

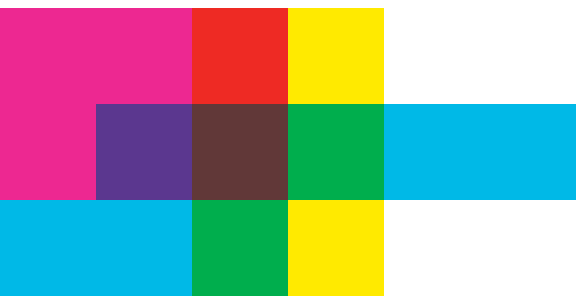
Asset and Investment Manager :: AIM

# TOTAL COST OF OWNERSHIP (TCO)

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An OMS Perspective

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**Bloomberg**  
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## TOTAL COST OF OWNERSHIP (TCO) AN OMS PERSPECTIVE

By Dan Matthies and Palak Patel

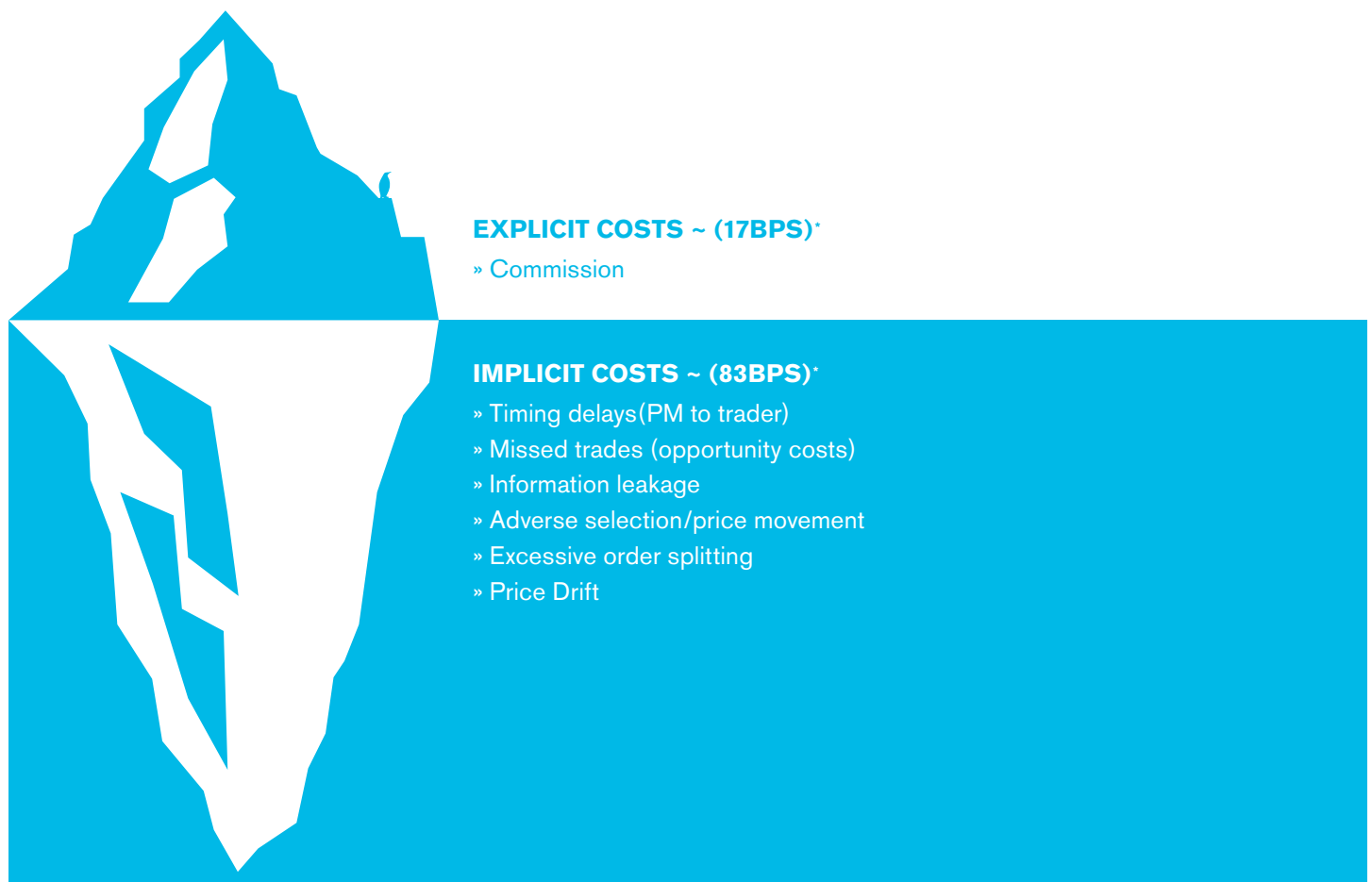
### Transaction cost analysis reveals explicit & implicit costs of trading to the institution

In 2003, Wayne Wagner of the Plexus Group pioneered Transaction Cost Analysis<sup>1</sup> to show institutions that they could significantly increase a fund's bottom line performance by focusing on reducing execution slippage. Wagner used the analogy of an iceberg to explain the costs of execution.

In his analogy, Wagner likened explicit costs to the part of the iceberg above the waterline. These costs—e.g., the commission rate—are those that the head of trading, the CFO and PM could see.

