FOURTH QUARTER 2014

ZENO'S TRADE PROCESS PEER GROUP UNIVERSES & LEAGUE TABLES

LARGE CAP GROWTH MANAGERS

In early 2014, 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 Growth Peer Group Universe. It also highlights those Large Cap Growth managers who incurred the lowest total trading costs, lowest commission rates, highest turnover rates, and lowest turnover rates.

Large Cap Growth - 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 range of trading costs, commissions, and impact to performance experienced by Large Cap Growth managers (for the four-quarter period ending September 30, 2014), ranged from less than +17bp to over -147bp (the 5th and 95th percentiles, respectively). As shown in the table below, the median Large Cap Growth manager had total trading costs of -51bp; and a spread of 73bp 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.

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- **FX Update: BNY Mellon FX settlement; what does it mean for asset owners?**

The 160+ bp that separate the 5% and 95% Large Cap Growth managers (noted above) underscores the importance of having a systematic and efficient trading process. This dramatic disparity also heightens the risk 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 Growth was only -9bp; with only 7bp separating the top quartile and bottom quartile managers (and only 24 bp separate the 5th and 95th percentile managers).

Given the relatively greater execution difficulty associated with many "growth-type" trades (due to adverse momentum trading environments) we typically expect relatively high commission rates. This is, in fact, what we see. The median Large Cap Growth commission rate was 2.7¢, with the top quartile and bottom quartile rates being 2.0¢ and 3.2¢, respectively. Of course, a portion of these rates are used to purchase of soft-dollar research. As discussed in this edition's Featured Article, global managers may shortly be facing a new soft-dollar regulatory regime. If/when that occurs, explicit commissions may be dramatically reduced (although clients can anticipate requests to approve new unbundled "manager research budgets").

Large Cap Growth				
Ranking	**Total Costs (bp)**	**Performance Impact (bp)**	**Commissions (¢)**	**Execution Price vs. VWAP (bp)**
Top (25%)	-15	-15	-1.95	-5
Median (50%)	-51	-51	-2.72	-9
Bottom (75%)	-88	-92	-3.16	-12

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

Large Cap Growth - 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 investment performance (due to trading costs) equated to an annualized return of -51bp. The difference between top quartile and bottom quartile managers was approximately 92bp! In essence, this means the stock picks of bottom quartile firms needed to outperform their peers by 92bp, in order for their net returns to break even. Put another way, the annual investment returns generated by half of all Large Cap Growth managers (i.e. the top 25% and the bottom 25%) vary by over 1% - *just due to their respective trading efficiency*.

The table below shows the **Large Cap Growth Manager League Table** for: "Total Trading Costs" (calculated on an implementation shortfall basis), "Commissions", and "Turnover" for the four-quarter period ending September 30, 2014. 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	TCW Group	1	Jacobs Levy Equity Management
2	Vision Capital Management	2	ClearBridge Investments
3	Lord, Abbett & Co.	3	Mellon Equity Associates
4	Columbia Management Inv Adv	4	American Century Investments
5	Cornerstone Asset Management	5	OakBrook Investments
High Turnover		Low Turnover	
Rank	Manager	Rank	Manager
1	Fred Alger Management	1	Baron Capital Group
2	American Century Investments	2	Sands Capital Management
3	Jacobs Levy Equity Management	3	TCW Group
4	ClearBridge Investments	4	MFS Investment Management
5	INTECH	5	Morgan Stanley

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

FEATURED ARTICLE

In late 2014 and January 2015, new regulations were proposed in the UK and European Union that dramatically alter the manner by which investment management firms obtain soft-dollar research and other services. It appears likely that these regulations (or language very similar) will be adopted by the end of 2016. At that point in time, global managers will need to implement new administrative and operating procedures, *which entail new fiduciary obligations for both the managers and their institutional clients regarding the oversight of their Fund assets.*

Of course, investment managers will need to start modifying their practices and systems well before that deadline. This in turn means that asset owners may begin fielding substantive discussions and requests from their global managers throughout 2016 (and perhaps earlier). To help prepare for those deliberations, Zeno has authored the article below. The article summarizes this issue, describes what soft-dollars are, why it's important to discuss this matter today, the risks and benefits of allowing managers to use Fund assets to purchase research (as opposed to the manager paying for the research itself), and details potential steps asset owners can consider - to best protect their Funds. The article's Introduction and first section follow below. The entire article can be accessed by clicking the link at the end of the section below.

