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Trading

Because the investment process is not complete until securities are bought or sold, the quality of trade execution is an important determinant of investment results. The methods by which managers and traders interact with markets, choose appropriate trading strategies and tactics, and measure success in execution are key topics addressed in this study session.

READING ASSIGNMENTS

LEARNING OUTCOMES

READING 35. EXECUTION OF PORTFOLIO DECISIONS

The candidate should be able to:

a compare market orders with limit orders, including the price and execution uncertainty of each;

b calculate and interpret the effective spread of a market order and contrast it to the quoted bid–ask spread as a measure of trading cost;

c compare alternative market structures and their relative advantages;

d explain the criteria of market quality and evaluate the quality of a market when given a description of its characteristics;

e explain the components of execution costs, including explicit and implicit costs, and evaluate a trade in terms of these costs;

f calculate and discuss implementation shortfall as a measure of transaction costs;

g contrast volume weighted average price (VWAP) and implementation shortfall as measures of transaction costs;

h explain the use of econometric methods in pretrade analysis to estimate implicit transaction costs;

i discuss the major types of traders, based on their motivation to trade, time versus price preferences, and preferred order types;

j describe the suitable uses of major trading tactics, evaluate their relative costs, advantages, and weaknesses, and recommend a trading tactic when given a description of the investor's motivation to trade, the size of the trade, and key market characteristics;

k explain the motivation for algorithmic trading and discuss the basic classes of algorithmic trading strategies;

l discuss the factors that typically determine the selection of a specific algorithmic trading strategy, including order size, average daily trading volume, bid–ask spread, and the urgency of the order;

m explain the meaning and criteria of best execution;

n evaluate a firm's investment and trading procedures, including processes, disclosures, and record keeping, with respect to best execution;

o discuss the role of ethics in trading.