



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 17

MEETING DATE: May 19, 2021

SUBJECT: Transaction Cost Analysis Policy

SUBMITTED FOR: Consent **Deliberation and Action** **Receive and File**

RECOMMENDATION

Staff recommends the Board approve the Transaction Cost Analysis Policy, which has been updated and replaces the Directed Brokerage Transactions and Commission Recapture Policy.

PURPOSE

This item supports the Strategic Management Plan by contributing to effective oversight of the investment program and assisting in facilitating investment planning and growth.

SUMMARY

This policy provide guidelines and procedures for the monitoring of SCERS' public investment manager transaction costs, including directed brokerage transactions, to minimize overall transaction costs while maintaining the manager's primary and foremost requirement to obtain best execution. The policy was first approved in 1996, amended in 2002, and reaffirmed in February 2018. Pursuant to SCERS' practice of reviewing and refreshing policies every three years, Staff has updated the policy for clarity without significant modification to the underlying substance or intent.

Public equity and fixed income investment managers hired by SCERS to manage plan assets serve as fiduciaries to the Plan. Included in the fiduciary duties of investment managers is an obligation to obtain best execution when implementing trades on behalf of SCERS. Best execution is defined as taking reasonable care to obtain the most advantageous terms when executing trades on behalf of clients. Best execution includes the total cost to execute a trade, including explicit and implicit costs, and is not limited to paying the lowest possible commission fee.

Investment managers have a wide range of strategies and methods when executing trades, and seeking best execution, which includes the evaluation of numerous factors to achieve the most favorable outcome given market conditions. The monitoring and reporting of transaction costs

contributes to the policy objectives for investment managers to minimize total transaction costs while seeking best execution for all transactions and maximizing the value of services received.

Commission recapture programs help to minimize SCERS' overall transaction costs. When a SCERS investment manager believes that "all things being equal," the manager can direct a trade and still achieve best execution as required by the manager's investment management agreement with SCERS, the manager shall direct trades through SCERS' commission recapture program. The commission recapture program will be administered by a third-party provider with the goal of reducing the explicit commission costs for SCERS. Currently, the commission recapture program is administered by SCERS' custodian bank, State Street.

A designated commission recapture broker is a broker that participates in a commission recapture program through which a portion of the direct commissions is credited to an institutional investor such as SCERS. SCERS' custodian bank, which administers the commission recapture program on behalf of SCERS, maintains a list of approved designated commission recapture brokers that participate in the program. The approved brokers that participate in the commission recapture program will be updated by the administrator of the program. The recaptured commissions shall be treated as income to SCERS, and shall not be used to purchase services.

MONITORING AND REPORTING

The policy also covers guidelines for monitoring and reporting transaction costs, which can have a meaningful impact on the implementation of an investment strategy. Minimizing transaction costs helps generate higher net returns and contributes to achieving the financial objectives of the Plan. Monitoring of transaction costs and participating in a commission recapture program are two methods used to lower overall transaction costs, by emphasizing this objective with SCERS' external investment managers and directly receiving rebates of commission costs, where feasible.

Transaction cost analysis (TCA) is an established service with several reputable providers in the market with decades of experience. SCERS will utilize a third-party service provider to monitor transaction costs for its public market investment managers. SCERS currently utilizes the services of Elkins/McSherry, a subsidiary of State Street, for transaction cost analysis. Under the policy, SCERS' Staff will review and recommend a service provider to the Board for approval. The analysis will review costs at the overall asset class level, as well as at the individual manager level. The analysis, when possible, will include explicit and implicit transaction costs.

SCERS investment staff is responsible for reviewing the quarterly TCA reports prepared by the third-party service provider. The reports will be reviewed for unusual activity and deviations from relevant benchmarks. While transaction costs can vary from quarter-to-quarter, over extended time periods it is expected that SCERS' investment managers will rank in the top half of relevant industry benchmarks. When an investment manager ranks below the top half of their benchmark for multiple quarters, Staff will perform additional analysis, which includes following up directly with the manager and TCA service provider, to identify causes and potential action necessary to reduce costs. The TCA will be included in the overall evaluation of the investment manager, which includes both quantitative and qualitative analysis.

