

Q&A: Best Execution



Barry Marshall, COO, Investment Division, Gartmore, answers questions put to him by *FIXGlobal's* Edward Mangles.

Why should the industry work towards 'best execution' and what does it mean for plan sponsors?

The need for transparency is striking a chord in financial markets in a wider context than best execution. But, even if one concentrates on this "implementation" issue alone, the consequences are significant. Not just to the investment manager and broker, but also to the plan sponsors, consultants, custodians and exchanges.

Encouragingly, the regulatory interest in best execution is moving away from box ticking ("prove to me you checked three prices for Vodafone at 11.15 am on Jan 5 2002 and dealt immediately") to being viewed as an integral part of the investment decision-making process. Nonetheless, best execution further needs to embrace the operational aspects of both the investment manager and the full transactional process e.g. FX and interaction with custodians.

An investment manager with paper-based systems, but managing multi-clients and multi-benchmarks, is unlikely to be in a position to enable economic best execution. Put another way, electronic dealing systems are becoming a prerequisite to managing money.

Investment managers should want congruity between what a client should reasonably require and what it would do anyway. Scrutiny of best execution should be genuinely internalised within, and not just externally imposed from without.

The strongest incentives to best execution are:

- Internal buy-in at the investment manager to the importance of implementation to its investment process, and
- Informed questioning, or "tyre kicking", by clients of the manager's dealing systems and processes.

Whilst the sponsors might need to get more up to speed with terminology, the initial questions are not rocket science. What should a sponsor think of an investment analyst who can not use Microsoft Excel? It should probably think the same of an investment manager who uses paper-based dealing tickets. And, if the manager is using Excel as the basis for its dealing systems, the sponsor should think about its own Finance department. Excel is a great product but it is not an industrial strength accounting package. Nor is it an electronic order management system.

To what extent, if at all, should clients and consultants differentiate between investment managers on execution capabilities?

Management speak is full of redundant jargon but, risking this, the concept of "order qualifiers and order winners" can be illuminating. A client will appoint an investment manager if it believes the manager has that "something" – an order winner that differentiates this manager from the competition to bring about outperformance. However, order qualifiers that are needed to be in a position to deliver that performance do matter. Not all managers can qualify, and their execution capabilities are now far more important in a market that is experiencing technological and structural change.

Best execution further needs to embrace the operational aspects of both the investment manager and the full transactional process e.g. FX and interaction with custodians.

In less pretentious language, the "end" is more important than the "means". But, if the means consist of paper-based systems, any beneficial end might be a result based more on luck than judgment. Similarly, if "repeatability" of the investment process is a key client criterion, then this suggests robust systems are needed across the investment process. Over and above, there are due diligence and compliance imperatives. It is not unusual for an investment manager to have upwards of 10,000 restrictions (e.g. a client which does not want a tobacco stock bought or a mutual fund concentration rule limit) across its funds. Patently, something more than paper and human memory must be required to ensure breaches do not occur.

"What gets measured, gets managed". Does this apply to Transaction Cost Analysis?

TCA is an inexact science. Notwithstanding the siren calls of commercial purveyors, who often quote regulatory reasons to buy their service, most informed market participants would recognise that TCA has some inherent flaws.

There is no simple tool to monitor quality of execution across markets and venues. The assumptions and methodology behind commercial measurers are each

subject to legitimate debate and in any event are often not subject to full transparency. There have to be severe doubts about the basic data validity, given the paucity of accurate time-stamped data available from the many paper-based dealing systems in existence.

It does seem, particularly to equity managers, that equities can be the sole focus of best execution rules. However, if best execution is an integral part of the investment process then, it surely follows, that it is applicable to all securities.

Currently, it is only too common for an investment manager to be driven to using TCA through external pressure to be seen to be using it, rather than any belief in its value. Mischievously, an investment manager might wonder whether the custodians, who have been rapidly acquiring TCA firms, are seriously analysing the costs of their own client FX trades with the same fervour that they seek to analyse external investment managers' equity transactions.

Do different securities justify different 'best execution' treatment?

It does seem, particularly to equity managers, that equities can be the sole focus of best execution rules. However, if best execution is an integral part of the investment process then, it surely follows, that it is applicable to all securities. Just because data is less easily available for non-equity securities it is not logical to ignore them.

The end vision should be a liquid and efficient market in all securities. The bringing together of willing buyers and sellers together in a cost-effective manner is what matters, with technology and transparency likely to be key inputs.

Correlation does not prove causation, but perhaps it can be argued that the spotlight of best execution has encouraged more innovation in equity markets with the emergence of electronic crossing systems and the like. In contrast, it does appear that the FX and fixed interest markets have been more resistant to change, continuing to rely on the telephone.

Most people will agree that innovation and challenging of the status quo are hallmarks of robust financial markets. But is this a canard? Perhaps we might usefully ruminate on the old exam question: "If a stock exchange did not exist, would it have to be invented?" The answer might be different now.

Are electronic dealing systems necessary to manage money and what are their impact in terms of transaction costs?

It must be a truism to say that the technology at the majority of investment managers can be improved. The obligation on an investment manager to do its best for its clients applies whether or not a "regulatory best execution" rule exists. However, it is not so obvious that clients and consultants are fully aware of how some managers are technologically better than others and, consequently, genuinely competitively advantaged. This applies as strongly to "traditional" long-only managers as much as to those who have attempted to move into even more demanding areas, such as hedge funds.

At the risk of further digressing into the world of "Three Letter Acronyms", FIX is the messaging standard developed specifically for the real-time electronic communication of securities transactions. One does not need to be a technology expert to get a feel for whether the investment manager is seriously embracing FIX.

Of course, there are no guarantees that two plus two equals four, let alone five, in investment management but dealing must be intimately integrated with portfolio construction and research. Securities ideas are valueless if not implemented. And, whilst a modicum of funds can always be handled using manual resources, it stretches belief that this is sustainable on any more than a trivial scale.

Whilst the idea of best execution is simply stated, the practicalities can be complex. However, if an investment manager has genuinely invested in electronic systems, it will be better placed to "plug and play" into what is the next best electronic "thing" in dealing. And, for sure, this fast-changing market will continue to throw up many "things". **FIX**