Best Execution:
Defining Best Execution in an Increasingly Complex Trading Environment

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Introduction

Defining Best Execution in an increasingly complex trading environment can be tough; finding two sides that agree on a common definition can be even tougher. Made up of both quantitative and qualitative factors, best execution has been argued several ways. Many professionals claim best execution is solely determined by price, while others state it is identified by commission. With as subjective a term as best execution is, it’s clear that the meaning is left up to the individual firm to justify.

This paper addresses the fiduciary responsibility of best execution for buy-side institutional managers and details the practice that it entails. Best execution is more of a process driven by sound policies and procedures, than it is any one single data point. It begins by creating an environment in which best execution can be achieved. Several tools are available used to identify the components that define best execution, including the use of Transaction Cost Analysis (TCA).

Implications from the development of technology have played a role in an ever changing complex of the equity markets, which have caused traders to become adaptive in their methods of providing best execution. High Frequency Trading (HFT) and market fragmentation have made the environment more difficult to execute in. Creating best practices and oversight, combined with an effective use of technology and human capital, are essential tools for organizations that strive to provide best executions for their clients.
The RBC GAM-US Approach

RBC GAM-US has an obligation to seek to obtain best execution for client transactions under the circumstances of that particular transaction. Rather than focus on a single data point, RBC GAM seeks to satisfy this obligation by creating the conditions under which best execution is most likely to occur; by creating sound processes, structures and systems in its overall trading environment.

While traders are required to strive for best execution, it has yet to be definitively defined. The Securities and Exchange Commission (SEC) states that in deciding how to execute orders, your broker has a duty to seek the best execution that is reasonable available. That means your broker must evaluate the orders it receives from all customers in the aggregate and periodically assess which competing markets, market makers or electronic communications networks (ECNs) offer the most favorable terms of execution. According to the Chartered Financial Analyst (CFA) Institute’s trade-management guidelines, best execution is defined as the trading process firms apply that seeks to maximize the value of a client’s portfolio within the client’s stated investment objectives and constraints.

The determinative factor in best execution is not necessarily the most favorable price point or lowest commission cost, but whether the transaction represents the best quantitative and qualitative execution for the client account. It is the environment created by a process, in which best execution is most likely to be achieved. Developing effective trading strategies and monitoring execution is an essential step in that process. Determination should be given to the proper execution venue; direct order routing, ECNs, algorithms or alternative trading systems (ATS), such as dark liquidity pools, crossing networks and aggregators. Traders should consider factors such as price, commission, timing of the transaction, desired outcome and current market conditions and trends. In additions, traders should also consider execution capabilities such as liquidity, timeliness, clearance, settlement and responsiveness; as well as the overall financial solvency and risk associated with counter parties.

As technology has redefined the macro trading environment, a firm’s commitment to embrace technology as part of its process in defining best execution is essential. Managing the execution tools available to facilitate best execution is a key component in the definition, but those tools are only as effective as the human capital a firm deploys behind it.

The U.S. equity market is in the middle of a fundamental shift as the complexity of regulation, fragmentation and competition have given more power to the buy-side. Historically, there has been a clear separation between the buy-side, the sell-side and the exchanges. As traditional exchanges have faced increased competition to third markets, and technology has fueled an evolution of electronic trading venues, buy-side traders have greater control over the best execution process, and with that, greater responsibility.

Best Execution and Transaction Cost Analysis (TCA)

One of the tools that are commonly used to determine best execution is Transaction Cost Analysis. TCA is viewed as playing a crucial role in meeting best execution requirements and allowing trading desks to refine their process, but it is not determinative. Used properly, it should measure the effectiveness of trading strategies against various benchmarks, among the most common being Volume Weighted Average Price (VWAP) and Implementation Shortfall (or entry strike price). TCA has grown in usage as increased regulation and greater accountability has forced those not monitoring execution to refocus on fiduciary responsibility. According to Tabb Group, 90 percent of traditional asset managers had adopted TCA by the end of 2007.

While TCA has historically been used to analyze equity trading performance, it can also provide a firm with valuable information regarding the portfolio management process. The data give both traders and portfolio managers detailed analysis on how TCA can be used to change or improve current strategies.

TCA can be used to help manage cost impacts for both trading executions and commissions. It can provide data as to how an equity trader performs versus various benchmarks. One problem with TCA is the data tends to provide historical information, rather than real-time metrics. However, as firms embrace technology, TCA can be expanded to provide current data that help traders adjust trading strategies in a real-time environment. Data is now available on a tick-by-tick analysis, as well as on a T+1 basis, which allows trading desks at the forefront of the TCA revolution to monitor performance more closely than in the past.

Not only can TCA provide valuable information on trade executions, it can also provide information on the timing of portfolio management decisions. TCA can be incorporated in the best execution process to analyze the timing of portfolio decision to provide traders
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with the environment in which they are executing. It’s a tool that has proved valuable as market volatility as increased substantially over the years. Portfolio managers also benefit from the analysis by gaining a better understanding of the impact from the timing of a decision; and helps create open dialog between the trader and portfolio manager.

