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New Trends in Transaction Cost Analysis

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At a time when our industry remains under heavy scrutiny, the need for accurate and reliable transaction cost analysis (TCA) continues to grow. Designed to help quantify transaction costs, TCA is used by over 80 percent of all mid-sized to large asset managers. And as the use of TCA continues to grow, so does the demand for new features and enhancements. Many TCA products have added additional asset classes including fixed income, options and foreign exchange. However, analyzing these asset classes-finding accurate transaction data and appropriate measurement benchmarks-can be difficult. Below we discuss these asset classes and some of the issues surrounding them.

Fixed Income

Unlike equities, where liquidity and transparency make it easy to compare transactions against a number of widely used benchmarks such as volume weighted average price (VWAP) and implementation shortfall, finding benchmarks for fixed income instruments presents some unique challenges. For example, some highly liquid corporate bonds can be easily benchmarked against average price, but using the same approach for a municipal bond that trades only a few times a month may create inaccurate results. One solution may be to derive a benchmark price based on other factors such as historical prices or comparable issues. But depending on the type of factors used to determine the price, the confidence in a particular benchmark price can vary dramatically and may not be useful for analysis purposes.

Options

Options have similar challenges; the market also lacks a common benchmark for cost measurement. One benchmark that is starting to gain acceptance is the gamma weighted average price (GWAP), which is similar to the VWAP benchmark used for equity analysis. In addition, the options market is fragmented and lacks some of the automated execution capabilities of the equity markets, making it more difficult to capture the necessary trade data needed to effectively analyze an execution price.

Foreign Exchange

Many asset managers have traditionally left the foreign exchange (FX) component of international transactions to their respective custody banks. However, recent allegations of overcharging by some custody banks have put FX TCA into the spotlight. Like the other asset classes, the foreign exchange component also lacks an industry-accepted benchmark for accurate analysis. One of the primary challenges in trying to analyze FX transactions is obtaining accurate time-stamped data, especially if a custody bank is conducting the FX transactions. With accurate time stamps, benchmarks such as implementation shortfall and arrival price can be utilized. In the absence of time-stamped transaction data, other methods such as comparing the execution price to the midpoint of the high and low range can still provide meaningful analysis.

As TCA becomes increasingly sophisticated, more comprehensive and in-depth analysis of different asset classes will become more widely available. And as trading in these instruments becomes more automated, the ability to accurately capture and subsequently analyze transaction data will also be greatly enhanced. This will ultimately allow managers to better quantify costs in all asset classes they trade.

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