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Trading Cost Anomalies

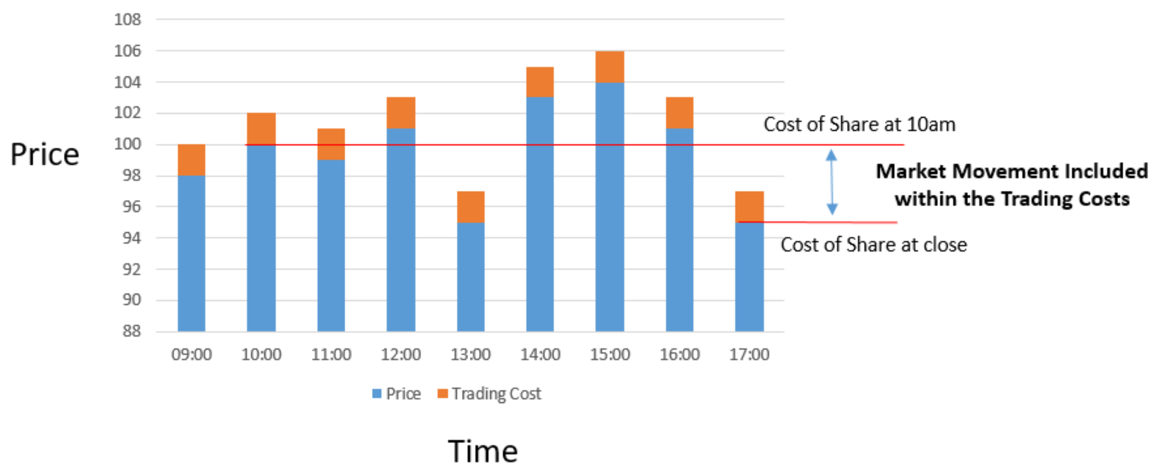
Over the past few days people have highlighted the vast increase in ongoing costs being reported for funds, mainly through ex ante (forecasted) transaction fees. One of the reasons for this is that the reporting is not a true reflection of the trading costs but rather a reflection of the regulation approved calculation methods used to calculate the expected (ex-ante) trading costs. This involves the market movement between time of trade and time of reporting.

If we assume that a fund manager purchases a share at 10am in the morning for 100p and the cost to trade was 2p, the trading cost you would assume would be 2p. **WRONG**

The reporting requires that fund managers use three years of historical information to calculate these ex-ante (forecasted) costs for the first 12 months of MiFID II before ex-post (actual) costs can be used.

A fund management house may execute multiple trades of the same stock at different points during the day as different fund managers' trade on their funds. Therefore, it can be difficult, from a systems perspective to match all historical prices traded with the price that the market showed at that time. For this reason, the regulation allows the fund to report the market close price instead of the live price to make it easier to calculate. This can lead to vast differences in prices between the price traded and the price at market close. This is then reflected in larger assumed transaction prices and potential negative prices also.

If we assume that over the course of the day, the traded price of 100p falls to 95 pence at close (the market reported price), this looks like fund manager paid 5p more than they should have, along with the 2p of the cost to trade, the result in a trading cost of 7p.



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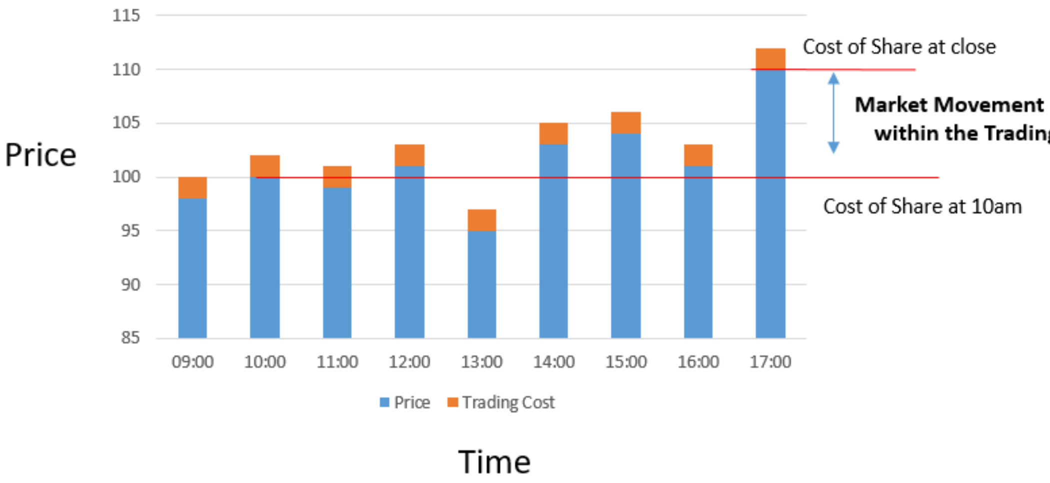
Conversely, if the price moves up, in this example let's say to 110p, the manager looks like he got the stock cheaper than the market reported and the system will report the trading cost as negative 8p.



Investment firms are working towards building systems that will reflect a more accurate reporting function that will move away from using the market close price and a price closer to the traded price. As you can expect, this is quite a complicated process with lots of data points to be captured but something the firms aim to achieve.

We have set out this example for the sake of simplicity however in reality the additional costs include the following:

- Entry / Exit Costs
- Indirect Transaction Costs
- Transaction Taxes (Including Stamp Duty)
- Broker Commission
- Anti-Dilution Offset

Supporting Documents

https://www.theinvestmentassociation.org/assets/files/press/2017/IA%20code%20FINAL%20270317.pdf - Page 16

https://www.fca.org.uk/publication/policy/ps17-20.pdf - Page 6 (2.14)

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