COUNTRY COST INDEX

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This report provides insight into the current trading environment across countries. An understanding of these key factors allows managers to uncover potential superior returns opportunities.

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Executive Summary

- Trading Costs increased in the US & Canada continue to increase.
- Russell Indexes especially experienced a sharp increase.
  - Russell 1000 was up +14.3%.
  - Russell 2000 was up +11.4%.
- Small cap trading costs continue to rise, even on improved volume conditions. Trading in small cap stocks will become more difficult in early 2014 due to increased competition across funds. Small cap trading remains a favorite of the momentum players.
- Technology experienced the largest increase while Consumer Staples experienced the largest reduction. These two sectors have historically moved opposite directions.
- European costs remain high (both developed and emerging countries). In fact, our I-Star cost index is now higher in Europe than in Asia for the first time.
  - There was a large variation in costs across European countries over 2013, thus resulting in increased portfolio slippage.
  - This has since stabilized for Developed Europe but remains true for Emerging Europe.
  - Investors can realize higher returns through more appropriate allocations (see our Case Study – page 7).
- Trading costs in Asia are at their lowest levels (since 2000). This is primarily due to:
  - An improved market efficiency rating.
  - A lower perception of information based trading.
- Trading Costs across Latam and the Frontier Market remain high. But most interesting, there is a large variation across the countries as well as extreme fluctuations in costs (within the same country) from month to month. Thus making the timing of investments in these markets very difficult. Many funds have experienced their losses occurring during implementation and liquidation of the order – not from any negative price appreciation.
- Case Study: We found that a Cost Adjusted Dollar Weighting for an EAFE investment could result in excess portfolio returns of +1.1% over the underlying index. These results are even more dramatic trading in the Emerging & Frontier Markets (see page 7).

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- Case Study on How to Achieve Superior Returns using the I-Star Index (page 7)
North America & US Sectors

Highlights:

- Trading Costs in the US and Canada increased from end of 2013.
- This was especially true for small cap stocks where the I-Star Index spiked +11% for R2000 and +7% for SP600.
- For large cap stocks, SP500 costs increased +6% and R1000 costs increased +14%.
- Trading costs in Canada (CA) also increased but the overall change was not as dramatic as for the US. CA small cap stocks increased +5.2% and CA large cap increased only +2%.
- The recent surge in small cap trading costs in the US and Canada has been primarily due to momentum investment strategies and an increased competition in the marketplace – thus driving up prices and costs.
- The Technology sector had the largest increase in trading costs MOM. Costs spiked +21% from December 2013 and was mostly fueled by increased sensitivity to company specific information and the potential for higher returns from the sector in general.
- Consumer Staples decreased 9.7% from last month primarily due to a decrease in volatility.
- Trading costs also decreased in Healthcare (8.7%), Materials (5.9%) and Financials (4.2%)
- Another significant increase was in Telecomm, 13%, Energy 11.5% and ConsDiscr, 10.3.

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Developed and Emerging Europe

Highlights:

- Average trading costs throughout Developed Europe was 34bp.
- On a MOM change this was relatively flat but there was dramatic fluctuation is costs across countries.
- There was a significant decrease in Italy, -30.5%, followed by France, -16.7%, and Belgium -15.2%. The countries with the largest increases were Portugal, +29.9%, Ireland, +17.5% and Austria, +13.2%.
- Interesting, costs across the Nordic counties (Sweden, Denmark, Norway, and Finland) all increased around +3% to +4%. In the past, the change in costs in these countries has been a leading indicator for future change in the other European countries.
- The story for Emerging Europe is a little different. Turkey and South Africa still have much higher trading costs than other Emerging European countries.
- There was a significant increase in Morocco, +26.2%, Egypt, +18.5%, Poland, +18.1%, and Israel, +15.8%. Israel is now one of the most expensive countries to trade in Emerging Europe.
- Trading costs in Russia, Hungary and Czech Republic have moved inline with trading costs in Developed Europe.
- Finally, Trading costs in Europe have become more expensive than in Asia. This has been fueled by higher permanent market impact cost and a higher perception of information based investment decisions.
Developed and Emerging Asia

Highlights:

