asset owner utilized meaningful trade cost analysis ("TCA") with their investment manager to improve that manager's trading efficiency. Those improvements reduced the average trading costs incurred by the manager from -230bp to less than -50bp; which given the level of trade volume the manager typically engaged in, boosted the manager's annual investment performance by 2.8%! Equally important, the improved execution efficiency (realized as a result of the prudent oversight and follow-up taken by that asset owner), represents a **recurring savings** to the asset owner's Fund.[1]

Of course, the follow-up actions taken by the asset owner were only necessary because the Fund had hired the investment manager prior to discovering the obstacles to best execution, within the manager's trading process. This begs the question: how much more could have been saved had the problem been identified earlier? Put slightly differently, meaningful TCA can help avoid unnecessary costs - if deployed in a prospective manner, during Manager Searches.

[1] To read the full Case Study, visit the Research section on Zeno's website www.zenocg.com

By utilizing TCA during a Manager Search process, Funds looking to engage a new investment manager have the ability to assess the efficiency of each finalist's trading process. Obviously, trading costs are but one small consideration in the overall evaluation of a prospective investment manager. However, *all else being equal*, managers who employ trading processes free of artificial impediments to best execution, are by definition, more likely to sustain their superior historical performance going forward.

Asset owners who enjoy these TCA-related insights are thereby able to make more informed decisions - before making their final fiduciary decision as to which candidate to hire. This abstract provides a summary of an article on a recent instance where one asset owner used meaningful TCA in just such a fashion.

Background

In mid-2014, a large public plan sponsor determined that it needed a Non-US Developed Markets investment manager. In working with their full-service investment consultant, the asset owner narrowed the search down to two finalists. As a supplement to the standard due-diligence conducted by the Fund's staff and investment consultant, the asset owner then utilized TCA to provide a blend of quantitative and qualitative assessments regarding each finalist's:

- Trade process and overall trading costs;
- "Execution efficiency";
- Commission levels;
- Broker/dealer counterparties;
- Trading of foreign exchange; and
- The extent to which each finalist's trading process systematically impacted their overall investment performance on an ongoing basis.

To this end, both finalists were requested to complete a qualitative TCA questionnaire, and submit representative trade files covering their 2013 trade executions. Their responses were then reviewed and analyzed by Zeno. A summary of the focus and potential concerns prompting the review of each respective issue follows below (a description of the specific insights gleamed from the two finalists is included in the full Case Study posted on Zeno's website).

Trade process and overall trading costs

In evaluating a manager's trade process, the first step is to quantify the actual loss of asset value paid from an asset owner's Fund (as a result of a manager either building or unwinding positions in its portfolio). At the end of the day, these costs directly sap the manager's overall investment performance, and in many instances can equate to 10-15% of a manager's gross performance. For example, during 2013 (the period in which the asset owner's two finalists were being evaluated), the trading costs incurred by managers offering Non-US Developed Market's strategies, ranged from -7bp to as much as -111bp; with bottom quartile managers paying -79bp or more.

In Zeno's experience, managers ranking in the bottom quartile of trading costs often have administrative and/or operational impediments to best execution imbedded in their trading process. These impediments may be the result of either inattention to trading or conflicts of interest. Happily, once identified, such obstacles can frequently be addressed without compromising the integrity of the manager's normal investment process.

Execution Efficiency

Aside from calculating the absolute level of trading costs incurred by a manager, it is also useful to gauge the execution efficiency of a manager's trade process. In Zeno's view, both metrics are important, but distinct. Specifically, there is a subtle but critical difference between knowing what a manager's costs were, and knowing whether those costs were "reasonable" (given the *difficulty* of those trades).

Ultimately, a manager's performance is impacted by the total trading costs; not the "reasonableness" of those costs. That said, knowing if a manager systematically implements their trades efficiently (given the respective trade characteristics), can be an important factor in determining a client's comfort level with the firm's overall trading process.

Commission levels

A third focus of attention should be the Commission rates paid by each finalist. While Commissions are just the proverbial "tip of the iceberg" when it comes to trading costs, they are nevertheless an asset of the client's Fund. Consequently, asset owners have a fiduciary duty to monitor the Commission rates paid by their managers and ensure those rates are reasonable. Further, Commissions are explicitly negotiated between each manager and the various broker/dealers they use. As such they can be easily controlled by the manager, and readily quantified.

In this regard, during 2013 (the period in which the two finalists' trading were being evaluated), the Commissions incurred by other managers offering Non-US Developed Market's strategies, ranged from -1bp to over -15bp. In Zeno's experience, managers falling in the higher end of that range often do so, because they are purchasing soft-dollar research/brokerage services, participating in commission recapture programs, or do not have a rigorous Commission allocation policy.

Use of Broker/Dealer Counterparties

An important secondary area of review is the choice and utilization of counterparties. Managers are responsible for maintaining and managing a prudent list of broker/dealers with whom to execute trades. Specifically, managers look to the sell-side for a variety of execution-related services, including: "low touch" electronic trading platforms, algos, "higher touch" more manual brokerage services, principal trades (i.e. the commitment of capital), and soft-dollar research. Ultimately the manager must decide which level of service best meets their needs, and which broker/dealers deliver those services in the most effective and economical fashion.

