IN THE KNOW
Transaction Costs and What They Mean
As investment managers, we occupy the privileged position of being trusted with people’s money.

With trust comes responsibility and with a challenging investment climate, driving efficiency in every aspect of fund management is crucial. This is why SSGA is always assessing ways to reduce costs, improve execution and deliver greater value for our clients.

We fully support industry efforts to provide cost transparency. Clients are entitled to know how their money is being managed and what the costs are.
Since 2014, we have seen increased regulation and guidance for governance bodies on the subject of transaction costs for Defined Contribution (DC) workplace pension schemes.

In 2014, the Department for Work and Pensions’ Command Paper Better Workplace Pensions: Further Measures for Savers outlined ways that workplace pension schemes could give their members transparency of costs and charges. The aim was to enable governance bodies to compare costs and charges in order to evaluate value for money for scheme members.

In 2016, the focus on value for money increased when a duty was imposed on governance bodies to report on the level of transaction costs in their schemes as part of the annual Chair’s Statement and Independent Governance Committee (IGC) Annual Report.

This work closely follows the Markets in Financial Instruments Directive (MiFID II) which will require disclosure of all indirect costs for relevant investment products.

Most recently, in its September 2017 Policy Statement, the Financial Conduct Authority (FCA) stated that with effect from 3 January 2018, firms managing money on behalf of DC workplace pension schemes must disclose transaction costs to the governance bodies of those schemes, using a standard approach as set out by the FCA.

At SSGA we support this quest for transparency and will work with our industry colleagues to deliver the required disclosures to help pension schemes obtain better outcomes for their members.

In This Brochure

1 Understanding the costs — explicit and implicit
2 Other costs and considerations
3 SSGA’s approach to managing transaction costs
UNDERSTANDING THE COSTS

Funds incur transaction costs when securities within the funds are traded. Fund managers make trades when money flows into or out of funds and when investment decisions are made and portfolios need to be rebalanced. There are both explicit and implicit costs.

**EXPLICIT COSTS**

Explicit costs are directly measurable and are therefore simple to quantify. Examples of explicit costs include:

**Broker Commissions**
Intermediaries charge fees for buying and selling securities. Broker commissions include exchange fees, settlement fees and clearing fees.

**Taxes and Levies**
Taxes and levies (for example stamp duty) are charged by regulatory bodies and exchanges. For example, when UK shares are bought, 0.5% stamp duty reserve tax (SDRT) is paid.

**IMPLICIT COSTS**

Unlike explicit costs where the fee paid is clearly visible, implicit costs are more difficult to measure. They are measured as the difference between the transacted price and a ‘benchmark’ price. The difficulty lies in how a ‘benchmark’ price is defined as there is no industry standard.

**Slippage Costs**
The FCA’s consultation paper — *Transaction Cost Disclosure in Workplace Pensions* — proposes the slippage cost approach for calculating implicit costs. Slippage costs can be calculated by comparing actual asset prices with the sale or purchase price of the asset immediately before the order to transact entered the market.

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**FCA’s Approach to Calculating Slippage Costs**

<table>
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<tr>
<th>Pre-trade</th>
<th>Order sent to broker</th>
<th>Order executed in market</th>
<th>Commisions and taxes paid</th>
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<th>Investment valued at market price</th>
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<td>Price when order enters market</td>
<td>Actual execution price</td>
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Source: SSGA 2017, based upon FCA’s consultation paper.

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1. https://gov.uk/tax-buy-shares/overview
2. October 2016, Financial Conduct Authority, Transaction cost disclosure in workplace pensions (CP 16/30).
OTHER COSTS AND CONSIDERATIONS

Securities and Stock Lending Costs
A securities lending transaction involves a fund making a short-term loan in order to increase returns to investors. Income generated from securities lending is allocated between the funds and the lending agent in an agreed proportion. The proportion allocated to the lending agent is classed as a cost to the fund.

For example, if the stock lending revenue was 3 basis points and the proportion allocated to each party was 70% to the fund and 30% to the lending agent, the 30% allocated to the lending agent is added to the calculated transaction cost.

Anti-dilution Adjustments
When money flows into or out of a portfolio, the manager will need to undertake transactions to meet those flows. Funds use mechanisms called ‘anti-dilution’ to pass the transaction costs associated with these flows to the investor putting money in or taking it out. This prevents the fund’s assets from becoming diluted.

