THE EVOLVING ROLE OF BEST EXECUTION ANALYSIS

By David Weisberger, managing director, trading services

TRADE ANALYSIS IS CRITICAL IN BEST EXECUTION

TCA has evolved into a tool that enhances transparency in the trade execution process. It can provide detailed indications on overall trading performance and valuable insight into how certain trades achieved best possible execution, given external market conditions and internal restrictions. Properly constructed TCA provides actionable information for evaluating trading strategies and the capabilities of individual broker-dealers. To do so, however, asset managers should consider three key areas where improvement may be needed.

- Pre trade benchmarks measuring implementation shortfall that have been constructed using industry averages should be upgraded to be more specific to individual firms’ trading strategies.

- TCA that evaluates trading compared to participation based benchmarks, such as VWAP, provides some value but is not sufficient. The goal should be to compare execution quality to the pre trade expectation of cost.

- To create actionable information, TCA platforms should analyse individual executions and orders, in the appropriate context, based on the type of order and the subsequent market movement.

Understanding why trading costs should be part of the initial trading decision is simple. If the predicted cost to enter and exit a position becomes greater than the predicted “alpha” (outperformance of the benchmark) then the trade would make little sense. Quantitative fund managers refer to this as understanding the “capacity” of the fund to invest. They are careful to have a market impact model built into their investment process to avoid such risk.

The significance of best execution goes beyond the buyside community. Sellside service providers, trading technology platform vendors covering these buyside customers, and markets including exchanges and multilateral trading facilities (MTFs) also should be aware of its importance. As recognition grows around the potential for trading costs to reduce or eliminate manager outperformance, TCA adoption is becoming more popular across different asset classes and is only set to increase as market developments such as liquidity fragmentation, technological advances, and regulatory changes continue to drive the need for better analysis.