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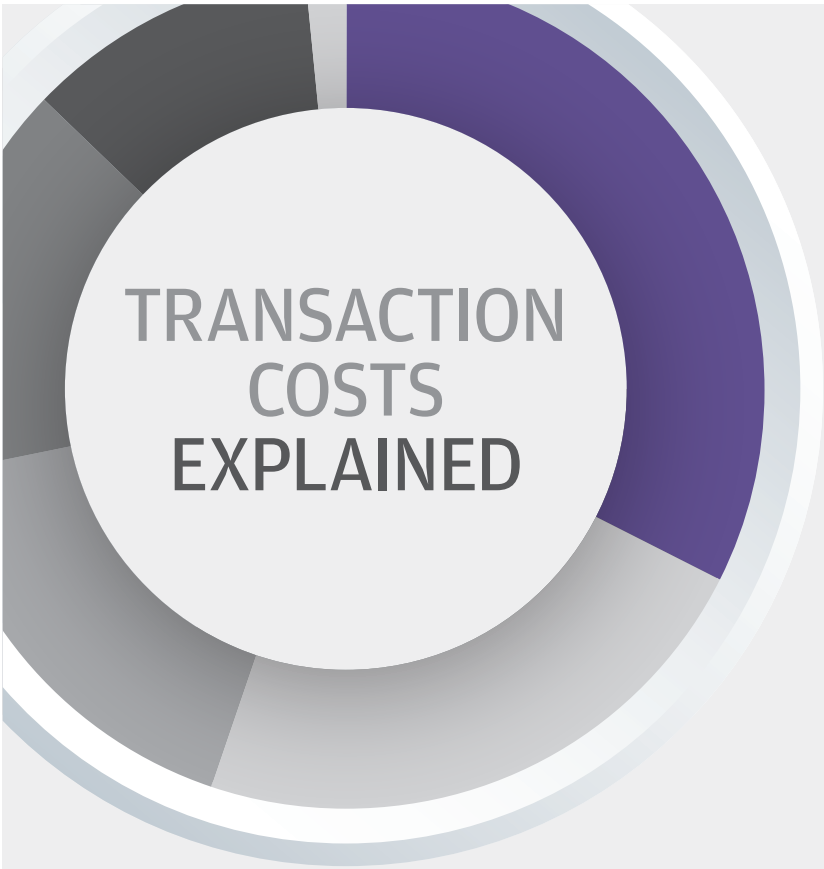


TRANSACTION COSTS EXPLAINED

Getting to grips with charging disclosure under MiFID II and PRIIPs

J.P.Morgan
Asset Management

MYTH 1

Transaction costs are a new cost

The transaction costs disclosed under MiFID II are NOT a new additional cost. They have always been involved in managing a fund and are already fully reflected in net returns. However, this is the first time they have had to be fully disclosed and expressed in percentage and monetary terms.

MYTH 2

Low transaction costs indicate a better investor outcome

Assessing the outcome from investing in a fund requires looking at its performance net of charges. A fund that trades infrequently may have low transaction costs but its strategy may be focused on achieving only modest returns. However, another fund with a more active trading strategy may incur higher transaction costs in order to generate higher long-term returns. Transaction costs (and other charges) must always be considered in the context of a fund's strategy and the return being achieved.

MYTH 3

Disclosing transaction costs makes competitor comparisons easier

Disclosing transaction costs may encourage fund managers to see how they can reduce the cost of trading, which is to be welcomed. But the very different basis on which costs can currently be calculated can be misleading and confusing for investors – and may actually serve to make fund comparisons harder.

Two pieces of EU legislation that came into force at the start of 2018 – the second Market in Financial Instruments Directive **(MiFID II)** and the Packaged Retail and Insurance-based Investment Products **(PRIIPs)** regulation – seek, among other aims, to make the cost of investing in products such as investment funds completely transparent and comparable.

Together, they require the disclosure of all costs and charges involved in investing in an investment fund.