- Trading Costs in Asia has dramatically improved. The decreasing cost trend started in 3Q-2013 and is expected to continue into 1Q-2014 where it will then stabilize.
- Costs in Asia are now lower than in Europe (for the first time).
- Japan still has the highest trading cost among Developed Asian countries. This appears to be due to higher volatility and increased completion for shares across funds.
- There was a large fluctuation in MOM trading cost change in the region. For example, New Zealand increased +16%, while Hong Kong decreased -16%.
- Taiwan has the lowest trading cost in Emerging Asia. It experienced a MOM decreased of -22%.
- Indonesia also experienced a decline in costs of -28%.
- Thailand and Pakistan experienced a spike in trading costs of +81% and +74% respectively. This was followed by Malaysia +38% and South Korea +18%.
- China and Philippines have been showing recent signs of improvement with a respective reduction in costs of -15% and -11%.
Highlights:
- The I-Star Cost Index remains exceptionally higher in Latam (48bp) and the Frontier (65) markets.
- Venezuela and Argentina still have highest trading costs among LatAm countries.
- Mexico and Chile are not far behind.
- Peru and Colombia are showing significant signs of improvement. Their trading cost decreased -19% and -21% from last month.
- Trading cost spiked in Frontier Middle Eastern countries: Oman, +104%, Qatar, +95%, and Jordan, +41%.
- Kuwait still has the highest trading costs among LatAm countries.
- Interesting situation is in Baltic region. Trading cost significantly decreased in Estonia, -32%, but increased in Lithuania, +36%. Thus making Frontier Market investing very difficult especially from a timing perspective.
Case Study:

- We performed an analysis of portfolio returns for an MSCI EAFE benchmark index compared to our I-Star Cost adjusted portfolio.
- For the I-Star Portfolio we adjusted the weightings across counties based on our I-Star trading cost index. Actual weights were determined by minimizing overall trading costs.
- The analysis was based on an investment of $100M in each portfolio in the beginning of Jan-2013. The portfolios were rebalanced weekly and the annual turnover value in both portfolios was ~60% over the year. Most EAFE rebalancings are around 40%-50% annual. We applied the I-Star trading cost index as a proxy for actual portfolio slippage during implementation. This results in different weightings over time and a difference in compounded returns.
- The I-Star Cost Adjusted Portfolio outperformed the EAFE Index by a dramatic +1.10%.
- Most of the improvement came directly from trading costs (and a compounding effect) but additional out-performance came from a higher return from the stocks where we allocated a higher weight.
- This analysis highlights the difference in portfolio returns that can be achieved via improved asset allocation.
- The top graph shows the fluctuation in our I-Star index across different countries in the EAFE index. Notice the large fluctuation by country and by month.
- On average, the range in trading costs in these countries was 42bp (the difference from the most expensive country and the least expensive country). Our analysis found that we could achieve an incremental return of +18bp to +22bp through lower costs and more efficient implementation.
- The bottom graph shows the difference in portfolio returns between the underlying benchmark index and our I-Star Portfolio.
Kissell Research Group – Recent Publications

The Science of Algorithmic Trading and Portfolio Management, Robert Kissell, (Elsevier, 2013). This text provides traders, portfolio managers, analysts, students, practitioners, and financial executives with an overview of the new electronic trading environment, and insight into how algorithms can be utilized to improve execution quality and fund performance. The book provides a discussion of the current state of the market and advanced modeling techniques for trading algorithms, stock selection and portfolio construction. Furthermore, the book provides insight into “best in class” methodologies for building, constructing, and evaluating algorithms, and insight into proper algorithmic forecasting techniques. The book provides the foundation for many of the forecasting models embedded in black-box models and used by today’s successful high frequency traders.

Multi-Asset Risk Modeling: Techniques for a Global Economy in an Electronic and Algorithmic Trading Era, Morton Glantz and Robert Kissell, (Elsevier, 2013). This text provides an introduction to the latest and most advanced risk modeling techniques for equities, debt, fixed income, futures and derivatives, commodities, and foreign exchange, as well as advanced algorithmic and electronic risk management. By giving coherent recommendations about which statistical models to use for which asset class, this book makes a real contribution to the sciences of portfolio management and risk management.

Multi-Asset Trading Costs, Robert Kissell, Journal of Trading, Fall 2013, Vol. 8, No. 4
This article provides insight into recent transaction cost trends across multi-asset trading classes. The article provides an in-depth analysis of trading across: Equities, ETFs (Liquid and Illiquid), Futures, Gov’t Bonds, Corporate Bonds, Commodities and Currencies, and also provides a long-term Trading Cost Index from 1990 - 2013 across the Global Markets (US, Canada, Developed, Emerging, Frontier, and Latam).

The Journal of Trading provides free registration and access to the paper at: http://www.iijournals.com/toc/jot/current

Smart Technology for Big Data, Michael Blake, Journal of Trading, Winter 2014, Vol. 9, No. 1
This article provides an underlying structure for managing the big data phenomenon. Innovations and tools fundamental to handling big data are highlighted, and we look at how these technologies are being implemented in the financial industry.

The Journal of Trading provides free registration and access to the paper at: http://www.iijournals.com/toc/jot/current
References

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