



FOURTH QUARTER 2013

INTRODUCING ZENO'S TRADE PROCESS: PEER GROUP UNIVERSES & LEAGUE TABLES

As the next step in the evolution of trade cost analysis, Zeno Consulting Group is pleased to introduce the industry's first Trade Process Peer Group Universes & League Tables. While trade-related universes have been available for several years, most suffered from two critical limitations: a focus on just broker-related costs while ignoring the trading costs incurred by asset managers "working" their orders over multiple days; and failing to rank managers against other managers charged with the same investment mandate (e.g. Small Cap Growth, Large Cap Value, EAFE etc.).

Zeno's Trade Process Peer Group Universes & League Tables address both these flaws. As such, they offer asset owners a practical tool to better assess the degree to which a manager's trading processes 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.

In combination, this information enables Fund fiduciaries to make more informed decisions when hiring/monitoring managers; and thereby better safeguard the assets of their Funds.

Trade Process - 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. The table below shows the range of trading costs, commissions, and impact to performance (for the four-quarter period ending September 30, 2013), incurred by managers in Zeno's **Large Cap Growth Peer Group Universe**.

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.

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US Large Cap Growth				
Ranking	Total Costs (bp)	Impact on Annual Returns (bp)	Commissions (¢)	Execution Price vs. VWAP (bp)
Top (25%)	-18	-32	-1.9	-6
Median (50%)	-61	-70	-2.5	-10
Bottom (75%)	-84	-121	-3.1	-14

To review all of Zeno's *Peer Group Universes*, key trends, and Glossary [click here](#).

Trade Process - 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. The table below shows the **Large Cap Growth Manager League Tables** for: "Total Trading Costs" (calculated on an implementation shortfall basis), "Commissions," and "Turnover" - for the four-quarter period ending September 30, 2013. The rankings are based on trading conducted by those managers reviewed in Zeno's Large Cap Growth Peer Group Universe.

Large Cap Growth Managers			
Efficient Total Costs		Efficient Commissions	
Rank	Manager	Rank	Manager
1	Vision Capital Management	1	Jacobs Levy Equity Management
2	Columbia Management	2	GMO
3	Wells Capital Management	3	OakBrook Investments
4	TCW Group	4	Rainier Investment Management
5	GMO	5	Mellon Equity Associates
High Turnover		Low Turnover	
Rank	Manager	Rank	Manager
1	SunAmerica Asset Management	1	TCW Group
2	Rainier Investment Management	2	GMO
3	Fred Alger Management	3	Morgan Stanley
4	Cornerstone Asset Management	4	Brown
5	Invesco	5	Logan Capital

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



FEATURE ARTICLE (summary)

The untapped ability of plan fiduciaries to save Fund assets through trade cost oversight.

(The full text of an earlier version of this article was featured in the FPPTA's May 2013 Continuing Educational Series webcast, and subsequently published in the September 19, 2013 edition of Public Fund Focus.)

Whether plans are trying to match liabilities, maximize returns to reduce unfunded liabilities, or simply pay benefits, unnecessary costs that sap investment performance are unacceptable. This is particularly true in equities, where the most recent data shows that on average, over 70% of active asset managers underperform their passive benchmarks.

Indeed, over the prior five years, the equal-weighted performance of all domestic active managers has lagged the S&P1500 by about -56bp. **Interestingly, the difference between the median and 4th quartile managers' trading processes is over 60 bp.**

Meaningful Trade Cost Analysis enables asset owners to not only flag and quantify high costs, but more importantly, understand why a manager's trading process is expensive. This in turn, helps asset owners make informed decisions as to whether adjustments to that process will help or hurt the Fund's performance. Armed with this knowledge, specific actions designed to help bring those costs in-line are often available to asset owners.

This article reviews one instance where a plan sponsor used meaningful trade cost analysis, in just such a fashion.

However, before exploring the facts and circumstances regarding this particular Case Study, it's important to understand exactly what we mean when we say, "trading costs," and/or "trading process." Specifically, given the size of institutional orders, managers sometimes "work" their orders for several days, using multiple brokers and algos. Understanding the true impact that trading has on Fund performance therefore requires asset owners to calculate not just the commissions and market-impact caused by a broker trading on a particular day, but also the costs incurred as a result of the asset manager "working" their order over multiple days. The combination of all three of these cost components is what we refer to herein as "Trading Costs."