Notably, this means that – for the first time – the transaction costs involved in buying and selling the underlying securities inside a fund must be disclosed.

In this guide, we want to explain what that means in practice – and both the challenges and potential benefits that disclosure of transaction costs presents.

MiFID II

Stands for the second Market in Financial Instruments Directive. It is an EU-wide piece of financial regulation designed to offer greater protection for investors and introduce more transparency across financial markets, improve orderly trading behaviour within markets and make the costs of trading and investing more explicit.

PRIIPs regulation

EU-wide rules governing information disclosure for all Packaged Retail and Insurance-based Investment Products (PRIIPs). Essentially, this covers any investment product used by a retail consumer that isn't a UCITS fund.

What costs does a fund need to disclose?

There are four types of cost that must now be disclosed separately on an investment fund, both before a fund is sold to an investor and on an ongoing annual basis:

One-off charges

Paid when entering or exiting an investment

- Initial charges
- Front-loaded management fees
- Distribution fees
- Exit fees on redemption

Ongoing charges

Taken annually for managing the fund

- Annual management charge (AMC)
- Operating and administration (O&A) costs – e.g. custody, trading, reporting costs
- Stock lending costs
- In a fund of funds, the costs of the underlying funds

Transaction costs

Incurred when trading underlying investments

- Explicit costs of trading underlying investments in a fund
- Implicit costs of trading underlying investments in a fund

(see below)

Incidental costs

Ad-hoc charges

- Performance fees

Transaction costs must take into account two types of cost

Explicit transaction costs

- **Broker commission** - to buy and sell securities
- **Research commission** - where the asset manager passes these on to the investor*
- **Taxes and levies** - such as stamp duty, regulatory and exchange levies
- **Securities lending** - the cost of borrowing or the admin fee from lending – e.g. for short selling activities

Implicit transaction costs

- **Arrival cost** - the difference between the price at which an asset is valued immediately before an order (the arrival price) and the price at which it is actually traded (the execution price)

...minus any value obtained from any swing pricing that may occur

*J.P. Morgan Asset Management does not pass these costs on to the investor

Swing Pricing

A mechanism used to protect long-term investors in a fund from having the value of their investment eroded by the costs involved in managing short-term fund inflows and outflows – especially during times of extreme market volatility. If a fund experiences unusually high inflows or outflows, the buying or selling price will be systematically adjusted up or down to absorb the impact of higher-than-usual transaction costs.

Please see relevant Prospectus for more information on Swing Pricing also referred to as Dilution Adjustment.

How must costs be disclosed?

Costs must be disclosed before a sale and then reported to the investor annually, based on the investor's own level of investment.

Pre-sales document

'Indicative' cost figures must

- Be based on the amount to be invested by the investor
- Show the four types of cost separately (see pages 4 and 5)
- Provide costs both in monetary terms and as a percentage

Annual reporting

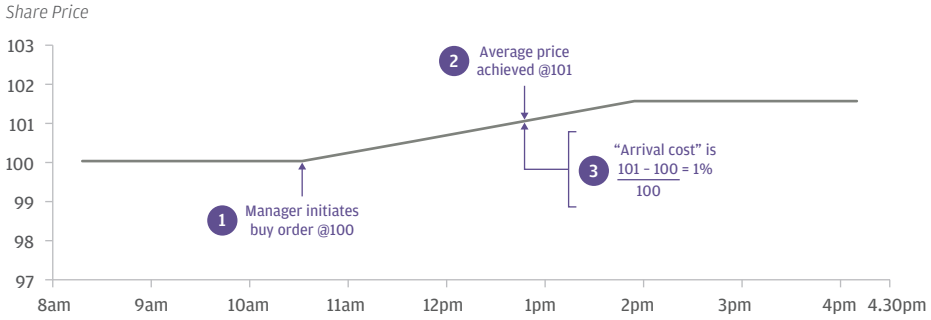
'Actual' cost figures must

- Be based on the client's average AUM over the previous 12-month period
- Show the four types of cost separately (see pages 4 and 5)
- Provide costs both in monetary terms and as a percentage
- Be based on all holdings – not just investments made from 2018

How is the 'arrival cost' calculated?

