Transaction cost & charges explained

This document seeks to provide clarity into the cost & charges associated with investing in investment funds. Since the unbundling of charges in 2012, legislation focused on ensuring that retail clients have transparency into the cost & charges they incur when investing.

Category:
Investment insights

The latest iteration of this legislation is the MiFID II & PRIIPs directives which requires the transaction charges associated with investing to be disclosed. In addition, the FCA's Policy Statement PS 22/2, "PRIIPs - Scope Rules and amendments to Regulatory Technical Standards" was published on 25 March 2022.

The PS sets out the final rules for the UK's version of the PRIIPs regime and follows on from the FCA's consultation under CP 21/23. The main impact is regarding Anti-Dilution and pricing of Debt Instruments and Index-Tracking funds.

What charges are included in the Ongoing Charges Figure (OCF)?

Annual Management Charge (AMC) + Operational costs + Underlying fund charges = These are the consistent charges which can be predicted with confidence.

More on costs

We explain more about our costs below.

What costs are included in the Transactional Costs?

The Transaction Costs are variable costs which are less predictable than the OCF charges, they can and will fluctuate over time. These are either Explicit, Implicit or Anti-Dilution costs.

Explicit transaction costs (Incurred)
Costs charged to and paid directly by the fund to purchase and/or sell financial instruments. For example, broker commissions, taxes and levies, securities lending.

Implicit transaction costs (Implied)
Are a result of operating in the financial markets and are not an actual physical charge made by an asset manager. Implicit costs can be both positive and negative and will vary depending on the type and liquidity of the instrument being bought or sold and the prevailing market conditions.

This is the difference between the price at which an asset is valued immediately before an order (the arrival price) and the price at which it is actually traded (the execution price) – see examples on the next page.

- **Buys** = Execution Price - Arrival Price/Arrival Price
- **Sells** = Arrival Price - Execution Price/Arrival Price

Anti-Dilution costs (Incurred)
Cost credited to the fund via any swing in the NAV (Net Asset Value) when the volume of net flows, in or out of the fund, is above a threshold trigger.

Please note that under FCA Policy Statement PS22/2, any portion of an anti-dilution benefit that would lead to negative transaction costs should be disregarded to prevent negative transaction costs from being disclosed.

Why are actively managed investments likely to have higher Transaction Costs than a passive equivalent?

- Will typically trade more frequently than a passive. A fund that trades infrequently, such as a passive strategy, may have low Transaction Costs. A fund with a more active trading strategy may incur higher Transaction Costs (both Explicit and Implicit) in aiming to generate a greater return for the investor.
- Can add value by selecting or selling companies that passive funds cannot.
- Have the flexibility to tilt their portfolios and focus on different sectors in light of prevailing market conditions, this will result in transactions being placed (at a cost) to make the most of these conditions.
- Can employ the use of sophisticated financial instruments to manage risk and take advantage of short-term opportunities. Trading in these instruments can generate additional transactional costs.

How do we measure the value of these Transaction Costs and the value they can add?

- Has the overall performance of the investment delivered on expectations net of all costs & charges?
- Has the additional cost that has been incurred benefited the overall performance? See examples on the next page.
- Are the OCF's being controlled by the Fund Manager to ensure that more return can be passed onto the investor?

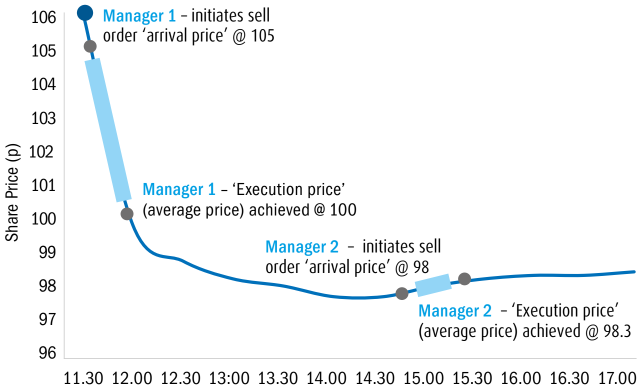
> “These costs should be considered in-line with overall performance of the fund in order to make a decision on whether the investment presents value for money.”

Trading examples

Below are two trading examples that an active strategy could execute and the benefits that could be provided with regards to the overall return profile of the fund, net of all costs & charges.