"The $250 Econ 101 Textbook" and other Soft-dollar concerns for asset owners

Introduction

On January 13, 2015 the Wall Street Journal published an opinion piece by economics Professor Craig Richardson titled, "The $250 Econ 101 Textbook". In the article, Professor Richardson notes an economic factoid: since 1985 the aggregate cost of consumer goods has only doubled, while the price of basic college textbooks rose 600%! The primary reason for this "free market" anomaly? Professors, who order textbooks for their students, don't have to pay for them.

Professor Richardson concludes by observing, “[T]he cardinal lesson is that prices rise unchecked if the people who order the goods aren’t paying the prices.” And if one changes the focus of Professor Richardson’s article from college text books to equity commissions, you have the crux of a fierce debate currently embroiling asset managers, investment banks, and regulators, regarding the use of “soft-dollars”.

For those unfamiliar with the term, “soft-dollars” refers to the practice of asset managers paying for research and brokerage services with their client’s commission dollars. By bundling the fee for such services into the commission already being paid to a broker (for executing a trade), the manager does not have to pay an explicit hard dollar fee for the research. While this certainly facilitates the acquisition of those services, it raises concerns that managers may use client commissions to purchase unnecessary research. Indeed in this respect, the analogy to textbooks is slightly off, since professors don’t receive pecuniary gain from having their students pay exorbitant prices. They simply lack incentive to conduct a thorough cost:benefit assessment of each book’s relative value.

To be clear, arguments surrounding the use of client commissions to purchase soft-dollar research for asset managers have been around for almost 50 years.[1] However, UK and European regulators are now revisiting their positions on soft-dollars, and entering the final stages of adopting dramatically revised standards of practice. If enacted in their current form (which appears increasingly likely), global managers and US-domiciled managers running Non-US strategies will face major changes in their operations, policies and practices for purchasing research.

This will, in turn, create new fiduciary responsibilities for their asset owner clients. Specifically, as discussed in greater detail below, the proposed new standards require asset managers to present specific “Research Payment Accounts” for approval from their clients. Once approved, these research budgets would then be paid for, as a separate line-item, from the client’s Fund assets.

To this end, Fund fiduciaries should start preparing for the not so distant future when their managers approach them with requests to formally approve “Research Payment Accounts”. Moreover, even if a global manager does not request its US clients to approve a research budget (since US clients can continue to pay for soft-dollar research the traditional way), prudent fiduciaries should take care that their Fund is not being disadvantaged in some fashion relative to that manager’s UK/EU clients (since their research must be obtained in a very different way).

This article is intended to provide asset owners with guidance on this fast-approaching matter. It begins with a brief explanation and history of soft-dollars, the various pros and cons regarding their use, and the primary positions of the UK and European regulators. The article concludes with a Case Study describing a recent audit conducted by a large public plan sponsor of their external managers’ soft-dollar practices, and a check-list of oversight measures asset owners may want to consider.

Soft-dollars – what are they?

At its most basic, a “soft-dollar” transaction occurs when a manager uses its clients’ commissions to pay a broker/dealer a commission rate above and beyond the cost of mere execution. In return, the broker/dealer provides the manager with “credits” (based on a percentage of the excess commissions), with which the manager can purchase various brokerage or

[1] In 1975 the SEC and Congress passed SEC Rule 19b-3, and Section 28 (e) of the Securities Exchange Act of 1934. Collectively, these enactments abolished fixed commission rates and established the concept of purchasing brokerage and research services with “soft-dollar” commission fees over and above the rate for just execution services.

research services.[2] Mechanically, this is akin to an individual consumer using credits, accumulated by making purchases on a credit card, to buy various items (albeit, in the case of soft-dollars, the managers are in essence, using your credit card and your credits to buy services for themselves).