In this regard, a truism of trading is that a natural tension exists between those three cost components, such that minimizing one often increases the others. *For this reason, in most instances, it is virtually impossible to make informed assessments regarding the efficiency and efficacy of a manager's trading process without measuring all three cost components.*

In practice, we tend to find that managers who rank in the 4th quartile of their peer group Trading Process Universe, are likely there as a result of one, or more, of three reasons:

1. The basic structure of a manager's investment process (e.g. concentrated portfolios inherently have very illiquid trades);
2. General inattention to trading, or administrative bottle-necks within the trading process; and/or
3. Conflicts caused by the manager juggling competing client demands, or balancing their own operational/administrative interests vs. their clients' interests (e.g. gathering more assets under management notwithstanding the impact on trade liquidity; using client commissions to pay for the manager's soft-dollar research needs etc).

Importantly, the last two causes are well within the manager's ability to control - without compromising the integrity of the manager's investment process. Consequently, attention to those issues by asset owners can act as a catalyst, "encouraging" the manager to adjust their practices so as to ensure the asset owner's trades receive the best possible treatment.

The Case Study below provides a concrete illustration of just how this all can work.

In mid-2011, a plan sponsor set up a "Cost Containment Program" (Program), whereby the Fund's managers were provided the opportunity (subject to best execution) to use a particular brokerage firm to execute the Fund's trades at a commission rate of 0¢. Clearly, no broker trades for free, and this arrangement was only possible because the Fund paid for a broader suite of services from that firm.

That said, those other services represented "fixed costs" for the Fund; and would be paid regardless of how many trades were sent to the broker. Accordingly, as long as using the Program did not compromise overall execution quality, the Fund hoped its managers would take advantage of the arrangement.



While most of the Fund's managers did in fact participate in the Program, one firm refused. This firm provided a Large Cap Growth strategy; and argued that they needed all of the Fund's trades to purchase soft-dollar research.

Had this manager been providing efficient overall trading costs it's likely the Fund would have let matters stand as they were (as it did with two of their other managers). However, this manager consistently ranked in the 4th quartile of Zeno's Trade Process Universe for Large Cap Growth managers (with trading costs often exceeding -240bp). Further, the soft-dollar brokers used by this manager were incurring high brokerage costs as well.

Consequently, the Fund was unwilling to simply acquiesce to the manager's position, without significant in-depth discussions.

Throughout 2012 and early-2013, follow-up meetings were conducted with the Large Cap Growth manager. Following these discussions (in which the above data was shared), the manager relaxed their earlier absolute refusal, and proposed a new arrangement. Under the new arrangement, the trades desired by the Large Cap Growth manager's portfolio managers would be forwarded to the trading desk of a completely different (but affiliated) asset management firm. The second manager's trading desk would then execute the Fund's shares through the Fund's Program at 0¢.

This type of arrangement, while rare, is not unheard of. In many respects, the proposal represented a good faith effort on the part of the manager to juggle the competing needs of the Fund and the firm's investment process. However, while these types of arrangements can sometimes operate effectively, if not structured properly, they can often result in significant hidden costs.

The primary concern with such arrangements is the timing of when the second trading desk is informed by the original firm of the various trade orders. If the original firm forwards their trade lists to the second firm after the original firm starts trading for its other clients, in all likelihood, the second firm will achieve worse execution quality on its trades (since the original firm's trading activity can impact prices and the additional time delay may result in stock prices moving before the second firm even has an opportunity to trade).

This then was the focus of a subsequent discussion between Zeno, the Fund's consultant, and the trading personnel of both managers. Happily, both managers indicated that the trades for these clients were forwarded to the second firm's trading desk concurrent with the original firm's trading desk (as opposed to sequentially). As a result, neither trading desk was disadvantaged relative to the other (although they in effect competed against each other).

Perhaps more importantly, the managers also stated that of the \$35+ billion currently managed by the original firm in its Large Cap Growth strategy, almost 90% was traded by the original firm's trading desk. In contrast, only about 3% was sent to the second firm's trading desk. From a trade cost perspective, this presented an intriguing dynamic.

