

# MiFID II:

## a closer look at fund transaction costs

With MiFID II legislation, fund groups have to disclose portfolio transaction costs (PTCs) for their funds. While ongoing charges figures (OCFs) have been published for some time, these do not include the costs the fund incurs when buying and selling securities. PTCs are an additional expense charged directly to the fund and reflected in daily fund prices – they are not charged directly to a client’s account. Previously, these costs may have been shown within a fund’s annual report and accounts. They are not new costs and the only change is they now have to be clearly disclosed to investors ahead of investment.

With the increased focus on fund charges – and to help you explain transaction costs to your clients – we examine PTCs in more detail below. We look at what is included within a PTC figure and explain why such wide variances exist between their reported figures for both individual funds and fund management groups.

### What are transaction costs?

■ Until MiFID II the Portfolio Transaction Costs disclosed in the fund’s annual report and accounts were only the **explicit** costs that the fund incurred when trading financial instruments over the year. Spreads are real so quoted in the report and accounts, but separately from the explicit costs. However, post MiFID II Portfolio Transaction Costs are now the sum of both **explicit** and **implicit** transaction costs, annualised over the last three years for the ex-ante illustration and over just one year for ex-post reporting.

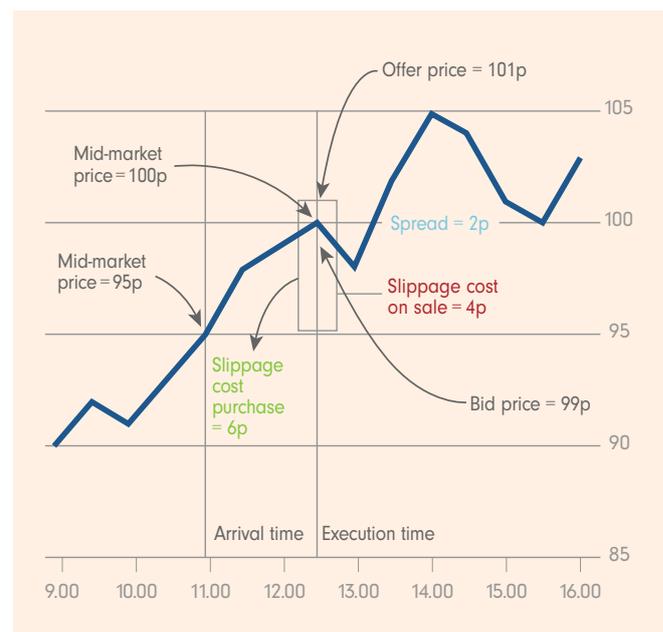
■ **Explicit transaction costs** are charges such as broker commissions and taxes and levies like stamp duty and the Panel on Takeovers and Mergers (PTM) Levy. These costs are easy to quantify as the fees/data is freely available and openly disclosed.

■ **Implicit transaction costs** are more challenging to quantify. They include market dealing spreads in the securities that funds buy and sell as well as the effect of “slippage”. Slippage is the impact of any change in a security’s price between placing and executing the trade. It arises from market movement during any delay in transacting - which can be positive or negative. Slippage can also arise from large deals moving prices adversely.

#### An example of slippage

■ **Negative slippage:** A portfolio manager decides to sell a stock at 11am when the mid-market price is 95p (this is known as the arrival price). The transaction is executed at 12.30pm by which time the bid price has risen to 99p. The slippage cost on the sale is therefore -4p (a negative transaction cost).

■ **Positive slippage:** Conversely, at the same time, another manager wants to buy the same stock at 95p. However, by the time the order is executed at 12.30pm, the offer price has risen to 101p. The slippage cost on the purchase is therefore +6p.



Source: The Financial Times

## Why do some funds have high transaction costs?

Factors which can inflate a fund's transaction costs include:

- The method of calculation – there is no standard approach to calculating transaction costs historically and so the figure will differ depending on the method used.
- Portfolio turnover – trading more heavily can lead to higher explicit and slippage/implicit costs.
- Market liquidity – a lack of liquidity can also lead to higher slippage/implicit costs (this explains why emerging markets funds typically have higher transaction costs than, for example, UK equity funds).
- The type of fund – an equity fund, for example, may have higher transaction costs than a bond fund.
- Deal size – a large trade may not be executed all at once and so can be more prone to slippage. Large deals can also move the market which will also increase slippage.
- Large inflows or outflows of assets - Funds experiencing large net flows of asset will be forced to trade more and therefore incur higher implicit and explicit transaction charges.
- Look through' – fund of funds (multi-manager) products need to look through to underlying funds as part of the PTC calculation. These costs need to be added to the fund's own transaction costs.
- Transaction cost figures can be reduced using the proceeds of swing pricing or other anti-dilution mechanisms. This means that funds using partial or no swing pricing could see higher transaction costs.

## Why do transaction costs vary so widely between funds and managers?

Reported transaction costs vary widely – we have seen some figures which are around +2% with others below zero. Slippage can account for many anomalies, such as negative, zero and very high PTC figures. However, another contributing factor is a lack of consistency when calculating figures.

There is no standard method of calculating transaction costs and so fund managers use many different methods. Implicit costs can also be difficult to calculate and the regulations allow a number of calculation options – this may include estimations. Another issue is that fund groups are not required to disclose which calculation method they use.

## Which calculation method does Fidelity use?

We only distribute funds – the responsibility for calculating a fund's portfolio transaction costs lies with the fund management group. As stated above, managers can use many different calculation methods. Fidelity, the fund management group for instance, uses the PRIIPS (Packaged Retail Investment and Insurance-based Products) method detailed below.

### Fidelity's PRIIPS transaction cost methodology

- Includes both explicit and implicit transaction charges
- Implicit costs include slippage

Please note that in instances where we believe the calculated PTC is not representative of the actual transaction costs incurred, an estimation may be used instead.

## Should transaction costs be used to make comparisons between funds?

Fund costs will always be an important consideration when selecting funds for your clients. In particular, ongoing charges figures (OCFs) allow you to make direct cost comparisons between similar funds (for example, one emerging markets fund versus another). Portfolio transaction costs are an additional charge but using these to make like-for-like comparisons between funds is more problematical for all the reasons stated above.

Charges are, of course, just one measure of value for money when investing in a fund. We believe the best like-for-like comparison between funds remains net performance – the return delivered to investors after both OCFs and PTCs have been taken in to account. On this point it is important to remember that reported net performance of funds will not change as a result of this increased disclosure, these costs have always existed and have therefore always been reflected in these figures.