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Trade smarter with FX TCA

Jim Cochrane, Head of Institutional Investor Sales for the Americas at 360T, tells FX-MM why FX transaction cost analysis is a must for the buy-side and how it can drive down trading costs.

Jim Cochrane
360T

What has been the driving force behind the rising use of transaction cost analysis (TCA) in FX?

There are a number of factors. One is certainly the scandals that hit the FX market. Another is the electronification of foreign exchange trading, which makes transparency tools more affordable. A third factor is regulation, which might be the strongest influence at this time. A significant portion of the investing community did not realise that FX transaction costs were expensive if you didn't pay attention to them. With legislation such as MiFID II, regulators are making institutional investors care about their FX transaction costs. The low-yield environment is also concentrating institutional investors' minds as alpha preservation tools are employed to maximise returns. These are a few of the major factors driving interest in transaction cost analysis. It is a natural progression, and is following the pattern of the birth and growth of the equity TCA business 20 years ago.

How difficult is it to create a benchmark for the FX market?

The difficulty lies in having a comprehensive database since FX is a fragmented, over-the-counter market. This situation makes creating an FX TCA database in which to start your analysis a complex task. Several firms have been successful at it, however.

At 360T, we are creating a data warehouse that will have more inputs than any other platform. Once you have an extensive and comprehensive database, testing the data and culling the bad data is paramount. Once that is accomplished, it is relatively simple to create judicious benchmarks that can appropriately measure execution and implementation costs.

How can TCA improve an investor's performance?

There are two elements to FX TCA: post-trade and pre-trade, and they are equally important. Post-trade TCA can be viewed as strategy and pre-trade TCA as tactics.

For post-trade TCA investors need a statistically significant amount of trade data to look at their average cost of doing business. This analysis can tell them the relative cost between counterparties, currencies and which trade size, just to name three inputs. They could also analyse spreads and volatility, which leads to what time of day they should execute their FX. It is a valuable process for firms that have enough trade flow, enabling them to improve their processes and shave basis points off their operating costs. Every dollar that they save is a dollar that can be re-invested and improve the performance of their portfolio.

Pre-trade analysis involves reacting to market conditions, deciding which tactic is appropriate at the point of execution. For that firms need a different platform than for post-trade analysis, ideally one on which they are trading.

A pre-trade TCA tool enables investors to look at the market at a moment in time and evaluate liquidity, momentum, volatility and spreads. To get a good feel for that, investors need to have a normalised view of market conditions over the last six months. Once they have the view of what is average for any size trade at any point in the day, versus what they are seeing in real time, they have the information they need for their first trade decision. Should they be aggressive, and hit a price in the market, or passive, and work an order in the market in hopes of lowering their all-in cost?

How can investors improve that trade execution?

Portfolio managers and traders need to evaluate the entire trading process in order to lower costs. Several questions need to be asked and analysed. For any given trade, you would want to trade in the best liquidity environment with the right liquidity provider using the best available trading tool. Certain trades should be auto-executed, others with RFQ and others with algos. Voice-trading will continue to slip out of favour, but if that method is used, then it should be measured for effectiveness. Other departments than trading should analyse trading in order to monitor progress, provide oversight and offer insights into the process.

An obvious way to improve on trade execution is to use algos. Trading with algorithms takes the human element and emotion out of the equation, which has lowered costs for my clients. Some would argue that human judgement is better, or anonymity is required, or liquidity is too low for algo use, necessitating a voice trade. There are times for operational control to revert back to the trader, but if If all my clients were using algorithms for execution I believe that the greater percentage would be outperforming their old execution style.

In summary, I would say to investors that have currency exposure: please look at pre-trade TCA analytics on your screen and use a post-trade TCA analytical tool to fully evaluate your trading and ensure the best possible FX execution.

For further information: www.360t.com