

PARTNER'S MESSAGE

Transaction Cost Management

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The best investment process is only as strong as its weakest link. Managing transaction costs is often that weak link.

Our approach to investment management identifies three critical components to our process:

- ◆ Alpha prediction process
- ◆ Risk management process
- ◆ Transaction cost management

These components are part of all active management process, and each is an important cog in delivering value. A recent study by Zen Alpha Group estimated that the average domestic equity fund incurs an all-in transaction cost, including commissions and execution costs, of 58bps¹. That is a significant cost, particularly in relation to the search for "scarce" alpha, a quest that has proved difficult for the average manager.

As that study points out, there are several costs included in transactions cost. The easiest to measure is commission costs, the cost usually expressed in cents per share (in the US) payable directly to the broker. The other cost, which is difficult to measure precisely, but which is generally far more significant, is execution cost – the cost of your trading moving the market away from its prior equilibrium price. To make this even more complicated, there may well be additional costs to investors – tax payments on realized gains for taxable investors, as well as opportunity cost, to the extent a stock trade is not made because of adverse price move or liquidity constraints, for example.

All these costs should be managed, and that is certainly something First Quadrant takes very seriously. In 2004 our average commission cost to trade US equities was 2.0 cents per share; the average equity manager incurred a cost of 3.3 cents per share.² In our tax-advantaged strategies we carefully manage tax costs, by minimizing dividends and eliminating as much as possible the realization of capital gains. We carefully balance opportunity cost against realized cost. Finally, we strive to minimize the execution

cost. We do that by single-mindedly focusing on quality of execution. We use alternative pools of liquidity, rather than traditional investment bank brokerage houses. We utilize crossing networks where possible, to manage market impact. We utilize basket trades, in cases where the brokerage houses offer lower bids than our estimated costs to trade stocks individually.

Very importantly we do not utilize soft dollars, at all. That is clearly the primary reason we trade for lower commissions – we pay directly for all our own research and data. There are absolutely no hidden fees. Even more importantly, by eliminating soft dollars our trading desk focuses completely on cost-effective execution. By not having to fulfill soft dollar commitments, we can parcel out liquidity across multiple channels, we can utilize a significantly larger pool of brokers,

and we can utilize crossing networks. In short, we can far more effectively manage our transaction costs.

In relation to our domestic equity peer group, the data clearly indicates that we are trading very effectively. Institutional Investor publishes a report annually on manager transaction costs, measuring total execution costs. The most recent ranking, published in the November 2004³ (See table on next page) issue, covering a universe of more than 200 of the largest equity managers, shows that First Quadrant was the lowest cost trader of NASDAQ stocks, the 8th lowest for NYSE stocks, and the 10th lowest for global trading. We had been ranked consistently high in the past - this was our best ranking ever.

Careful management of transaction costs is, of course, no guarantee of outperformance. But to be successful in the pursuit of active management each component – stock selection, risk management, and transaction cost management – must be carefully managed and integrated. Without that focus it is close to impossible to sustain a competitive advantage, in such a competitive marketplace.

The management of transaction costs, often overlooked, often the weakest link in the investment process, is critically important at First Quadrant, and is one of the reasons that we have been able to sustain our investment success over time.

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GLOBAL TRADING	07/03-06/04 rank	Brokerage firm (No. of countries firm traded in)	Principal vs. traded (\$ millions)	Difference E/M universe (basis points)	07/03-06/04 rank	Investment manager (No. of countries firm traded in)	Principal traded (\$ millions)	Difference vs. E/M universe (basis points)	GLOBAL TRADING
	1	Enskilda Securities (8)	\$ 1,457	25.2	1	Baillie Gifford & Co. (31)	\$1,365	64.7	
2	CIBC World Markets (2)	653	20.6	2	Nordea Asset Mgmt (22)	710	46.7		
3	RBC Dominion Securities (7)	1,004	14.2	3	Capital International (36)	3,897	42.2		
4	Dresdner Kleinwort Wasserstein (26)	9,831	13.7	4	Merrill Lynch Investment Managers (32)	2,655	37.2		
5	Liquidnet (5)	1,339	13.5	5	AXA Rosenberg Investment Mgmt (18)	511	24.6		
6	Goldman, Sachs & Co. (39)	46,264	12.7	6	Delaware Investments (15)	651	22.2		
7	Cheuvreux de Virieu (16)	1,670	10.5	7	Genesis Asset Managers(18)	555	22.2		
8	E*Trade (18)	1,858	9.9	8	Deutsche Asset Mgmt (23)	6,741	21.6		
9	ABN Amro Securities (39)	16,361	8.5	9	Alliance Bernstein Investment Mgmt (40)	3,053	18.4		
10	Crédit Lyonnais (34)	1,578	7.4	10	First Quadrant (19)	689	12.6		
11	Fox-Pitt, Kelton (27)	2,116	5.9	11	UBS Global Asset Mgmt (38)	2,698	12.3		
12	Deutsche Bank Securities (40)	27,337	5.0	12	Clay Finlay (36)	1,255	11.1		
13	UBS Securities (42)	43,368	4.5	13	Goldman Sachs Asset Mgmt (32)	4,673	7.9		
14	Credit Suisse First Boston (39)	30,518	3.9	14	Irish Life Investment Managers (28)	1,077	7.4		
15	Merrill Lynch Global Markets (40)	44,269	3.2	15	Marathon Asset Mgmt (27)	1,962	4.9		