From a Manager Search due diligence perspective, asset owners should monitor where their managers route trades, and the costs thereby generated. More specifically, this includes: how many counterparties were used on a consistent basis, whether too much trade volume was concentrated in just a few firms (e.g. potential "counterparty risk"), whether any firms seem to generate excessive costs, and which firms (if any) appear to be receiving soft-dollar commissions.

Where necessary, additional due diligence on the manager's broker allocation procedures may also be warranted. This due diligence could include, for example, how the manager routes orders to different venues so as to avoid predatory practices by High Frequency Traders.[2]

Foreign Exchange

An often overlooked aspect of Manager Searches (for international or global investment strategies) is the skill and aptitude with which the managers execute the foreign exchange ("FX") necessary to settle their equity/bond trades. Further, to the extent these FX trades are executed by the client's custodial bank pursuant to "Standing Instruction" arrangements, heightened scrutiny is recommended – since recent court cases have confirmed that those custodial banks do not automatically have a fiduciary responsibility to provide best execution.[3]

In this context, the goal of a Manager Search is to review a variety of FX-related issues, including: whether the manager trades FX itself, outsources those responsibilities, or defers to the client's custodial bank; whether the manager will act as a fiduciary in executing and monitoring the Fund's FX transactions; and the degree to which the manager conducts TCA on the FX transactions needed to settle its equity/bond trades.

Turnover Rates and Impact of Investment Returns

Perhaps the most important trade-related consideration when conducting a Manager Search is the impact that trading has on each finalist's overall returns. As a general matter, turnover, in and of itself, is neither good nor bad. However, in determining the degree to which a manager's trading process impacts <u>overall investment performance</u>, the average trading costs incurred by the manager must be multiplied by the level of trade volume executed. Clearly, a manager with low turnover can be less concerned about high trading costs, than a manager with higher turnover.

In way of illustration, during 2013 (the period in which the asset owner's two finalists were being evaluated), the turnover rates of Non-US Developed Market's strategies, ranged from 13% to 92%; and the overall impact to annual investment returns (caused by the combination of trading costs and turnover levels) ranged from -3bp to over -1.5%. In the context of a Manager Search, the goal is to therefore analyze each finalist's typical turnover rate, and apply that rate to the firm's typical trading costs. In this fashion, the asset owner can fully understand the impact each manager's trading process will have on their respective annual investment performance.

Conclusion

In summary, TCA cannot replace the traditional factors and considerations involved when selecting a new manager. However, using TCA to supplement traditional forms of manager due diligence, provides unique insights that enable asset owners (and their consultants) to make more informed fiduciary decisions.

---

[2] For a fuller discussion of High Frequency Trading, and the types of due diligence plan sponsors can ask their managers, read <u>*High Frequency Trading: What does it mean for Asset Owners?*</u>, which can be found in the Research section of Zeno's website www.zenocg.com

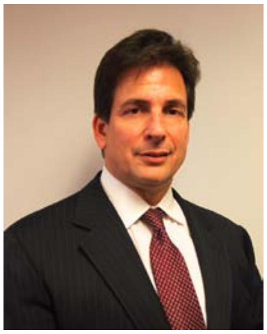
[3] See e.g. <u>*Louisiana Municipal Police Employees' Retirement System v. JPMorgan Chase & Co. et al.*</u>, (SD, NY 2013).

There may often be instances, where one candidate appears to have a slightly more efficient trading process than another candidate, but other factors outweigh the benefits associated with that superior trading. And there will be many instances, where no candidate exhibits any significant concerns. However, from a due diligence perspective, knowing a manager's process has no "critical issues," is just as important as identifying something that warrants follow-up.

Under either circumstance, the asset owner is able to make more informed (and therefore more prudent) decisions. Bottom-line, a Manager Search is an exercise whose ultimate goal is to assess the likelihood of continued superior performance. In this context, TCA represents an additional "touch point" for evaluating a manager's investment approach and aptitude. More to the point, TCA ascertains the portion of a manager's returns attributable to their trading process, and helps uncover potential conflicts and other compliance-related concerns.

Just as TCA is important in the context of ongoing manager oversight, so should its value be recognized when trying to decide which manager to hire in the first place.

To read the full article, and a description of the more relevant findings regarding each of the key areas uncovered by this Money Manager Search analysis, click here.



About the author
Steven Glass, JD
President & CEO

Steven joined Zeno (formerly Plexus Group) in 1996. He manages all client servicing, sales, marketing and product development for institutional clients including plan sponsors, mutual fund boards, and other entities exercising oversight over 3rd party investment managers.
Prior to joining Zeno, Steven served as General Counsel to the District of Columbia Retirement Board where he provided fiduciary guidance on investment management issues, and developed the Board's Transaction Cost Monitoring Program.

Upcoming Newsletter

- 4Q14 Newsletter
  How to compare Transition Manager Pre-Trade reports and choose the best firm