Plugging implementation leakage: Real savings realised for multi-asset investors

Without the appropriate focus on trading and execution it’s easy to introduce unnecessary costs and unrewarded risks into a portfolio. Having an agent accountable for performance for this function is the easiest source of return. We highlight some of the common areas of implementation leakage and give solutions that have been demonstrated to improve investment outcomes for multi-asset investors.

The Russell approach to implementation can lead to savings of 25 bps a year at the total portfolio level

Since Andre Perold’s landmark 1988 paper on implementation shortfall, institutional investors have learned to view investment success not in terms of how well a strategy might work on paper, but in terms of the real value performance of the portfolio.

The insight brought by implementation shortfall is that transaction costs can have significant impact on a portfolio’s performance. The round-trip costs of trading an investment idea can materially affect its realised value – and in some cases dominate. An example is the Value Line Anomaly, whereby the popular investment newsletter’s recommended stock picks delivered superior returns over the market on paper, yet whose picks when put into a real portfolio underperformed the market.

The commissions, spreads, fees, market impact, opportunity costs of trading, and portfolio drift are factors that contribute to implementation shortfall. ‘Implementation leakage’ – that is, the loss of return that results from any inefficiency in converting investment decisions into actions – ultimately hurts investors. It is a form of capital waste that trustees should seek to eliminate, or at least minimise, and there are strategies available now that can help them to do so. That waste can occur in good times and in bad, at the fund level and in all asset classes, and it often arises from unexpected or obscure sources. It may amount to a dozen basis points here.

1 Implementation savings of 25 bps assumes no trading outside of policy implementation, and halves Russell’s observed cost savings from Policy Implementation. [See basis for Policy Implementation savings in footnote 12 for the sake of providing a conservative estimate.] If one trades securities, incurs commission costs, requires currency transactions, and implements any of Russell’s emulation strategies for more cost-effective exposure management, then the savings can be significantly higher yet. Although not all portfolios will need or use all of the implementation services described in this note, e.g. a domestic equity fund will not use Russell’s currency services, all of the portfolios Russell manages do use some of them.

2 Journal of Portfolio Management 14, no. 3 (spring 1988): 4–9

another handful there, and a few more elsewhere. Over time, it adds up and eats away at investors’ end benefits.

Academic studies estimate that for US equity funds, which are traded in some of the most efficient and liquid markets in the world, transaction costs can be similar in magnitude to the fund expense ratio (144 bps versus 123 bps, respectively). Costs can be higher yet in other asset classes that are less liquid or trade in less efficient markets.

In Russell’s experience, implementation savings in excess of 25 basis points a year are quite achievable; even for very large funds that otherwise operate efficiently. From an investor’s perspective, a simple calculation shows that even seemingly small cost savings accumulate to large amounts over time. For example an extra 25 bps a year in investment return over an assumed working life of 40 years will increase retirement income by 9.8%.

Russell, as a multi-asset investment manager, has developed a full suite of implementation services to help manage implementation leakage. The best practices of investment implementation are much improved over the days of unmanaged, commissions, execution and exposures. Implementation excellence is achieved when the fund portfolio captures as much of the theoretical, paper return as possible.

Sources of waste
Implementation leakage results from funds incurring unnecessary costs. In addition, holding unintended asset exposures results in unnecessary and unintended risk, which results in costs of a different kind. The waste can take the form of:

- **Direct costs**, which include brokerage and custodial fees, excessive ‘spreads’ on cash balances and trading that results in a higher than necessary capital gains tax imposed.

- **Indirect (hidden) costs**, which can occur when service providers act contrary to the fund’s best interests. This can occur, for example, when a broker is able to act on ‘the other side’ of a trade they are conducting on behalf of the fund.

- **Unintended asset exposures**, such as being improperly hedged or letting exposures to asset classes ‘drift’ from pre-agreed levels.

Solutions available
Fortunately, the waste can be managed. Russell offers solutions that are proven, effective and demonstrably in the best interests of investors.

Exhibit 1 provides an overview of the most common sources of implementation leakage, the typical magnitude of those leakages and the solutions available.

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5 See footnote 1.

