

The Ambachtsheer Letter

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COMPETITION AND TRADING TECHNOLOGY:

WILL THEY RESOLVE THE SOFT DOLLAR ISSUE?

“Electronic technology has made it possible to combine systems in new ways so as to give users trading strategies for working orders they did not have before.....”

Prof. Robert Schwartz
NYU, April 20, 1995

Trading Technology On The Move

Our ‘take away’ from a recent NYU Symposium on trading technology advances is that evolution might soon become revolution in the trading arena. The revolution drivers are competition and technology. They are breaking down the traditional barriers to the creation of trading systems which offer investing institutions cost effective trading services right across the immediacy-liquidity spectrum.

Further, these forces are compressing that spectrum. In other words, seen from one end of the spectrum, the cost of immediacy is coming down as technology aids natural buyers and sellers to find each other quickly without broker-dealer intervention. Seen from the other end of the spectrum, the wait time involved in finding natural liquidity is also coming down for the same reason.

The U.S. stock market context for this ‘story’ is well-known. First there was the NYSE and the regional exchanges. Then came the upstairs ‘block’ market, the NASDAQ dealer market, and the Instinet electronic market. Then, with the blessing of the SEC, came various forms of independent electronic call markets such as POSIT and AZX. Then came ‘smart’ electronic trading systems such Quantex and Lattice which will take instructions, and then go shopping among the various competing markets for the best deal.

The NYSE and NASDAQ are now responding to these competitive pressures with more user-friendly options. For example, NASDAQ is proposing to add N-PROVE to its arsenal, an order viewing and limit order facility. The pressure on the NYSE specialists to open up their order books, and run non-interventionist, direct access, electronic call markets at the opening, mid-day, and close continues to mount.

What Do The Customers Want?

Advances in technology by themselves are not enough. Changes in practices also require knowledgeable customers who know what they want. A recent study by NYU Profs. Schwartz and Economides on 150 buy-side equity traders collectively responsible for \$1.5 trillion in equity assets produced the following findings:

- ◆ Traders clearly understand the relationship between immediacy and trading costs. They say they will reduce execution speed if it lowers trading costs. Many of their large orders take more than one day to complete. Some are broken into smaller lots before execution is attempted.
- ◆ There is a generally positive view to electronic trading systems. They are perceived to reduce market impact, lower spreads, improve liquidity, and facilitate anonymity. However, they would be even more useful if execution percentages increased, and if trading times were more convenient.
- ◆ The existence of soft dollar commitments was also seen as an impediment to greater use of alternate electronic trading systems.

Schwartz and Economides conclude that further integration of continuous auction and dealer markets with electronic call markets is a logical next step for the U.S. stock market system.

Price Discovery For Execution And Other Investment-Related Services

A consequence of the developments described above is that the average cost of order execution is becoming increasingly well-defined. It is about 2 cents per share for institutional-size orders. Another consequence is that it is becoming less necessary to 'pay up' for superior execution. After all, the easier it is for natural buyers and sellers to find each other through technology, the less need there is for the services of an intermediary who would have to be paid.

So while there will continue to be instances when special trading services will command a higher than 2 cents per share fee, they should increasingly be the exception rather than the rule. Yet full brokerage commissions continue to hover in the 6 cents per share area. And most business continues to be done at the full 6 cent rate. What is going on here?

The answer is the payment for non-execution services being purchased by money managers, or in some cases by other fiduciaries such as pension fund officers themselves. While some of these services may be of questionable legitimacy (send the perpetrators to jail!), the vast majority of services being purchased are clearly investment decision process-related. To us, the question of whether such services are provided by the broker of record, or by a third party such as *KPA Advisory Services* is a red herring.

If there is an issue here at all, it relates to the still common practice by money managers and other fiduciaries to load payment for these services on top of payment for execution services. This practice raises a number of pertinent questions. For example, does the expected value of the non-execution service typically exceed its cost to the fund? Even if it does, would its hard dollar price be as high as its soft dollar price?

Quantifying The Questions

Converting these questions into dollars and cents adds perspective. Let's take the \$1.5 trillion in equity assets in the Schwartz-Economides study. A typical 40% turnover rate, an average stock price of close to \$40/share, and a 2 cents/share execution fee produces a \$600 million (or 4 basis points) annual payment stream for execution services. However, a typical three-quarters of the transactions continues to

be done at 6 cents/share, producing an additional annual revenue stream of \$1.0 billion for payment of non-execution services.

Thus, quantitatively, the questions become: what is the expected value to the 150 funds of that additional \$1.0 billion per annum, or 7 basis points in relation to the \$1.5 trillion asset base? Would this bundle of services fetch \$1.0 billion per annum in a hard dollar market place? The questions are impossible to answer definitively. However, we surmise that part of the \$1.0 billion has in fact little or no pay-off, and that a further part would fetch a considerably lower fee in a hard dollar market place.