In a soft-dollar arrangement, the brokerage and research services provided by the broker/dealer must benefit the manager (i.e. enable it to better manage its assets). However, the acquired service does not have to directly benefit the specific client whose commissions paid for the service. As discussed more fully below, this introduces potential conflicts of interest, which the manager must balance on an ongoing basis.

The term "soft-dollars" has also sometimes been used to describe an arrangement in which a manager sends trades sent to a specific broker/dealer at the direction of the manager's institutional clients. However, from a legal perspective, this type of arrangement does not constitute "soft-dollars", but rather, "directed brokerage".

While directed brokerage and soft-dollars both involve the use of client commissions, in directed brokerage arrangements, the client is directing the manager to place the client's trades with a particular broker, in order that the client receives something of value.[3] Because the client is the direct beneficiary of these programs, the inherent conflicts faced by managers who utilize soft dollars are not present in directed brokerage arrangements. Consequently, directed brokerage programs are viewed (and treated) very differently under the law.

In the US, both Congress and the SEC have repeatedly made clear that managers can use client commissions to purchase various brokerage and research services. At the same time, the law requires that managers pay only a reasonable amount for such purchases, and their overall duty to obtain "Best Execution" (including the commission costs) still applies to these trades. Because of the inherent difficulty in balancing the right to purchase soft-dollar services (with client commissions) vs. the obligation to obtain Best Execution, the SEC has identified various services they felt represented legitimate uses of client commissions. These services were described in Section 28 (e) of the Securities and Exchange Act of 1934 (and subsequent Interpreted Releases), and is referred to as a "Safe Harbor".

Essentially, as long as a manager's soft-dollar purchases are limited to the types of services detailed in Section 28 (e), the manager's trades will be deemed to be "reasonable". While a manager's soft-dollar purchases are not technically limited to the items listed in Section 28 (e), if a different item is purchased, the manager must be prepared to demonstrate why such a purchase was "reasonable". As a practical matter then, most soft-dollar purchases are restricted to the services described under Section 28 (e).

[2] Managers can accumulate and utilize soft-dollars in two ways. One way is for the manager to establish a soft-dollar account (and accumulate credits) with each broker/dealer it sends trades to. This is the traditional soft-dollar arrangement. While still in effect, this approach has received criticism due to the fact that managers may be incented to send trades to a particular broker simply to grow the manager's soft-dollar account balance, rather than for "best execution". Largely in response to those potential conflicts of interest, in 2006 the SEC and FCA allowed (and sometimes encouraged) managers to establish "Commission Sharing Agreements" ("CSAs" - sometimes also referred to as "Client Commission Agreements"). CSAs permit managers to establish a soft-dollar account with just one broker/dealer and then instruct all of the other brokers the manager uses for trade execution to allocate a portion of their commission directly to the CSA. The manager can then direct their CSA broker to pay for research etc. from any 3rd party vendor. One disadvantage of CSAs is increased "counterparty risk" – due to the fact that all of the accumulated soft-dollar credits are maintained at one broker.

[3] Common motivations for directed brokerage arrangements include: commission rebates; or social benefits such as promoting local, minority, or women-owned brokerage firms.

Of course, even if technically legal, asset owners have a right to prohibit the use of their Fund assets for purchasing soft-dollar services. This then begs the question: are soft-dollar practices good or bad? While market participants have debated this question literally for decades, as noted above, recent regulatory developments have brought this issue front and center.

To read the full article, click here.

FX UPDATE: BNY Mellon settles FX lawsuit! What does that mean for Asset Owners?