However, according to Wagner's research, explicit costs were the smallest portion of the total cost of execution. The commission (explicit cost) was dwarfed by implicit costs such as price drift (opportunity costs) resulting from time delays in getting orders into the market, information leakage and adverse selection resulting from poor order-handling decisions. The implicit costs had a much greater (negative) impact on the performance of a fund—largely because of the scale differential between commission (less than 1 cent) and price (bid/offer spreads greater than 1 cent).

<sup>1</sup> Wayne H. Wagner, "Cost Versus Liquidity: The Quest for Best Execution," [www.aimrpubs.org](http://www.aimrpubs.org), 2003: 46.



\*Source: Elkins McSherry, a State Street Company

## WHAT'S YOUR ORDER MANAGEMENT SYSTEM'S TCO?

Minimizing the total cost of ownership (TCO) is a new kind of asset-management efficiency. TCO isn't just a TCA concept. It's in our daily lives.

For example, smartphone apps: The free or \$0.99 “store” (direct/explicit) cost often pales in comparison with the in-app purchases (indirect/implicit costs) that are needed to make the app run the way you want it to.

It's frustrating. Unfortunately, the OMS is no different. The costs just need to be identified. The process is similar to the exercise that Wagner did with trade costs.

Often, you don't see the OMS TCO because the start-up and continuing costs may be allocated to different P&Ls across a firm, thus making the TCO somewhat opaque.

For example, monthly software license costs may hit the trading desk's expenses—therefore they are a direct cost and can be seen. In some cases, market data and FIX network costs may also be allocated as direct costs, thus they are transparent.

For a modern OMS to function, however, it also needs supporting functionality that may hit several different P&Ls; tracking becomes opaque—an indirect cost. For example, upgrades, maintenance and local IT support may be allocated to the firm's IT budget. A firm maybe duplicating its market data costs; if the OMS is not supported by a top-notch execution management system (EMS) or trader's worksheet blotter, the firm maybe integrating third-party EMS, resulting in a doubling up on market data and other costs.

An iceberg graphic where the visible tip represents direct costs and the much larger submerged part represents indirect costs. The iceberg is white with a blue outline, set against a blue background.

### DIRECT OMS COSTS

- » Software License Fees
- » AUM Fees
- » Market Data
- » FIX Network Fees

### INDIRECT OMS COSTS

- » System Hosting
- » Integration & Training
- » Market Data
- » Upgrades & Maintenance
- » Local IT Support
- » Inefficient Workflows & Post-Trade Errors
- » Disaster Recovery & Mobile Access
- » Access to Data for Counterparty Insights
- » FIX Execution “tolls”

One of the more significant costs incurred by buy-side firms is perhaps the most discreet or “hidden” cost of all: the costs passed along to their sell-side coverage. Several OMS vendors charge the sell side “FIX execution tolls” and connectivity fees to receive trading flow from their clients. A flat monthly connection fee plus a per share/contract/notional value “toll” is charged to each of the buy-side firm’s brokers. Each year, the sell side pays in the hundreds of millions of dollars just to receive orders from their clients. In fact, some OMS vendors realize more than 70% of their annual revenues from these connectivity fees rather than from the software deployed by the end users at buy-side firms. These costs, although implicit to the buy side, are very real when the sell side evaluates their client’s profitability and both the type and level of service they will provide.

The sell side subsidizing the OMS is becoming more and more of an issue as commission rates and volumes decline and overall margins get squeezed by rising regulatory costs. The buy side has to understand how their OMS pricing policies affect their relationship with the sell side. For example: Are the OMS pricing policies: (1) Dictating how the buy side can execute with their brokers? (2) Resulting in pricing policies becoming a best-execution issue for both the buy and the sell side? (3) Affecting how the sell side views their buy-side relationship (profitability) and research calls and initial offering allocations? As regulations such as MiFID II and the FCA’s “Thematic Statement on Best Execution and Payment for Order Flow” start to formally address best execution, PMs, head traders and compliance have to become more sensitive to how these costs affect their sell-side relationships and the impact it can have on best execution. They can no longer be passive — they need to actively manage their service providers and the pricing policies that affect execution quality and their overall relationship.

These and other expenses such as inefficient workflows, disaster recovery, mobile support, etc., may be allocated to different corporate entities and done in a way that their expenses hide below the surface.

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### OMS Infrastructure Cost and License Fee Overview

OMS	Description
Current OMS	License Fee
AUM Fee @ \$X_xxx per billion	Fees for AUM >10 Billion
System Interfaces @ X,000 each	Connectivity
Managed Offsite Hosting Services	Outsource
Managed FIX Network	Outsource
Other connectivity	Outsource
Pricing Data Feeds	License Fee
Other Feeds	License Fee
Backup Provider	Real-Time Backup
Omgeo	Oasys/Allocations
Disaster Recovery Operator	Disaster Recovery
Managed Service fees	Outsource
Additional Hardware feeds	Capital Charges
IT Support Headcount/Maintenance Allocation	Human Capital Charges

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## ABOUT THE AUTHORS

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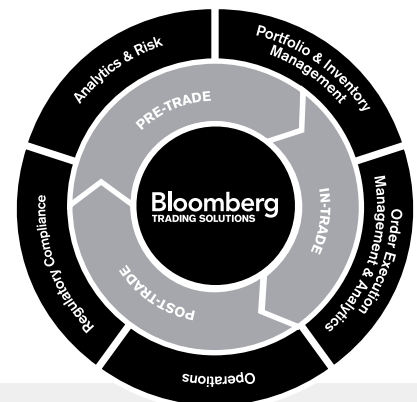
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To learn more, email our AIM team at [bbaim@bloomberg.net](mailto:bbaim@bloomberg.net)



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