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Morningstar to Shine Light on Fund Trading Costs

by **Hannah Glover**

Morningstar plans to publish estimated trading costs for specific funds, a new measure the firm says can help individuals and financial advisors make smarter decisions when picking products.

The Chicago-based research and information firm has teamed up with liquidity provider ReFlow and several academics to develop a method of determining estimated trading costs for funds. The forthcoming metric will allow investors to compare trading costs of similar funds within a category.

“It is a really big part of the story that isn’t out there,” says Russel Kinnel, Morningstar’s director of mutual fund research. In fact, on average, trading costs of a fund, which are not included in the fund’s published net expenses, can be greater than the expense ratio.

“These are invisible and can be very damaging,” said Roger Edelen, an assistant professor at the University of California at Davis, who spoke last week at the Morningstar Investment Conference in Chicago. In a painstaking study of trade data for one group of funds of various sizes and strategies published in 2008, Edelen and two other academics found that the aggregated trading costs of those funds, on average, was 1.44%. The average expense ratio, on the other hand, was 1.19%. Trading costs include not only the commission and bid-ask spread, but the price impact of a trade, which he says can account for 65% of the total trade cost. Commissions, the factor that has probably received the most attention from investor watchdogs, by comparison, account for less than 20% of the cost.

This attention to trading costs comes as investors and advisors are watching expenses more closely than ever, and at a time when industry luminaries predict a protracted period of market returns far lower than what investors saw over the past decade. Morningstar has been examining ways to break out these costs for several years, but today’s every-basis-point-counts environment may make the company’s effort to highlight this metric even more powerful.

For investors and financial intermediaries, trading costs can give a rough view of the types of hurdles the fund faces in delivering the returns investors seek, says Kinnel. Morningstar is still tweaking the methodology it will use to calculate its estimates, says Kinnel, who declined to give a date when the company would begin publishing the data. “We’re not going to rush it,” he says, but he did not rule out the possibility of adding the data before the end of 2009.

Morningstar is optimistic about the data’s impact once published. “It is compelling if you can bring out something that has some predictive power,” says Kinnel. It can also help highlight for investment managers how they fare among their peers, just as Morningstar’s attention to fund expenses has helped incite competition between firms on that front. “If it makes companies smarter about that, it is beneficial to investors,” he says.

Still, others note that trading costs can be difficult to calculate, and say that the usefulness of the new Morningstar measure will depend on the firm’s methodology.

“We support the concept of providing investors with cost information, but it must be accurate (not an estimate), meaningful, objective, and comparable across funds,” writes Vanguard spokeswoman Rebecca Cohen in an e-mail to Ignites. Trading costs are reflected in funds’ net returns, and right now they take a backseat — if they come up at all — to bigger issues such as stock selection during meetings between Vanguard’s investment analysts and retirement plan sponsors and advisors, she says.

The new metric is not to suggest that all trading is bad, Edelen stressed in his presentation. Rather, if trading fund securities is done for the wrong reason — for example to accommodate fund flows, as opposed to taking advantage of information or a new investment idea — the result can be a significant drag on performance.

Such pressures to meet investor demand often cause managers to sell securities they might not otherwise choose to in an effort to meet investor redemptions. Conversely, funds that see large inflows of cash might have trouble effectively putting that money to work while remaining true to a fund’s overall strategy or mandate.

Those concerns are what prompted ReFlow to begin trying to measure the impact of such trades. In the case of a fund facing redemptions, ReFlow, which has special exemptive relief from the Securities and Exchange Commission, takes the shares in exchange for cash, which is then used to pay out redeeming shareholders. ReFlow then holds the shares for up to 28 days. Managers can essentially buy back the shares by paying ReFlow with incoming cash contributions or securities from the portfolio in kind.

ReFlow has helped fund some of the more recent research of Edelen and his colleagues, Virginia Tech professor of finance Gregory Kadlec and Richard Evans, an assistant professor at the University of Virginia. Their methodology, the ReFlow Trading Cost Average Methodology (RTCAM), is what ReFlow relies on and has licensed to Morningstar, which continues to hone the methodology to suit its new product.

ReFlow president Paul Schaeffer says that squeezing cost out of trades can help managers position themselves for sales. “If I have a choice of well-performing, five-star funds, by seeing [the estimated trading cost] I can look at the ability of those funds to continue to generate this performance,” he says. Morningstar’s publication of that information can help them demonstrate that, he says.

How useful a measure estimated trading cost is to investors will depend on how well Morningstar illustrates the relationship to fund performance, says Phillip Silitschanu, a senior analyst at Aite Group, who has written about trading strategies and systems in the U.S. and is presently studying the efficiency of electronic crossing networks in Europe. He is not involved in the Morningstar initiative. “What it really boils down to is the final answer,” he says.

The new measure will, however, will likely pique the interest of other investment managers, he says. “They will be able to peek inside their competitors and see who is paying how much for what.”