NYSE TRADING	07/03-06/04 rank	Brokerage firm	Principal traded (\$ millions)	Difference vs. E/M universe (basis points)	07/03-06/04 rank	Investment manager	Principal traded (\$ millions)	Difference vs. E/M universe (basis points)	NYSE TRADING
	1	LaBranche Financial Services	\$ 590	29.6	1	Dimensional Fund Advisors	\$1,243	36.5	
2	M.J. Whitman	633	27.2	2	Legg Mason Capital Mgmt	607	33.7		
3	Boston Institutional Services	948	25.7	3	AXA Rosenberg Investment Mgmt	720	30.1		
4	Liquidnet	1,914	23.4	4	Hotchkis and Wiley Capital Mgmt	1,097	30.0		
5	B-Trade Services	688	20.7	5	Lazard Asset Mgmt	840	29.7		
6	Bridge Trading	724	18.2	6	Vanguard Group	1,974	24.9		
7	Spear, Leeds & Kellogg	2,391	17.4	7	Harris & Associates	756	24.9		
8	Griswold & Co.	577	16.7	8	First Quadrant	1,585	22.8		
9	Guzman & Co.	592	16.6	9	Pioneer Investment Mgmt	1,283	22.3		
10	Broadcort Capital	539	16.2	10	Alliance Bernstein Investment Mgmt	3,409	21.2		
11	Fox-Pitt, Kelton	906	15.5	11	Citigroup Asset Mgmt	1,288	19.8		
12	Pershing	2,480	13.5	12	Nuveen Investments	665	17.0		
13	Charles Schwab Capital Markets ¹	1,205	12.2	13	Dresdner RCM Global Investors	2,203	16.5		
14	Instinet	5,878	12.1	14	Goldman Sachs Asset Mgmt	1,426	15.5		
15	UBS Securities	9,969	6.4	15	Delaware Investments	2,375	15.3		

NASDAQ TRADING	07/03-06/04 rank	Brokerage firm	Principal traded (\$ millions)	Difference vs. E/M universe (basis points)	07/03-06/04 rank	Investment manager	Principal traded (\$ millions)	Difference vs. E/M universe (basis points)	NASDAQ TRADING
	1	B-Trade Services	\$2,595	32.3	1	First Quadrant	\$2,177	108.0	
2	M.J. Whitman	596	25.5	2	Alliance Bernstein Investment Mgmt	2,469	53.9		
3	Morgan Stanley	1,961	20.3	3	Citigroup Asset Mgmt	3,517	31.6		
4	Liquidnet	1,704	19.2	4	Capital Guardian	3,309	30.1		
5	Bridge Trading	1,100	19.0	5	Delaware Investments	7,373	29.3		
6	Pershing	1,405	17.9	6	Martingale Asset Mgmt	530	27.6		
7	Archipelago	538	15.7	7	Jacobs Levy Equity Mgmt	583	25.6		
8	Knight Trading Group	670	14.5	8	J.P. Morgan Fleming Asset Mgmt	2,203	25.5		
9	Instinet	6,699	14.2	9	Global Asset Mgmt	544	22.1		
10	Goldman, Sachs & Co.	9,611	14.0	10	AIG Global Investment Group	615	17.9		
11	Credit Suisse First Boston	2,456	13.5	11	WP Stewart & Co.	1,665	13.9		
12	Boston Institutional Services	650	8.7	12	Wellington Mgmt Co.	5,371	12.1		
13	Citigroup Global Markets	6,619	4.1	13	Janus Capital Group	1,555	11.8		
14	UBS Securities	5,889	3.7	14	State Street Global Advisors	1,459	10.4		
15	Needham & Co.	677	1.5	15	Goldman Sachs Asset Mgmt	4,470	5.8		

Endnotes

¹ Source: Forbes Magazine, "Hidden Expenses," January 31, 2005.

² Source: Elkins - McSherry data for 2004

³ Institutional Investor, "Stealth Alpha," November 2004