6 Start with a long term return assumption of 7%, So we calculate: \((1.07)^{40} = 14.97\). Add 25 basis points and start over: \((1.0725)^{40} = 16.44\), or 9.8% more
Exhibit 1 / Summary of common implementation leakages

<table>
<thead>
<tr>
<th>Source of leakage</th>
<th>Potential savings available (where quantifiable)</th>
<th>Solutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unnecessary costs in multi-manager funds</td>
<td>More than 13 bps (US Large Cap Equity) and 23 bps (Non-US Equity) per annum⁷</td>
<td>‘Emulation’ portfolios</td>
</tr>
<tr>
<td>Unnecessary costs through higher than necessary commission rates</td>
<td>8-15% of commission paid⁸</td>
<td>Commission Recapture programmes and active monitoring of commission arrangements, to include savings from third party execution services that, through higher volume, realises more advantageous commission rates</td>
</tr>
<tr>
<td>Unnecessary costs of unmanaged transitions</td>
<td>Average 12 bps per transition⁹</td>
<td>Efficient transition management, ensuring that manager and affiliates act at all times as an agent and cannot profit in ways that do not benefit the investor</td>
</tr>
<tr>
<td>Unnecessary costs of equities, fixed income and currency trading</td>
<td>13.5 bps on fixed income trading¹⁰</td>
<td>Use agency trading, multi-venue execution, and a rigorous programme of monitoring risk and performance. By making brokers compete - and negotiating commissions aggressively, managers save in execution costs relative to non-negotiated brokerage.</td>
</tr>
<tr>
<td>Unnecessary costs of equities, fixed income and currency trading</td>
<td>10 bps on equities trading¹¹</td>
<td>Use agency trading, multi-venue execution, and a rigorous programme of monitoring risk and performance. By making brokers compete - and negotiating commissions aggressively, managers save in execution costs relative to non-negotiated brokerage.</td>
</tr>
<tr>
<td>Unnecessary costs of equities, fixed income and currency trading</td>
<td>10 bps on FX trading¹²</td>
<td>Use agency trading, multi-venue execution, and a rigorous programme of monitoring risk and performance. By making brokers compete - and negotiating commissions aggressively, managers save in execution costs relative to non-negotiated brokerage.</td>
</tr>
</tbody>
</table>
| Unintended asset exposures | Equitising cash exposure: 10-15 bps at fund level¹³ | Effective policy implementation through:  
- cash equitisation  
- trading futures rather than physcials to re-weight  
- reduction of tracking error to policy benchmarks |
| Unintended asset exposures | Reduce trading costs through derivatives: 3-4 bps at fund level¹⁴ | Effective policy implementation through:  
- cash equitisation  
- trading futures rather than physcials to re-weight  
- reduction of tracking error to policy benchmarks |
| Unintended asset exposures | Impact of policy implementation trimming TE: 30-40 bps lower at fund level¹⁵ | Effective policy implementation through:  
- cash equitisation  
- trading futures rather than physcials to re-weight  
- reduction of tracking error to policy benchmarks |
| Unnecessary costs of unmanaged fundings and redemptions in a multi-manager fund structure | Frictions result as cash is managed in a fund | According to Russell estimates, unmanaged fundings and redemptions can cost as much as 80 bps on an annualised basis. |

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⁷ Emulating multi-manager equity portfolios, Russell Research, June 2010

⁸ Assumed 15-20% Commission Recapture participation x 65% (average broker retention is approx 35% of gross) x Standard client rate of 75% = 7.3% to 12.5%

⁹ Based upon average retained securities rates and average T Standard implementation shortfall data from Russell’s transition universe for 2011. Data was applied across different asset classes and weighted by the asset managed in 2011 for each asset class.


¹¹ See footnote 10


¹³ Historical simulation from Jan 1979 to July 2012. Portfolio = 2% US equity manager cash, 3% non-US equity manager cash and 1% fund cash (total cash = 2.3%) vs. a Policy of 35% Russell 3000 / 20% MSCI ACWI ex-US / 25% LB Aggregate / 10% NCREIF / 10% Alternatives (benchmarked to the S&P 500).

¹⁴ Estimated transaction cost for typical fund rebalancing and benefit payments

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