ATTACHMENT

- Transaction Cost Analysis Policy (New Policy)
- Directed Brokerage Transactions and Commission Recapture Policy (Prior Policy)

Prepared by:

/S/

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Investment Officer

Reviewed by:

/S/

Steve Davis
Chief Investment Officer

/S/

Eric Stern
Chief Executive Officer



TRANSACTION COST ANALYSIS POLICY

PURPOSE

The purpose of this policy is to provide guidelines and procedures for the monitoring of Sacramento County Employees' Retirement System public investment manager transaction costs, including directed brokerage transactions, to minimize overall transaction costs while maintaining the manager's primary and foremost requirement to obtain best execution.

POLICY

SCERS' investment managers have a fiduciary duty to obtain best execution when implementing trades on behalf of SCERS. Best execution is defined as taking reasonable care to obtain the most advantageous terms when executing trades on behalf of clients. The goal of SCERS' investment managers should be to minimize total transaction costs while seeking best execution for all transactions and maximizing the value of services received.

Commission recapture programs help to minimize SCERS' overall transaction costs. SCERS' investment managers should direct trades through the designated commission recapture program when "all things being equal" the manager can direct a trade and still achieve best execution as required by the manager's investment management agreement with SCERS. The commission recapture program is administered by an approved third-party provider. When able to maintain best execution, an investment manager should direct through the commission recapture program as follows:

- A. **U.S. stock exchange listed securities:** Obtain a commission of three cents or less per share or direct the trade to a SCERS designated commission recapture broker. Any trade directed to a commission recapture broker shall be identified as a trade for the benefit of the plan. SCERS anticipates that a manager will be able to direct 25% of U.S. exchange transaction commissions to a commission recapture broker.
- B. **Non-U.S. stock exchange listed securities:** Obtain a commission that is 25% or more below the prevailing local market rate or direct the trade to a SCERS designated commission recapture broker. Any trade directed to a commission recapture broker shall be identified as a trade for the benefit of the plan. SCERS anticipates that a manager will be able to direct 25% of non-U.S. exchange transaction commissions to a commission recapture broker.

Staff shall provide each of SCERS' public market investment managers a copy of this policy and SCERS' list of approved designated commission recapture brokers, as that list may be amended from time to time without revision to this policy.

MONITORING AND REPORTING

SCERS will utilize a third-party service provider to monitor transaction costs for its public market investment managers. SCERS' Staff will review and recommend a service provider to the Board for approval.

The transaction cost analysis will be performed across public equity and fixed income asset classes, and will include any trades executed through SCERS' commission recapture program, in addition to all other trades executed by SCERS' public market investment managers. TCA will be performed on a quarterly basis and will review costs for each manager and asset class to peer universe and relevant asset class benchmarks, as determined by the service provider and SCERS' investment staff.

While transaction costs can vary from quarter-to-quarter, over extended time periods it is expected that SCERS' investment managers will rank in the top half of relevant industry benchmarks. When an investment manager ranks below the top half of their benchmark for multiple quarters, Staff will perform additional analysis, which includes following up directly with the manager and TCA service provider, to identify causes and potential action necessary to reduce costs. The TCA will be included in the overall evaluation of the investment manager, which includes both quantitative and qualitative analysis.

Staff will provide a quarterly report to the Board summarizing the transaction cost analysis. The summary report will emphasize overall transaction costs by asset class, but will also include instances when transaction costs were above industry benchmarks and/or if follow up action was necessary by Staff. The quarterly report will also include an update on SCERS' commission recapture program and the net benefit provided to SCERS.

BACKGROUND

A significant portion of SCERS' multi-billion dollar investment portfolio is invested in publicly traded equity securities, across domestic and international markets. Transaction costs are incurred whenever a security is bought or sold. Transaction costs are made up of the direct fee or commission (explicit costs) and the market impact of executing a trade (implicit costs). Transaction cost analysis has become a recognized industry standard for evaluating transaction costs. While transaction cost analysis initially focused on public equity assets, improved market data and transparency has allowed for the analysis to expand into fixed income markets. Transaction cost analysis helps to ensure investment managers are meeting their fiduciary obligations to achieve best execution.

