Guide to transaction costs

This is not a consumer advertisement. It is intended for professional financial advisers and should not be relied upon by private customers or any other persons.
Why you need to know about transaction costs

The Financial Conduct Authority (FCA) has advised that more information must be provided on transaction costs relating to investment funds available to defined contribution (DC) pension scheme members for the investment of their pension contributions.

For trust-based schemes, trustees are now legally required to consider transaction costs when assessing value for money.

This document has been designed to provide you with information on the type of transaction costs that may apply to pension scheme investments.

Transacting in a DC pension fund

When a DC fund transacts, the spread (the difference between the price offered to buyers and sellers in the market) protects existing investors or those remaining in a fund; the assets will be bought at an offer price and sold at bid, depending upon how funds are priced.

Typically for pension funds at Legal & General, there is a single ‘swinging price’ and therefore there won’t be an explicit bid and offer price as described above. More details about the way a swinging price works are provided on pages 6 – 7.

However, transaction costs do not only relate to this level of transacting and instead apply to all trading undertaken by a fund manager. The section ‘When transaction costs affect a DC pension plan’ on page 5 provides further information on when transaction costs may apply.
Transaction costs explained

Transaction costs are incurred as a result of the buying, selling, lending or borrowing of investments within the funds. All of these activities involve a level of trading and the costs that arise because of that trading are known as transaction costs.

Some transaction costs are explicit and some are implicit:

**Explicit costs**

These are known costs which may include:

- taxes and levies (such as stamp duty reserve tax)
- broker commissions (fees which are charged in order to buy and sell investments such as equities), and
- the costs of borrowing or lending securities.

**Implicit costs**

These are costs that cannot be readily defined, for example where a large trade is placed which moves the market, meaning that the price achieved is different than expected.

FCA rules for the disclosure of implicit costs state that Legal & General must calculate the difference between the price at which the asset is valued immediately before an order is placed and the price at which it is actually traded (arrival price). This is known as the slippage cost methodology.

In addition to the spread this approach aims to capture other less readily identifiable costs, such as the impact the trade has on the price of the asset when it enters the market.

The methodology within FCA rules do not require these implicit costs to be broken down any further.
**Portfolio turnover**

Because transaction costs apply to all trading undertaken by a fund manager, a fund which adopts a buy-and-hold approach (passive strategy) will usually have a lower turnover and therefore lower transaction costs than an active investment strategy.

When considering the transaction costs that a pension scheme has incurred you should also take into account the fact that different types of assets cost different amounts to trade, for example hedge funds may cost more to trade than more common FTSE stock.

For both these reasons you should therefore always compare transaction costs on a like-for-like basis in terms of investment strategy and asset class.

**Costs and charge categories**

In addition to transaction costs, the costs and charges for funds may be categorised as ongoing, one-off or incidental.

- Ongoing charges include all ongoing costs and charges related to the day-to-day management of the fund, such as management fees.
- One-off costs are paid by an investor to buy or sell units in a fund, for example, entry and/or exit charges.
- Incidental costs are other ad hoc costs, for example, performance fees that are not covered in the above categories.

Legal & General does not charge any one-off or incidental costs on its workplace pension products. Ongoing charges are fully disclosed to investors in the appropriate fund fact sheet.
When transaction costs affect a DC pension plan

Transaction costs may be applied to investments in a DC pension in different ways throughout the life of a plan:

- On the investment of contributions or transfers in
- Whilst funds are invested (ongoing management of fund)
- When investments are switched from one fund to another
- When assets are sold to take pension benefits or transfer to another provider.

The diagram below illustrates how these transaction costs are applied to a pension plan.

<table>
<thead>
<tr>
<th></th>
<th>Investment</th>
<th>Ongoing investment management</th>
<th>Switch</th>
<th>Sale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit price (Offer/Bid)</td>
<td>x</td>
<td></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Fund Management Charge (FMC)</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
</tr>
</tbody>
</table>

To ensure that the cost incurred by assets being invested and sold from the fund are only borne by those who buy and sell units, fund managers use various mechanisms such as a ‘swinging price’ to adjust the price at which units are bought and sold.
Swinging price

Legal & General’s funds use a swinging price mechanism which is set by the net flow of assets in the individual fund. If there is a net inflow, the price will be based on the offer price – if there is a net outflow, the price will be based on the bid price.

All deals, whether sales or purchases, will be carried out at this price. This is determined by the fund so will impact all sales or purchases of units in the fund on that day.
How a swinging price works

All funds have a mid-price (sometimes known as the net asset value). The mid-price is simply the value of all the fund assets divided by the number of units in issue.

A swinging price works by creating a dealing price via the adjustment of the mid-price of a fund. The size of the swing (the spread) reflects the level of transaction costs due to activity within the fund. The direction of the swing is based on the net flow in and out of the fund on the dealing day.

For example, if the unit price of the fund is 100 and the fund spread is 0.25% then:

- If the fund experiences net inflows, the price swings up to 100.25 and is known as the ‘offer’ price
- If the fund experiences net out flows, the price swings down to 99.75 and is known as the ‘bid’ price
- If the in and out flows are equal, or there is no trading, the price will remain at 100 (mid-price).