We base these judgments on our view that many active money managers (and some of their clients) still lack the incentives to break old, well-established ways of doing business. That is to say, many continue to act as though the 6 cents per share price is a 'given', and thus all the non-execution services that come along with that price are somehow 'free'.

Excess Soft Dollar Payments Are Dead Weight Losses to The Fund

Cost Effectiveness Measurement Inc. (CEM) measures the dollar-weighted average external management fee for active domestic equity management mandates in U.S. pension funds. Last year that fee averaged 37 basis points. Above we estimated the cost of acquiring non-execution services through stock brokerage may be an additional 7 basis points per annum. If the true economic value of these services in a hard dollar world is only half at 3.5 basis points, a dead weight loss to the fund of 3.5 basis points per annum results.

In relation to a 37 basis point management fee, a 3.5 basis point dead weight loss is not inconsequential. It represents almost 10% of the management fee. Thus there is an important question here for fiduciaries: what can be done to minimize the cost to the fund inherent in a mechanism which bundles payment for execution and non-execution services?

Getting The Incentive Structure Right

Conceptually, this question is not difficult to answer. The key is to re-arrange compensation structures. It must be clearly, and directly in the money manager's economic interest to minimize any dead weight losses associated with the payment for non-execution services through stock commissions. Two options present themselves.

If it is necessary to stay on an asset-based fee structure, the customer and the investment manager discuss what proportion of transactions must be done at 6 cents a share in order to purchase essential non-execution services. If that proportion is 30%, the other 70% of the transaction are done at 2 cents a share. Any such agreement would be written into the management contract, with appropriate penalties for agreement breaches.

A more elegant solution is to move to a performance-based fee arrangement. Now the money manager participates directly in any cost savings in the form of incremental fees. In other words, unnecessary expenditures reduce fund performance and lower the money managers' paycheck. There is no better attention-getter.

There is, of course, a problem with any "getting the incentives right" solution. It assumes knowledgeable customers with considerable bargaining power. Such customers (in the form of large, sophisticated pension funds) certainly exist. However, many more customers lack the knowledge and bargaining power. What can be done to improve their lot?

The SEC To the Rescue

The SEC believes such money manager clients can be helped by more effective commission payment disclosure. It proposes the following rules for investment advisors:

- ◆ Disclose the 20 full service and soft dollar brokers receiving the largest commission revenue streams. Both the total commissions directed and average commission rate paid would also be disclosed.
- ◆ Provide detail on the products or services obtained from each broker in addition to the execution services.
- ◆ Name the 3 execution-only brokers receiving the largest commission revenue streams. Again, both the total commissions directed, and the average commission rate paid would have to be disclosed.
- ◆ Disclose the proportion of total commissions flowing to execution-only brokers.

The SEC invites comments on its proposals by May 19, 1995. We are happy to provide ours.

Our Comments On The SEC Proposals

First, we believe that the framework established in this *Letter* provides a useful context for the SEC proposals. That context suggests that the SEC proposals would provide useful information in the following ways:

- ◆ Is the money manager paying the standard 2 cents per share rate for execution-only services?
- ◆ What proportion and amount of the total commission payment stream is execution-only?
- ◆ By inference, what proportion and amount of the total commission stream is for non-execution services? Does the amount seem reasonable when evaluated against the list of products and services obtained?

We believe the answer to these questions would reveal a great deal about the money manager providing the answers. For example, if the manager is paying considerably more than 2 cents per share for execution only services, is there a good reason? If the manager does a large proportion of its trades with either full service brokers or soft dollar brokers, is there a reasonable relationship between the value of the non-execution services acquired and their cost? If not, why not?

These are questions even less sophisticated pension fund officers can ask. In the mutual fund arena, these questions are useful grist for the mills of such fund evaluation services as Morningstar. The answers would say a great deal about money manager stewardship.

Progress On A Nagging Issue

The bundling of payments for execution and non-execution services has been a nagging issue for a long time. The resulting wide-spread view that such bundling creates abuse at worst, and higher than necessary costs for investors at best, continues to linger. So it is good to see progress.

We would place the SEC proposals in the progress category. But the increased competition among market places interacting with advances in technology are playing an important role too. They are taking human intervention (and its associated costs) out of the processes of liquidity creation and stock price discovery. They are also establishing the direct cost of using these processes. By discovering the direct cost of execution-only services, we discover the cost of non-execution services too. With their cost known, we can all at last begin to assess if these services offer benefits to the ultimate customers in line with that cost.