

## 2010 TRANSACTION COSTS ANALYSIS

# Traders Thrive on Life in the Fast Lane

Amid the controversy over high frequency traders, transaction costs trend lower still.

BY JOHN AIDAN BYRNE

The May 6 “flash crash” has put high frequency traders under a harsh spotlight. Many investors contend that these traders, who use high-tech tools to buy and sell stocks in microseconds, put long-term investors at a disadvantage by front-running their orders and fueling market volatility. Such activity merely increases the effective cost of trading for pension funds and other institutional investors, critics say.

At a time when investors are struggling to eke out any returns they can get, costs are as important as ever. Fortunately, despite all the controversy about high frequency trading, the evidence suggests that these high-speed, high-volume players continue to put downward pressure on equity transaction costs, not raise them, according to our 14th annual survey of trading costs, conducted for *Institutional Investor* by New York-based Elkins/McSherry, a subsidiary of Boston's State Street Corp.

The average overall cost of equity trading in the U.S. edged up during the 12 months ended June 30, but that increase largely reflected lower trading volumes and higher volatility, says James Bryson, president of Elkins/McSherry. The underlying trend in costs is still headed lower, he adds. And costs fell significantly in most international markets.

“The concerns about high frequency trading are not justified, because we have seen trading costs falling pretty consistently,” says Jamie Ritchie, director of capital markets trading at Brockhouse & Cooper, a Montreal-based global agency execution brokerage operating in 39 coun-

tries, including the U.S. “Some of that has to do with the high frequency traders.”

Average transaction costs for New York Stock Exchange-listed stocks rose 10 percent in the latest period, while costs on the Nasdaq Stock Market were up 16 percent, according to the survey. The U.S., with an overall average cost of equity trading of 19.63 basis points in the period, is no longer the world's low-cost trading venue. Japan and Sweden share that crown, with an average cost of 18.34 basis points in the period, followed closely by France, at 18.49 basis points. Average transaction costs globally declined 8.1 percent over the past year, to 38.02 basis points.

Concern about high frequency trading soared after May 6, when the Dow Jones industrial average plunged nearly 600 points in a matter of minutes and temporarily erased \$862 billion in equity value. A report on the incident by the Securities and Exchange Commission and the Commodity Futures Trading Commission attributed the collapse to a large automated sell order placed by a mutual fund manager, but it added that temporary withdrawals from the market by some high frequency trading firms may have exacerbated the decline. Regulators are

**“WE NEED TO INTERACT WITH HIGH FREQUENCY TRADERS.”**

GLOBAL TRADING		
Top brokerage firms, benchmarked against arrival price		
RANK <sup>1</sup>	BROKERAGE FIRM <sup>2</sup> (NO. OF COUNTRIES FIRM TRADED IN)	DIFFERENCE VS. E/M UNIVERSE (BASIS POINTS)
1	Bloomberg Tradebook (34)	-40.69
2	Sanford C. Bernstein (33)	-29.80
3	Brockhouse & Cooper (39)	-27.23
4	BTIG (12)	-26.57
5	Cantor Fitzgerald (19)	-20.71
6	Société Générale (32)	-16.95
7	Execution (18)	-10.15
8	Investment Technology Group (37)	-7.46
9	Conifer Securities (16)	-7.30
10	Citigroup (41)	-5.11
11	J.P. Morgan (34)	-4.89
12	Cowen and Co. (25)	-4.73
13	Liquidnet (30)	-4.60
14	Goldman, Sachs & Co. (41)	-4.48
15	Deutsche Bank (41)	-3.45

<sup>1</sup>Rank is for 12 months ended June 30.

<sup>2</sup>Includes brokers with greater than \$5 billion in principal traded.

Source: Elkins/McSherry.

weighing whether to impose some curbs on high frequency trading, but with such activity accounting for as much as 70 percent of stock trading volume in the U.S., the prospects of a crackdown appear remote.