In particular, Zeno's TCA reports demonstrated that the original firm's trading desk could take up to ten days to complete the Fund's trades, with only about 50% being executed by the end of the first day. This was a function of both the original firm's trading style, and its assets under management. Zeno's TCA reports showed that these delays were largely responsible for the high overall trading costs noted earlier.

Understanding this dynamic unlocked the potential for the plan sponsor and manager to collaborate and adjust the manager's trading process so as to better manage this impediment to efficient trading. Given that the second firm's trade sizes would be about 1/20th the size of the original firm's trades, having the second firm trade the Fund's shares would in all likelihood result in much quicker and cheaper executions. Accordingly, the Fund accepted the manager's proposal.

3Q13 represented the first quarter in which the Large Cap Growth manager fully participated in the Program. The results were stunning.

Aside from commission rates falling to 0¢, the speed with which the Fund's trades were executed increased from ten days to less than five, with 80% of those trades being completed by the end of the first day (vs. 50-60% in prior quarters). More importantly, as a result of the quicker trading, overall trading costs improved 176bp!

As shown in Graph 1, trading costs fell from -227 bps in 2Q13 to only -55bp in 3Q13! Given the trade volume executed by the manager in 3Q13 (\$33.7 million), this equated to a savings in 3Q13 of over \$550,000, and an annualized savings of over \$2.2 million.

Graph 1

Review Period	Decision Value \$Millions	Total Cost bp	Total Cost Benchmark		Value Added (Versus Actual Cost Benchmark)		Turnover Ratio %	Index Return bp	Traded Returns*	
			Actual bp	Adjusted bp	\$ 000	bp			Before Costs bp	After Costs bp
2012/Q4	32.5	-195	-106	0	-288	-89	19	-197	175	-20
2013/Q1	23.8	-284	-195	0	-210	-88	13	836	204	-79
2013/Q2	37.0	-227	-170	0	-211	-57	20	202	100	-127
2013/Q3	33.7	-55	-53	0	-8	-2	16	766	369	314

Further, Zeno’s TCA reports enabled the Fund to demonstrate that since the Program’s inception, the manager’s average commission rates typically ranged between 2.8¢ and 2.9¢. In contrast, had the manager utilized the Fund’s Program, those trades would have been executed at a commission rate of 0.0¢. Given the number of shares the firm executed, this represented almost \$73,000 in excess commissions. In light of the TCA documentation, the Fund successfully negotiated a one-time reimbursement of that amount.

Conclusion

Coming full-circle; in an environment of single digit returns, no one can afford unnecessary costs. While asset owners often view trading costs as something esoteric and better left to their managers, doing so introduces significant “oversight risk” to the Fund. Trading costs, whether monitored or not, are very real – often representing in excess of 10% of a manager’s gross returns.

Just as important, asset owners must recognize that with respect to trading, the interests of their Fund and their managers are not always perfectly aligned. And when interests diverge, the Fund usually pays the price. Meaningful TCA helps identify these issues and ensure that, at a minimum, your Fund is treated equally well as all other clients.

While the above Case Study is nominally about a plan sponsor asking its manager to use a particular broker, the issues confronted and solutions arrived at, are applicable to a myriad of general TCA oversight scenarios. For example, potential roadblocks to execution efficiency include:

- Managers who have grown too large for their investment strategy;
- Trader Compensation Programs that inadvertently incent the traders to act in a manner adverse to the client’s interests;
- Trading Desks that try to “game” simplistic TCA benchmarks (such as VWAP);
- Lack of communication between the manager’s Portfolio Managers and Trading Desk;
- Younger asset management firms where the founding partners have difficulty delegating trading decisions (notwithstanding the fact that those partners may not be easily accessible to “sign off” on urgent trades).

Similarly, as the SEC and Department of Labor have made abundantly clear, commissions are an asset of the Fund. As such, asset owners should ensure the commissions paid to execute the Fund’s trades are reasonable. The combination of quantifying the actual vs. potential commission rates, and ranking those rates against the manager’s peer group, enable asset owners to flag and document excessive rates. And take steps to recoup those losses.

Bottom-line, meaningful TCA enables asset owners to not only flag and quantify high costs, but more importantly, understand *why* a process is expensive. This in turn, helps asset owners make more informed decisions whether adjustments to a manager’s trading process are warranted.

To read and access the full article, [click here](#).



About the author

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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.

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- CALAPRS – March 2–4th
- TEXPERS – March 23–26th

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