On March 19, 2015 the Bank of New York Mellon ("BNY Mellon") agreed to pay $714 million to settle accusations that it charged government pension funds and other investors excessive fees when executing their foreign exchange transactions. The lawsuits had charged that, dating back to 2000, the bank's "Standing Instruction" process systematically sold currencies to clients at rates close to the high of each day, and bought currencies from clients at rates that were near the low of the day. Consequently, BNY Mellon generated inordinate profits at the expense of their clients.

In addition to the monetary fines, certain bank employees, including the Managing Director in charge of drafting and disseminating the description of the bank's Standing Instruction program (including RFP responses), were terminated. Further, BNY Mellon agreed to install new functionality that afforded clients improved transparency regarding the quality of their prices.

At the core of the settlement, BNY Mellon acknowledged that it had made false or misleading representations (both written and oral) regarding its trading of foreign exchange and Standing Instruction program. These comments, as cited in the settlement agreement, included:

1. The bank provided "*FX execution according to best execution standards.*"
2. The bank "*ensures best execution on foreign exchange transactions … as a major market participant, the Bank is actively engaged in making markets and taking position in numerous currencies so that we can provide the best rates for our clients*."
3. *"[I]t is our goal to provide best execution for all foreign exchange executed in support of our clients' transactions*."
4. "*We price foreign exchange at levels generally reflecting the interbank market at the time the trade is executed by the foreign exchange desk*.''
5. The bank's "*primary focus is on securing the best possible rates for our clients rather than on trading for the bank's own account*."
6. The bank's "*FX standing instruction is designed to help clients minimize risks and costs related to the foreign exchange...*''

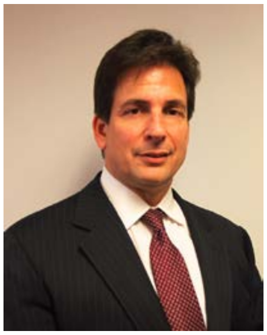
To a certain degree, the settlement vindicates many who felt the bank's foreign exchange pricing practices breached the implied trust and responsibilities associated with custodial bank relationships. Certainly, the settlement goes a long way towards helping reform historical practices (in this regard, it's worth noting that the *Wall Street Journal* recently reported that State Street revised its 4th quarter earnings, to reflect increases made to its reserves for resolving its custody clients' FX claims). However, it's also important to understand what the settlement did not do.

Most significantly, the settlement did not indicate BNY Mellon had a fiduciary duty to provide best execution (or reasonable prices), *simply because it was a custodial bank*. Rather, BNY Mellon's misconduct was in making the above noted extraneous representations that they would provide clients with best execution and/or reasonable pricing. Absent those representations, it's not at all clear if BNY Mellon would have been found guilty had the case gone before a judge.

Indeed, in July 2013, the same court that presided over this settlement, ruled that JPMorgan Chase was not guilty of breaching its fiduciary duty towards its custody clients simply by virtue of charging high prices on FX transactions.[4] In that case, the court stressed that since the Fund's custodial agreement did not specifically establish a fiduciary obligation or best execution standard for trading FX, JPMorgan Chase: did not have such an obligation when executing trades through its Standing Instruction platform, was free to sell or buy a currency at any rate it wished, and had no requirement to provide the best available market rate…or any other particular rate.

Accordingly, notwithstanding the BNY Mellon settlement, Zeno encourages all asset owners who utilize custodial Standing Instruction arrangements (for trading foreign exchange), to investigate the execution standards which those arrangements provide. Where the custody banks are unwilling or unable to act in a fiduciary capacity on FX transactions,[5] efforts should be made to formally incorporate execution standards similar to the extraneous representations referenced in the BNY Mellon settlement.

To learn more about the risks associated with foreign exchange transactions, and the steps asset owners can take to best manage those risks, click here to contact Zeno.



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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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[4] LAMPERS v. JPMorgan Chase, 12 Civ. 6659 (S.D.N.Y. July 3, 2013).

[5] Many banks who trade FX on a principal basis may be legally precluded from acting as a "fiduciary" to the Fund on those transactions (since their interests would, by definition, be adverse to the Fund, and they therefore could not act "in the sole and exclusive interest" of the Fund.)