Investors appreciate the liquidity that high frequency traders bring to the market, but they worry about potentially abusive practices such as ping-pong stocks, whereby traders rapidly send and cancel successive orders to uncover valuable information about an institutional investor's position in a bid to gain a trading edge. “If you put in an order and withdraw it immediately, and you have no intention of trading, that is something that needs to be looked at,” Ari Burstein, senior

counsel at the Investment Company Institute, told a conference on market quality at New York's Baruch College last month.

“I think everyone cares about speed,” says Phillip Mackintosh, who heads Credit Suisse's global portfolio strategy team. “What we don't want is to put an order into a machine and then find out that the offer you were going to hit is gone.”

High frequency trading is less pervasive in Europe, but industry executives expect volume there to continue to grow. Such trading is likely to account for 45 percent of European equity volume in 2012, up from 25 percent currently, according to Aite Group, a financial services consulting firm. “The case against HFT is

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GLOBAL TRADING

Top brokerage firms, benchmarked against volume-weighted average price

RANK <sup>1</sup>	BROKERAGE FIRM <sup>2</sup> (NO. OF COUNTRIES FIRM TRADED IN)	DIFFERENCE VS. E/M UNIVERSE (BASIS POINTS)
1	Bloomberg Tradebook (34)	-26.44
2	Liquidnet (30)	-23.01
3	Investment Technology Group (37)	-19.44
4	Goldman, Sachs & Co. (41)	-17.82
5	Credit Suisse (41)	-17.76
6	UBS (42)	-17.56
7	Citigroup (41)	-17.06
8	Société Générale (32)	-17.01
9	Brockhouse & Cooper (39)	-16.85
10	Nomura Securities International (39)	-16.77
11	Jefferies & Co. (23)	-16.16
12	J.P. Morgan (34)	-15.93
13	Barclays Capital (32)	-14.52
14	Macquarie Group (29)	-14.50
15	Morgan Stanley (44)	-14.05

<sup>1</sup>Rank is for 12 months ended June 30.

<sup>2</sup>Includes brokers with greater than \$10 billion in principal traded.

Source: Elkins/McSherry.

U.S. TRADING

Top brokerage firms, benchmarked against arrival price

RANK <sup>1</sup>	BROKERAGE FIRM <sup>2</sup>	DIFFERENCE VS. E/M UNIVERSE (BASIS POINTS)
1	Fox River Execution Technology	-33.84
2	Brockhouse & Cooper	-24.45
3	Nomura Securities International	-19.08
4	Deutsche Bank	-14.30
5	Bloomberg Tradebook	-14.20
6	Knight Capital Group	-14.10
7	Agency Trading Group	-14.09
8	Weeden & Co.	-13.93
9	Source Trading	-13.12
10	Guzman & Co.	-8.73
11	Merlin Securities	-8.48
12	Jefferies & Co.	-2.04
13	BTIG	-1.84
14	J.P. Morgan	-1.15
15	Liquidnet	-0.94

<sup>1</sup>Rank is for 12 months ended June 30.

<sup>2</sup>Includes brokers with greater than \$7.5 billion in principal traded.

Source: Elkins/McSherry.

generally overstated,” Reto Francioni, CEO of Frankfurt-based Deutsche Börse, told the Baruch College conference.

For brokers the key to interacting with high frequency players is to take advantage of the liquidity that they provide without revealing clients’ positions or trading intentions, executives say.

“The liquidity is important to the market, and we need to interact with high frequency traders just like we interact with any other liquidity providers,” says Jonathan Kellnar, president of the Americas business at Instinet in New York. “However, we always need to make sure we are acting in our customers’ best interest. We need to make sure we are not giving up clients’ information or leaving too big a footprint.” Instinet ranks No. 20 in global trading with an average transaction cost, including commissions, fees and market impact, of 4 basis points below volume-weighted average price.