Like all pension product providers, Legal & General will only publish one price, which simply represents the dealing price of the fund. All investors transacting on any given business day will pay the same bid or offer price, regardless of whether they are buying or selling units in the fund.
Examples of a swinging price in action

For these examples we have assumed that the assets backing the fund are worth £1 million and there are one million units. The mid-price is therefore 100p.

**Scenario 1 – an investor wants to invest £100,000 in the fund**

Legal & General will need to buy more assets and this will incur dealing costs of £500.

If we simply used the mid-price of 100p per unit then there would be 1.1 million units and assets of £1,099,500 (£1,000,000 + £100,000 – £500). This would reduce the next day’s unit price to 99.95p for everybody. In this example, the dealing costs of £500 have been spread across all the investors instead of being borne by the new investor only.

Taking into account the £500 dealing costs, the new investor should only get 99,500 units, Legal & General therefore ‘swing’ the unit price to 100.5p (£100,000 / 99,500 units) and the following day the unit price is swung back to 100p (£1,099,500 / 1,099,500 units).

**Scenario 2 – an investor wants to withdraw their 100,000 units**

Legal & General will need to sell assets and this will incur dealing costs of £500.

In this example the units are nominally worth £100,000, but after dealing costs this will be only £99,500. In order to make sure that only the withdrawing investor incurs these costs, the price is temporarily swung to 99.5p and the investor is paid their £99,500.

The following day Legal & General recalculate the unit price as follows:

- The value of the remaining assets are £1,000,000 – £99,500 – £500 = £900,000
- The units remaining are 1,000,000 – 100,000 = 900,000
- The unit price is 100p (again)
Negative transaction costs

There may be scenarios where transaction costs are presented as a negative value. This can occur for two reasons:

1. **Implicit costs** – when buying an asset, the valuation price when placing the order might be higher than the actual price paid upon execution of the trade. This gain may offset and be greater than other transaction costs resulting in a total negative transaction cost for the fund.

2. **Swing pricing mechanism** – when an investor is trading in the opposite direction to the net flow of the fund.

For example, an investor who buys units in a fund which is in net outflow will still receive the bid price. As the investor is buying at a price point that is lower than the mid-price, this results in a negative transaction cost for that investor.

**Example of negative transaction costs due to implicit costs**

In this simplified example we have again assumed that the assets backing the fund are worth £1,000,000. An asset is valued £100,000 at the time an order to buy is placed the fund, however at the time the trade is executed its value has decreased to £99,000. As the fund has bought the asset at a lower price, the implicit costs for this transaction represent –£1,000 (or a £1,000 gain).

Combined with the explicit costs for that trade of £500, the fund’s total transaction costs represent –£500 (gain) or –0.05% (−500/1,000,000).

**Example of negative transaction costs due to swing pricing**

We refer to the previous scenario of an investor wishing to invest £100,000.

In this example total net flows and transaction costs resulted in a fund spread of 0.50%. As the fund was in net outflow, the unit price swung to reflect to a ‘bid’ price of 99.5p. This would result in the investor receiving a total of 100,502 units for their £100,000 investment, and this would be reflected as transaction costs of −0.5% (or −£500).

However, had the fund had inverse flows, the unit price would swing to an ‘offer’ price of 100.5p with the investor receiving 99,502 units for the same investment. In this scenario transaction costs are reflected as 0.5% (or £500).
Guide to transaction costs

Typical transaction costs for a fund

The example fund used is the Legal & General (PMC) Multi-Asset Fund 3. This is the Legal & General default fund for new pension schemes.

<table>
<thead>
<tr>
<th>LEGAL &amp; GENERAL (PMC) MULTI-ASSET FUND 3</th>
<th>CONTRIBUTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund management charges</td>
<td>0.13%*</td>
</tr>
<tr>
<td>Total transaction costs</td>
<td>0.00%*</td>
</tr>
<tr>
<td>Explicit transaction costs</td>
<td>0.01%*</td>
</tr>
<tr>
<td>Implicit transaction costs</td>
<td>−0.01%*</td>
</tr>
</tbody>
</table>

*Costs are effective as at 30 September 2018.

To illustrate this example above, the explicit transaction costs of 0.01% mean that for every £1,000 of investment, explicit transaction costs of 10p will be incurred. The implicit costs in this example are negative (−0.01%) which means the execution price achieved exceeded the mid-market price at the previous evening’s close, and so for every £1,000 of investment, implicit costs will deliver a gain of 10p.

Accordingly, the total transaction costs incurred as a result of trading activities by the fund manager will be 0.00%.

Transaction costs incurred by Legal & General are calculated on the basis of the slippage (arrival price) methodology as outlined by the FCA.

FURTHER QUESTIONS

If you’re still unsure about how transaction costs may impact upon a pension scheme, we recommend that you speak to your usual Legal & General representative.
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