

Houston, We Have a Problem: High Trading Costs in Flat Markets

Operations

By Tom Warren, President, UAT, Inc.

Investing in the equity markets is always fraught with uncertainty, as no one can predict market returns for any future period. Over time, this uncertainty justifies the higher returns normally associated with equity investing. Take the last four decades, for example, and compare the average return of the **S&P 500** for each 10-year period:

- 1970's: -7.5%
- 1980's: 18.3%
- 1990's: 19.1%
- 2000's: -1.2%

The 2000-2010 period provided particularly low rewards for equity investors. Is it any surprise, given such low returns, that investors are beginning to look under the hood of their funds and to carefully scrutinize the brokerage commissions (trading costs) incurred by these funds?

Greenwich Associates reports that the average "all-in" equity brokerage commission in the U.S. remains close to 3 cents per share. Furthermore, **Morningstar's** 2010 study "A Big Fund Cost You Don't See" by **Karen Dolan** concludes that the average U.S. equity fund pays approximately 0.30% per year in brokerage costs.

A quick bit of math shows that average annual brokerage costs are running about 25% of the S&P 500's average annual return for the 2000-2009 period (0.3%/1.2%).

The net effect is lower performance, which could be a catalyst for poor sales numbers.

This is the point where the astronaut hurtling through space jumps on the radio and makes the terse, but classic, understatement: "Houston, we have a problem."

In addressing high brokerage costs, the standard approach is to implement a "Commission Recapture" program. The goal of these programs is to provide a mechanism in which some of the high commission costs on certain trades is captured and rebated back to the funds.

Commission recapture is a practice introduced in the mid-1980's. With a Commission Recapture program, funds direct their money managers, under an honor of a "best execution" obligation, to route a small portion of their order flow to a small group of brokers designated in

a Commission Recapture vendor's program. The actual capture rate across the industry is typically 15%. The mechanics are as follows:

The designated broker for the recapture program takes a trade from the money manager and may charge 4.0 cents per share as commission. This broker keeps 1.0 cent and credits the Recapture vendor 3.0 cents. The fund still incurs a 4.0-cents-per-share commission. The Commission Recapture vendor typically keeps one-quarter of the resulting savings as his revenue (0.75 cents per share in this example) and rebates the remaining 2.25 cents per share to the fund.

The fund receives a monthly rebate and reconciles all of its recapture trades to confirm the rebate amount. Thus, using a process involving some manual work by the broker, Recapture vendor and fund, Commission Recapture programs can generate 1 to 2 basis points per year in savings.

However, an even better solution is on the horizon. Simply call it Commission Savings.

Think of Commission Savings as what happens when the price of gasoline at the pump drops from \$3 per gallon to \$1 per gallon ... the savings are instantly realized by avoiding the original high costs in the first place!

Commission Savings programs increase order capture rates to about 50% while also lowering the cost on each trade that is captured.

A Commission Savings program achieves higher capture rates by providing money managers with an automated algorithm that uses a rules-based approach to generating commission savings.

The traders get lower commission costs and this helps the fund perform better. The idea from the money manager perspective is to use Commission Savings programs to protect



existing mandates and make winning new disciplines a little easier. Money managers control all aspects of these algorithms to save money on behalf of the funds. All the fund needs to do is to send an amended letter of direction to their fund managers.

Finally, where a money manager routes trades is also important.

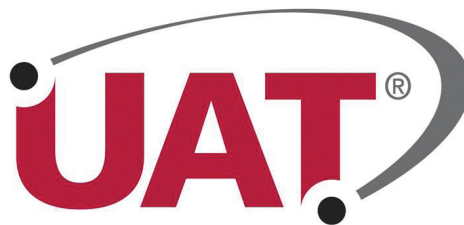
All-electronic agency executing brokers offer much lower commissions with best execution as the primary concern.

In essence, a Commission Savings program can capture more orders and auto-route them to a low-cost agency broker to generate maximum commission savings. This can generate

commission savings of 4 to 6 basis points per year, a measurable and significant increase in savings compared to Commission Recapture programs.

As a volatile and low equity return environment remains in the cards for the foreseeable future, investors will continue to remain laser-focused on any high brokerage costs that eat up a considerable percentage of a fund's annual return. So, fund companies should carefully consider new technology that automatically lowers commission costs. [MME](#)

Tom Warren is President of UAT, Inc., which provides technology to automate Commission Savings Programs.



Harness The Power™