Scenario 1

Two managers react to some negative news on a stock price: Manager 1 reacts quickly and sells the stock nearly immediately on the bad news. Manager 2 takes longer to initiate the sell order.



Manager 1 – 'arrival cost' $\frac{105 - 100}{105} = 4.76\%$

Manager 2 – 'arrival cost' $\frac{98 - 98.3}{98} \times 100 = -0.31\%$

Analysis

Both managers on the same day sold after bad news. The manager who achieved the highest selling price and best outcome was Manager 1. However had a higher Implicit Transaction Cost than Manager 2. Manager 2, achieved a worst outcome for the clients in terms of Execution Price, the trade actually had an negative Implicit Transaction Cost. Therefore even though Manager 1 had the higher Implicit Transaction Cost, the trade gave the client the best outcome.

Manager 1

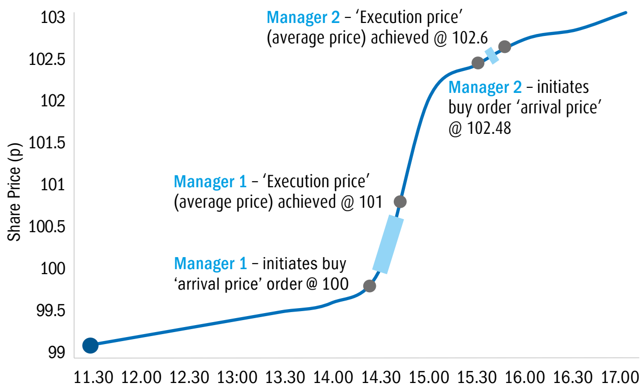
Initiates the sell order at 105p 'Arrival Price', and finish selling when the stock reaches 100p, 'Execution Price'. They will have to report an 'Arrival Cost ' (Implicit Transaction Cost) of 4.76% (105-100/105p).

Manager 2

Takes slightly longer to react, perhaps to ensure they better understand the implications of the news. They initiate their order with the 'Arrival price' at 98p and finish with an 'Execution Price' of 98.3p. They will have a negative 'Arrival Cost' (Implicit Transaction Cost) of -0.31%. (98p-98.3p/98p).

Scenario 2

Two managers react to some positive news in a stock price: Manager 1 reacts quickly and initiates an order to buy the stock nearly immediately. Manager 2 takes longer to initiate the buy order.



Manager 1 – 'arrival cost' $\frac{101 - 100}{100} \times 100 = 0.99\%$

Manager 2 – 'arrival cost' $\frac{102.6 - 102.48}{102.48} \times 100 = 0.117\%$

Analysis

Again, both managers react to the news over different time scales. Manager 1, even though they have secured the best outcome for the client, by purchasing stock at lower price, shows a higher Implicit Transaction cost than Manager 2. Therefore, Manager 2 had a lower Implicit Transaction Cost on the trade but overall had the worst outcome for the client.

Manager 1

Initiates the buy order at 100p 'Arrival Price', and finish buying when the stock reaches 101p ('Execution Price'). They will have to report an 'Arrival Cost '(Implicit Transaction Cost) of 1% (101-100/100).

Manager 2

Takes slightly longer to react, perhaps to ensure they better understand the implications of the news. They initiate their order with the price at 102.48p 'Arrival Price' and end up with an 'Execution Price' of 102.6p. They will have an 'Arrival Cost' (Implicit Transaction Cost) of 0.117%. (102.6-102.48p/102.48p).

Key takeaways:

1. **Low Transaction Costs may not deliver the best client outcome.**
   Having a higher Transaction Cost (as seen in the worked example on the previous page) can deliver better investor outcomes.

2. **Transaction Costs will likely be higher for active funds than passive funds, this is due to the active trades they undertake.**
   The overall performance (which is net of cost & charges) is a better indicator of value to investors than simply looking at the overall cost & charges of an investment in isolation.

3. **Performance of investment Funds is quoted after all cost & charges have been deducted.**

4. **Transaction costs are not new costs, they have always existed.**

5. **Transaction costs are not fees paid to the asset manager.**

Contact us

+44 (0)20 7464 5855

clientsupport@columbiathreadneedle.com

columbiathreadneedle.co.uk/adviser-edge

Telephone calls may be recorded.

243873 (10/22). UK.