Another common way for an institutional investor to control commission costs is through commission recapture. Commission recapture programs help reduce overall commission costs by providing a rebate of commission costs back to the asset owner. This policy provides direction to SCERS' investment managers in the conduct of investment trades to control commission costs, but not interfere with the manager's first and foremost obligation to achieve best execution.

RESPONSIBILITIES

Executive Owner: Chief Investment Officer

POLICY HISTORY

Date	Description
05-19-2021	Board approved revised policy, retitled as Transaction Cost Analysis Policy, replacing the Directed Brokerage Transactions and Commissions Recapture Policy
02-21-2018	Board affirmed policy in revised policy format
08-22-2002	Board amended Inv. Policy No. 2001-01 by Resolution 2002-02
01-18-2001	Board approved Investment Policy No. 2001-01 that replaced the previous policy
October 1996	Board adopted policy



DIRECTED BROKERAGE TRANSACTIONS AND COMMISSIONS RECAPTURE POLICY

PURPOSE

The purpose of this policy is to provide direction to SCERS public equity investment managers in the conduct of investment trades to control commission costs while maintaining the manager's primary and foremost requirement to obtain best net execution.

POLICY

When a SCERS investment manager believes that "all things being equal," the manager can direct a trade and still achieve best net execution as required by the manager's investment management agreement with SCERS, the manager shall direct trades as follows:

- A. U.S. stock exchange listed securities:** Obtain a commission of three cents or less per share or direct the trade to a SCERS designated commission recapture broker. Any trade directed to a commission recapture broker shall be identified as a trade for the benefit of the plan. SCERS anticipates that a manager will be able to direct 30% of U.S. exchange transaction commissions to a commission recapture broker.

- B. Non-U.S. stock exchange listed securities:** Obtain a commission that is 25% or more below the prevailing local market rate or direct the trade to a SCERS designated commission recapture broker. Any trade directed to a commission recapture broker shall be identified as a trade for the benefit of the plan. SCERS anticipates that a manager will be able to direct 25% of non-U.S. exchange transaction commissions to a commission recapture broker.

A designated commission recapture broker is a broker that offers a commission recapture program through which a portion of the direct commissions is credited to an institutional investor such as SCERS that is included on SCERS' list of approved designated commission recapture brokers as maintained by SCERS' custodian bank. The recaptured commissions shall be treated as income to SCERS, and shall not be used to purchase services.

APPLICATION

Staff shall provide each of SCERS' public securities investment managers a copy of this policy and SCERS' list of approved designated commission recapture brokers, as that list may be amended from time to time without revision to this policy.

Staff shall monitor SCERS' transactions costs and provide the Board a quarterly report on the impact of directed trades and commission recapture on trade execution costs.

SCERS will conduct an annual review of the commission recapture sharing percentage and determine that the percentage is consistent with industry practice.

BACKGROUND

A significant portion of SCERS' multi-billion dollar investment portfolio is invested in publicly traded equity securities in several investment markets globally. Transaction costs are incurred whenever a security is bought or sold. Transaction costs are made up of the direct fee or commission and the market impact of executing a trade. One common way for an institutional investor to control commission costs is through commission recapture. This policy provides direction to SCERS' equity investment managers in the conduct of investment trades to control commission costs, but not interfere with the manager's first and foremost obligation to achieve "best net execution."

RESPONSIBILITIES

Executive Owner: Chief Investment Officer

POLICY HISTORY

Date	Description
08-01-2018	Renumbered from 032
04-18-2018	Board affirmed in revised policy format
08-22-2002	Board amended Inv. Policy No. 2001-01 by Resolution 2002-02
01-18-2001	Board approved Investment Policy No. 2001-01 that replaced the previous policy
October 1996	Board adopted policy