INVESTMENT

Achieving and measuring best execution in FX

Marisa Kurk discusses why pension fund investors need to precisely determine and achieve best execution within FX transactions

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As we move into a more transparent and regulated world of FX, it is crucial that pension fund managers and their agents focus on achieving, measuring, and communicating best execution on FX transactions. While achieving best execution should always be a primary focus, measuring and communicating these results has become even more important under a new FX landscape. This article will explore the importance of best execution, outside factors that have shed additional light on this topic, key factors for achieving execution quality, and Transaction Cost Analysis (TCA) as a tool to measure and communicate execution results.

Regardless of asset class, fund managers and their agents should always remain focused on best execution; unfortunately, until the last few years the marketplace did not universally demand precision and communication in FX. Beginning in 2009, pension funds started to more carefully evaluate the performance of their custodial managers in executing their FX hedges. It was discovered that by allowing custody providers to have such extensive discretion over the timing and mechanisms of FX execution, the custodian was able to benefit, at the cost of pension funds, by providing unfavourable rates and wide spreads, and being the sole or primary recipient of trade volume. Over the next several years the unscrupulous execution methods of custodians dominated the headlines. Clients were at times provided prices on trades that were significantly different than the actual prices executed by the custodian, or the client's price would be as extreme as buying near the high or selling near the low of the day, depending on the direction of the trade. This was one of the key catalysts for an increased desire of transparency when transacting FX.

Furthermore, as global regulators began to focus more on risk and FX regulations post global financial crisis, additional light and scrutiny was shed on the topic of best execution in FX. Presently the Markets in Financial Instruments Directive (MiFID) states that firms "must take all reasonable steps to obtain the best possible result….." . The updated guidance of MiFID II, set to come into the marketplace as early as 2018, looks to strengthen the language and requirements for obtaining best execution. While the exact market requirements around the heightened fiduciary and regulatory obligations are still being scoped out, it is clear that the standards for achieving best execution will be set even higher.

Best execution is especially important in FX given the typical magnitude of hedge sizes. Let us examine a client that rolls €5 billion in three month maturity hedges, for an annual roll volume of €20 billion. If the execution price is off market by even one-tenth of a basis point, the client will incur €200,000 in hidden execution costs per year, for what is often approximately a tenth of a forward point. Accordingly it is imperative that every effort is made to keep this cost to an absolute minimum as the price of each trade will directly have an effect on the overall performance of the fund.

The following key factors outline some of the primary ways to help ensure best execution:

- **Trading desk experience:** A well rounded, experienced trading team is crucial in providing continual best execution practices. Whether it is dealing with extreme market events such as the SNB EURCHF 1.2000 floor removal, or more common daily situations such as executing a large order, an experienced FX focused trader is invaluable. A variety of backgrounds can further complement a trading team as well. For example, sell-side experience on the trading desk is a significant plus as it provides direct insight into the sell side methods and tactics, better preparing the desk to push back in order to achieve best execution for the fund.

- **Multiple pricing sources:** Obviously a trading desk must know exactly where the market is trading at all times to help ensure precise market pricing on each trade. To obtain this information, access to multiple pricing sources such as Bloomberg, Reuters, Currenex and other various ECN's is essential. In addition, the ability to reach out to multiple counterparties for indicative pricing provides important additional clarity on the actual market.
- **Multiple execution strategies:** A trading desk must have the ability to vary execution strategy depending on the deal to be completed. This may include utilising competitive and/or streaming pricing, having a large order execution methodology or taking into account time of trading day when planning execution.
- **Strong and broad counterparty relationships:** It is important to have strong working counterparty relationships with clear pricing expectations. Counterparties should recognise that excellent pricing leads to increased business, and less than excellent pricing leads to the opposite. Furthermore, the larger the counterparty roster, the greater flexibility available to the trading desk.
- **Large trading volume:** Trading desks with large currency volume have more impact and influence with the counterparty trading desks they execute against. Continual large trade volumes with a counterparty lead to a relationship that is important to the counterparty; typically resulting in high quality pricing.

Even after internally determining that best execution is being achieved, it is important to ensure it can also be documented. The established need for execution transparency has led to the popularity of TCA as a tool to fill this void. The basic elements of TCA are threefold. First, it captures key execution details including spot rate, forward points, execution timestamp, quantity, currency pair, and value date. Second, it selects the benchmark to be utilised for benchmarking; whether it be one data source or a more comprehensive multi-factor benchmark provided by a third party, it ensures spot and forward rates from an external data source are captured along with time stamps. Finally, TCA utilises a systematic process to calculate the costs arising from the difference between the executed rates and the benchmark rates. This analysis can be further broken down into various details such as spot costs, forward costs, costs by currency pair, time of day or order type.

While these basic elements of TCA are similar throughout the industry, variances in methodology may exist among currency managers. It may be possible for similar execution to have significantly different TCA results. Accordingly, before reviewing the TCA results, it is essential to understand the underlying methodology being employed, specifically the benchmark rate source, the application of the bid/ask spread, and the timestamping methodology. As previously stated, benchmarks can vary from a single data source to a more comprehensive multi-factor benchmark. A robust source of benchmark data will serve as a more accurate assessment of the transaction cost. Ideally, the benchmark data feed should include a high frequency of prices from multiple platforms. Next, when looking at bid/ask spreads, the most neutral benchmark will utilise the MIDPOINT rate, even though this rate is typically not an achievable execution price. Thus, utilising the bid or ask may artificially reduce displayed costs. Finally, it is important to understand that the method for applying timestamps will have a direct effect on the results. Ideally, timestamps should be generated and captured from an electronic trading platform. Importantly, timestamps should never be recorded after a trade was completed, as this can artificially influence the cost.

An additional consideration for TCA implementation is whether to conduct the analysis in-house, or use an outside TCA provider. While TCA can certainly be successfully analysed in-house, the desire for third party providers has grown significantly in recent years, as outside providers offer an independent analysis and an increased level of transparency. In addition, the benchmark rate source of third party providers is often much more robust than an in-house TCA. For these reasons the trend toward outside providers will likely continue to gain momentum in the coming years.

In summary, it is critical that best execution is sought and applied in all FX transactions, regardless of agent or method. Additional factors over the past several years such as public custodial shortcomings and new regulations have heightened the need to prove best execution is being achieved. Furthermore, TCA, and the trend toward third party TCA, has emerged as a useful tool to measure and communicate the quality of execution to the client. The combination of a highly experienced trading desk and a quality TCA process will ensure both best execution and clear communication of this achievement. ■

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