There are a number of ways of calculating transaction costs. The method used by J.P. Morgan Asset Management and others to determine implicit transaction costs is the full PRIIPs method, also known as the arrival price methodology.

THE ARRIVAL PRICE METHODOLOGY For illustration purposes only.



1. The **arrival price** is the mid-price of the security at the exact time the trade is sent to the broker.
2. The **execution price** is the price achieved for the whole trade (or the average price achieved where the trade has been broken down into multiple parts).
3. The **arrival cost** is the difference between the average execution price and the arrival price, expressed as a percentage.

In the buy example shown above, the execution price is 101p and the arrival price is 100p, so the arrival cost is 1%.

What can create the differential between the arrival price and execution price?

A difference between the price at which an order to trade is given and the price at which it is executed can result for a number of reasons:

- **Opportunity cost** - Sometimes it is not possible to execute a large trade in one go. Executing a trade in stages can create gains or losses depending on how the market price of the security moves.
- **Trade impact** - Instructing a large trade can have the effect of moving the security's price up (if buying) or down (if selling). Managing this impact is a key skill for asset managers and their trading desks.
- **Delay impact** - If a transaction is delayed, for whatever reason – even by a minute or so – market movements in the meantime can contribute to the arrival cost. Powerful trading systems that minimise latency (the delay between a trading request and response) are vital.

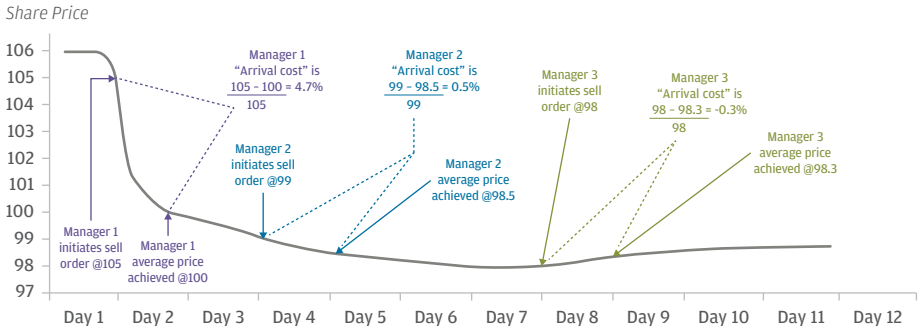
Do low transaction costs indicate the best investor outcome?

It can be easy to assume that the most attractive funds are those with the lowest transaction costs. But an example of three different managers reacting to news on the same stock shows that's not necessarily the case.

Case study: Putting transaction costs in context

Three managers react to some negative news in a stock price:

- **Manager 1** sells on the day of the bad news, achieving an execution price of 100, but accumulating an arrival cost of 4.7%.
- Three days after the newsflow, **Manager 2** decides to follow suit and sells. They start their order with the price at 99, and ends up with an execution price of 98.5.
- Lastly, **Manager 3** takes the longest time to decide, enters the sell order on Day 8 once the price has fallen to 98, and achieves an execution price of 98.3.



Despite all three managers coming to the same conclusion to sell, and each taking one day to execute their order, the manager who achieved the highest selling price, Manager 1, is considered to have the highest transaction costs. Indeed, under the above scenario, Manager 3 would show negative transaction costs, but would have achieved the worst outcome for clients.

	Manager 1	Manager 2	Manager 3	
Order start date	Day 1	Day 4	Day 8	
Arrival price	105	99	98	
Days to execute	1	1	1	
Execution price	100	98.5	**98.3**	◀ **Worst outcome**
Arrival cost	4.7%	0.5%	**-0.3%**	◀ **Lowest transaction cost**

Why do some funds show a negative or zero transaction cost?

