

Watch those transaction costs warns Tom Murphy of the IAPF Benefits Committee

Did you know that transactions could be costing your fund in the region of 0.6% p.a.¹ Transaction costs matter and new thinking suggests that "skill" for an active manager should be defined to encompass not only the ability to generate value added investment ideas but also the ability to implement these ideas efficiently.

The initial Myners Review published in the UK in March 2001 generated a storm of protest when Myners recommended that the best means of controlling transaction costs was for fund managers to charge a fee inclusive of all associated costs:

"The review recommends that it is good practice for institutional investment management mandates to incorporate a management fee inclusive of any external research, information or transaction services acquired or used by the fund manager rather than these costs being passed on to the client."

The fund managers would then be liable to the brokers for all costs incurred on behalf of a client. Such an arrangement would obviously provide a very strong incentive for managers to control transaction costs.

DIRECT AND INDIRECT

Transaction costs can be split into direct costs and indirect costs. The two most obvious direct costs are commissions and taxes.

Indirect transaction costs are more difficult to pin down. The concept of these costs is captured by the "spread" for a share price, i.e. the difference between the price quoted for buying a share (the "offer" price) and the price quoted for selling a share (the "bid"

price). However, these spreads are by no means fixed (typically between 1-2%). They are highly sensitive to conditions in the stock market and the volume of shares in which the investor wishes to transact.

As mentioned above, these costs are linked to transaction volumes and are primarily payments for effecting buy and sell transactions. However they can also cover the cost of two other types of services that brokers provide to investment managers. First, there is the research input that brokers provide to managers to help them make investment decisions. Second, there are "soft commission" services, whereby the broker provides the manager with some other service, on the basis that the manager will in return direct some minimum volume of business through the broker. The manager does not pay for these services directly – the costs are covered by loadings built into commission rates and/or bid/offer spreads.

Myners argues that this creates an incentive for investment managers to rely on research services provided by brokers on a "soft commission" basis, and unfairly favours managers who do so over those that pay "hard" money for third party research or for internally-generated research. It should be noted that soft commissions are not as common in Ireland as in the UK, with very few Irish managers having a soft

commission agreement in place.

The argument extends to client's best interests and whether they would be better served if they required fund managers to absorb the costs of any commissions paid, and treated these commissions as a cost of the business of fund management. Firstly, the overall cost would be much more transparent to the client than at present. Secondly, investment managers would be given an incentive to manage the costs of the broker research that they receive in the same way that they manage their other costs, ensuring the best deal is made. Trustees should expect that the main investment management fee would likely be increased initially in order to reflect the extra costs; however, in aggregate, Myners expects the fees to be less without compromising the overall service.

INDUSTRY RESPONSE

The Investment Management Association (IMA) in the UK, in

¹ Based on a turnover of ~50%



conjunction with the National Association of Pension Funds (NAPF), in May 2002 published a Pension Fund Cost Disclosure Code. The objective of the "Disclosure Code" is "transparency in order to assist pension fund trustees' understanding of the charges and costs levied on the pension fund assets for which they have responsibility".

The code sets out minimum standards, and managers can only claim compliance with the code if they meet all required disclosures of which there are two levels. Level 1 disclosure covers house policies, processes and procedures on managing transaction costs. Level 2 disclosure will be client-specific and quantitative.

In terms of an Irish response, in November 2002 the Irish Association of Investment Managers (IAIM) proposed a voluntary code of practice. This code supports the principle of fair disclosure of the costs of investing and aims to encourage all investment managers operating in the Irish market to disclose to their clients the nature

and extent of all the ancillary costs that are incurred when investing.

The 'Investment Costs Disclosure Code' is non-prescriptive as to the format and detail of the information to be disclosed, the primary principle being that "the information should be presented in such a way and to such a level of detail that a client is able to fully appreciate the impact of those ancillary costs on the overall investment return."

The proposed code recommends that clients should receive an annual statement detailing the management fee, the custody fee where this applies, any commissions paid to brokers and any other expenses such as stamp duty or auditing expenses.

The code also recommends that investment managers should present to their clients a "statement of policy on the management and control of ancillary investment costs". Such a statement should make reference to assets held by or through third parties where separate charges may occur.

The IAIM is working to have the code adopted by its members in respect of reporting periods on or after July 1st, 2003. While it is envisaged that the code will initially apply to segregated pension funds only, the IAIM has indicated it will open discussions with the providers of pooled funds to see whether this or similar information could be given to unitised clients.

The IAPF fully supports transparency in this area and we encourage trustees to engage with their manager(s) in order to understand these issues and to ensure that, in these difficult times, there is no unnecessary leakage from pension plan assets.



Tom Murphy
On Behalf of the
IAPF Investment
Committee

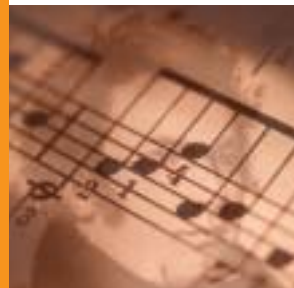
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