Benefits received by the fund from this mechanism must be removed from transaction costs. These anti-dilution effects often take the form of bid-offer spreads.

Calculating Transaction Costs

<table>
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<th>Taxes and Levies</th>
<th>Stock Lending Costs*</th>
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* If applicable. Source: SSGA.

Assessing Transaction Costs in Multi-Asset Funds
Default arrangements for DC pension schemes are usually created by blending a number of funds together i.e., ‘multi-asset funds’ or ‘fund of funds’. All transactions made within the default arrangement need to be analysed as a number of the underlying funds may deploy anti-dilution measures, such as the use of “bid-offer” spreads. In addition, the asset allocation of multi-asset funds is likely to evolve over the course of the year and a simple weighted-average calculation of transaction costs may not be suitable. Addressing these complexities will be a major challenge over the coming months and may require the development of market-wide assumptions to provide consistency.
SSGA APPROACH

At SSGA, our focus is on creating an efficient, transparent trading operation using the best tools and techniques available, seeking to reduce costs and protect returns.

We aim to ensure that overall cost is balanced with overall benefit, bearing in mind that transaction costs reduce the value of funds and therefore require diligent oversight. We seek to avoid excessive costs and turnover, proactively pursuing the best outcome for our clients.

We embrace the ethos of best execution on behalf of our clients and have developed organisational and technical processes to deliver on that commitment.

Continuous Improvement

In a challenging investment climate, driving efficiency in every aspect of the trading operation counts.

By focusing intensively on how transactions are undertaken, we have created a culture of continuous improvement.

The Trade Analytics Group at SSGA is at the core of this effort. The group is responsible for Transaction Cost Analysis (TCA) for all futures, equities, currency and fixed-income trading.

The Whole Process

For us, best execution is about the entire trading process, including price, and is not limited to only one point in time. TCA is a valuable part of this process because it provides a clear measure of trading performance, allowing our portfolio managers and traders to evaluate prices in a systematic manner. Frequent assessment of transactions can provide insights on trading cost trends across asset classes and around the world.

TCA can be used to forecast expected costs, confirm the efficacy of current processes and highlight opportunities to improve trading outcomes in the future.

In addition, TCA stands in the nexus of a highly effective feedback loop that connects traders with portfolio managers, with the ultimate benefits being passed on to our clients.

Striving For Best Trading Execution

Trade Management Oversight Committee (TMOC)
The purpose of this committee is to provide oversight of trade execution activities, broker interaction and regulatory requirements. On an annual basis, TMOC reviews and approves best execution presentations of every asset class.

Trading Departments
We conduct reviews of broker/dealers and clearing houses. These are done via regular face to face meetings and daily conversations with representatives of the respective broker/dealers and clearing houses.

Corporate Audit
This group reviews best execution on an ad-hoc basis.

Compliance
The Compliance Controls and Testing programme reviews processes on a risk-assessed basis.

Transaction Cost Analysis (TCA) — A Valuable Feedback Process

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Coordination and Communication: A Communal Endeavour

Across SSGA’s Global Trading platform, we interact with more than 25 different industry and/or regulatory bodies, including the Securities & Exchange Commission (US), the Financial Conduct Authority (UK), and the Financial Services Agency (Japan). We also participate with industry groups including Quorum 15, the Investment Company Institute, and Trader Forum.

This communal effort is very important for improving market structure as it leads to higher quality markets, benefitting our clients over time. We seek a leadership role in this evolution because we see the importance of building a trading environment that supports and instils the values we hold in the highest regard: fairness, efficiency, accessibility, stability and transparency.

Transaction Costs in DC

Transaction costs reduce the size of DC members’ funds and it is therefore crucial that asset managers aim to minimise these costs as much as possible. Alongside requesting transaction cost data, we encourage trustees and independent governance committees (IGCs) to speak to their fund managers about the measures being taken to reduce transaction costs.

At SSGA through every phase of our operations, oversight and industry engagement, we focus on the complete picture in delivering best execution to our clients around the world. We believe the introduction of cost transparency is a key step for trustees and IGCs in making value for money assessments, something that we are fully committed to delivering.

We support the introduction of a consistent framework for transaction cost disclosures and the obligation for managers to provide the necessary information and data on transaction costs.

For more information, please contact your relationship manager or email us at: ukdc@ssga.com
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