A negative transaction cost indicates that transacting has resulted in a net revenue rather than a net cost for the fund. This can happen for two main reasons:

- The amount of money a fund obtains from its Swing Pricing mechanism offsets most or all of the transaction costs that the fund incurs.
- If a stock is taking a number of hours to sell/buy, the price can rise/fall in the time between placing the order and execution, so it exceeds/falls below the original arrival price and therefore offsets other transaction costs. If this happens to enough trades, an overall negative transaction cost can accrue.

A zero transaction cost can also result from:

- Firms inputting a zero cost where the actual cost is unknown or data quality is not good enough to give an accurate cost – this is only allowed as a short-term measure.
- Funds of funds including the transaction costs of the underlying funds in the ongoing charges of the main fund.
- Cash and liquidity funds where transaction activity is very low.

However it is important not to take negative or zero transaction costs at face value. They are often circumstantial and the basis for their calculation needs to be understood to ensure that costs do not look artificially low.

What are the implications of the new rules?

Costs have a major impact on investor returns. The regulatory intent of MiFID II and PRIIPs to enable investors to see and understand fully all the costs involved in investing in a fund is to be welcomed and supported.

Minimising trading costs by trading as efficiently and cheaply as possible has always been a priority for asset managers in order to show better net returns. Shining a light on transaction costs may encourage asset managers to work even harder to bring these costs down.

But there are three important factors to bear in mind:

1. **Hard to compare costs on a like-for-like basis:** The flexibility given to fund managers to use different calculation methods and swing pricing mechanisms to measure transaction costs makes it very difficult to make a meaningful comparison of transaction charges, even on funds with a similar mandate.
2. **Transaction costs need to be put into context:** Different funds can have very different cost profiles depending on their investment strategy and how frequently they trade. Transaction costs therefore need to be assessed against the aims, strategy and risk profile of the fund – never in isolation.
3. **Regulatory disclosure is not consistent:** Performance figures in a Key Investor Information Document (KIID), which is governed by UCITS legislation, may be based on a different time period and include different costs from those shown in MiFID and PRIIPs disclosures (for example, KIIDs do not have to show any type of transaction costs). Investors may therefore be presented with different costs for the same fund, depending on what documentation they are looking at.

Managing transaction costs at J.P. Morgan Asset Management

- **Investing in best execution:** J.P. Morgan Asset Management is committed to achieving best execution for all transactions we conduct. We invest extensively both in proprietary trading technology and teams of trading specialists to drive down execution costs and achieve the best trading outcome for the benefit of our clients.

  Our Global Equities team comprises 34 traders around the world, augmented by a further seven experts within our dedicated Systematic Trading and Analytics team that focuses solely on improving trading efficiency. Using data-driven machine-learning processes, we identify the optimal trading style in various trading situations. Through this agile, quantifiable approach, we strive to keep our transaction costs low.
- **Clear and accurate disclosure:** We calculate transaction costs using the full PRIIPs methodology, using three-year historic data which is refreshed monthly.
- **Not passing on research costs:** We were also one of the first asset managers to pay explicitly for third-party research, clearly separating the provision of research from the cost of transacting. Today, we have a policy not to pass on the costs of third-party research to investors for investments covered by MiFID II.

  We continue to invest in research and technology to achieve optimal trading outcomes without ever compromising security or reliability.

Markets Media Markets Choice Awards Winner:

Best Buy-Side Trading Desk 2016 & 2017

Past performance is not an indication of current and future performance.

BUILDING STRONGER PORTFOLIOS

At J.P. Morgan Asset Management, collaborating with our clients in an effort to build stronger portfolios drives everything that we do.

We are commited to sharing our expertise, insights and solutions across all asset classes to help make better investment decisions. Whatever you are looking to achieve, together we can solve it.

LET'S SOLVE IT.℠

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