The controversy about high

frequency trading has led some institutional clients to demand more information about where their trades are executed and the level of commissions and rebates, which exchanges typically offer to high frequency traders, that are paid, says George Sofianos, who heads up the Equity Execution Strategies group at Goldman, Sachs & Co. in New York. “Their greatest concern seems to be about more transparency on the choice of execution venues,” he says. Goldman ranks fourth among brokerage firms in global trading and ninth among U.S. firms, with an average cost of 17.82 basis points and 8.15 basis points, respectively, below VWAP. By a separate measure, execution relative to arrival price, Goldman ranks No. 14 in global trading, with an average cost of 4.48 basis points below the benchmark.

At Brockhouse & Cooper, Ritchie says his firm also worries about information leakage, and the concern extends to parties


other than high frequency traders. “You want to use a broker who has no conflicts of interest with a proprietary trading desk,” he says. As for high frequency trading, he says that although some customers had misgivings, “a lot of our investment manager clients think it is a good thing.” Brockhouse & Cooper ranks ninth in global trading, with an average cost of 16.85 basis points below VWAP. Relative to arrival price, Brockhouse & Cooper ranks No. 2 in U.S. trading and No. 3 globally, with an average execution of 24.45 basis points and 27.23 basis points, respectively, below the benchmark.

Both Goldman and Brockhouse & Cooper rank in the top five in more than one cost category. Other firms that also appear in the top five in more than one category include Bloomberg Tradebook, Liquidnet and Fox River Execution Technology. The Elkins/McSherry data are based on an analysis of more than 11 million

trades by 677 brokerages and nearly 3,000 managers on a universe of 19,669 individual stocks.

The challenge of preventing information leakage of customers’ orders and of sourcing liquidity in today’s marketplace has helped fuel the growth of Liquidnet, says New York-based Alfred Eskandar, head of U.S. equities at the firm. Liquidnet, a buy-side-only dark pool, ranks No. 2 in both global and U.S. trading.

Notwithstanding all the fuss over today’s market structure and the role played by high frequency firms, participants need to realize that the basics of trading haven’t really changed, says Alan Hill, chief financial officer of JonesTrading in Westlake Village, California. “Someone is always looking to reap short-term profit,” he says. The only difference today, he adds, is that “the players have changed, and it’s gotten a lot faster.” ●●

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## GLOBAL TRADING

Top investment managers, benchmarked against volume-weighted average price

RANK <sup>1</sup>	INVESTMENT MANAGER <sup>2</sup> (NO. OF COUNTRIES FIRM TRADED IN)	DIFFERENCE VS. E/M UNIVERSE (BASIS POINTS)
1	<b>Capital Guardian Trust Co.</b> (35)	-16.43
2	<b>Arrowstreet Capital</b> (37)	-14.79
3	<b>Goldman Sachs Asset Mgmt</b> (34)	-13.74
4	<b>Pzena Investment Mgmt</b> (17)	-13.28
5	<b>ING Investment Mgmt</b> (37)	-11.95
6	<b>AllianceBernstein</b> (35)	-11.42
7	<b>GMO</b> (32)	-10.52
8	<b>Acadian Asset Mgmt</b> (34)	-9.83
9	<b>Batterymarch Financial Mgmt</b> (37)	-9.12
10	<b>Baillie Gifford &amp; Co.</b> (32)	-8.77
11	<b>Loomis, Sayles &amp; Co.</b> (20)	-6.79
12	<b>Franklin Templeton Investments</b> (35)	-6.67
13	<b>Pyramis Global Advisors</b> (22)	-4.94
14	<b>Barclays Global Investors</b> <sup>3</sup> (23)	-4.43
15	<b>State Street Global Advisors</b> (24)	-3.42

<sup>1</sup>Rank is for 12 months ended June 30.

<sup>2</sup>Includes managers with greater than \$2 billion in principal traded.

<sup>3</sup>BlackRock acquired Barclays Global Investors in December 2009.

Source: Elkins/McSherry.

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