When bad data is good data; while TCA is an essential tool in the overall process of defining best execution, it has its downsides as well. TCA is great at analyzing the quantitative aspects of effective trading; but does a poor job at measuring the qualitative aspects that factor into a trading strategy.

High Frequency Trading (HFT) and the Case for Human Capital

In November 1999, then SEC Chairman Arthur Levitt gave a speech to the Securities Industry Association claiming, “With more market centers than ever before, the duty of best execution must be woven more fully into the fabric of our markets.” In the last decade, the U.S. equity market has seen electronic trading evolve to the point where market fragmentation has made it more challenging than ever to manage the best execution process.

Two major events that opened the door for change were the dramatic move to decimalization and the creation of Regulation National Market System (Reg NMS). The move to decimalization sought to lessen trading costs and enhance liquidity. Regulation National Market System (Reg NMS) was created to foster both competition among individual markets and competition among individual orders in order to promote efficient and fair price formation across securities markets, according to the SEC. However, what ensued, was the creation of exchange competition that forced volume to be geographically fragmented across both tradition and non-traditional exchanges. The U.S. market structure now is an aggregation of exchanges, broker-sponsored execution venues and alternative trading systems (ATS); a far cry from the traditional days of specialists and natural price discovery. No single trading destination executes more than 25% of the total U.S. equity market and in 2009, it was estimated that High Frequency Trading (HFT) accounted for 60 to 70 percent of U.S. shares traded. Electronic trading now dominates the market landscape and floor-based exchanges are quickly becoming irrelevant.

The effects of High Frequency Trading (HFT) have been felt by traders for some time; and most recently highlighted on May 6, 2010, in what the media has called the “flash crash” in which natural price discovery failed and liquidity disappeared as HFT firms failed to provide the “structure” they had claimed to provide in light of the technology evolution. High frequency traders make marginal amounts of money per share, on a large amount of volume of small trades. Some estimate that HFT enter anywhere from several hundred to one million orders for every 100 trades they execute. As the market share for the traditional specialist has dropped from 80 to 25 percent, specialists are no longer able to provide natural price stability. Proponents of HFT claim that HFT provides increased liquidity and natural price discovery to the market, however, institutions are growing concerned about its effects. A Greenwich Associates survey found that 45 percent of participating institutions believe HFT poses a threat to the current market structure, while 36 percent believe it benefits the market and investors by increasing overall liquidity. The balance say they do not know enough to judge.

As a result, the number of quote changes and overall volatility has increased dramatically over the years. The markets’ average daily price swing has gone from historically low levels around 1 percent to upwards of 4 percent in recent years. According to research at Goldman Sachs, spreads on the S&P 500 more than doubled during the market turmoil in October 2008 and spreads in Russell 2000 stocks have more than tripled in recent years while quoted depth has been cut in half.

What does this mean for the buy-side equity trader and how does it fit into best execution? It means a firm must effectively embrace technology, while relying on the instincts of its “human capital”. An algorithm can only be as effective as the trader setting the trading strategy behind it. Currently there are more than 20 dark-pool destinations and countless algorithm strategies available to traders, which create potentially costly outcomes for investors, including higher trading costs. Traders must efficiently manage the various potential sources of liquidity, and the threat of information leakage.

Understanding the environment, including functionality and characteristics of each electronic trading venue, can greatly increase the effectiveness of a trading strategy. No algorithm has been able to replace human judgment in trading as markets have become more electronic and fragmented. At times, a trading desk’s greatest value add, is when it appears no value has been added at all. In an increasingly complex environment, trading effectively, while reducing market impact and reducing costs, lies at the heart of best execution.
Creating Best Practices

Institutions have a responsibility to go beyond defining best execution, and create best practices that encompass the process of best execution. In creating best practices, oversight is essential to foster the environment of excellence. Equity trading oversight committees should be implemented and professionals from all areas of the investment process should be consulted; including compliance, trading, portfolio management, operations and administration. Trading operations are always most effective when they are defined by policies and procedures that define the context in which to execute.

A firm must support and embrace the use of technology while relying on the human capital of the firm to facilitate effective strategies. Traders and portfolio managers must also be in close collaboration to ensure all client transactions are executed within the context of best execution for that given order. Part of best execution responsibilities include a trader’s ability to identify and disseminate market moving news, and relay that news in a timely manner to portfolio managers and analysts. It also includes the ability to identify new regulation and market trends and adapt trading strategies to meet best executions mandates.

In an increasingly complex environment, both from a trading and portfolio management perspective, creating best practices helps a firm manage the process of providing best execution.

Conclusion

Now more than ever, it is important for firms to define best execution as a process rather than a single metric. The process involves both quantitative and qualitative factors and begins by creating framework in which best execution is most likely to be achieved. Not only do firms need to implement policies and procedures to create the framework, traders must understand the context in which they trade.

Defined within the context of a process, best execution can be managed effectively to ensure that fiduciary responsibility is met and that the client’s best interests are always at the forefront of the investment process.