BEACON POINTE
ADVISORS

BEACON POINTE RESEARCH WHITE PAPER

AN INTRODUCTION TO COMMISSION RECAPTURE
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CONFIDENTIAL – PROPRIETARY

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HIGHLIGHTS

- *Background:* When looking at investment "costs", most evaluate the fees that are paid to the investment managers or mutual funds, the custodian fee, and the investment consultant fee. The costs associated with trading, however, often escape attention.

- Trading cost is normally defined as the cost of making a transaction, including the commission and the bid/ask spread (or the market maker spread). Trading costs include a number of different components, some less easily measured and some with greater costs. The costs associated with trading equity securities have a definite impact on the performance of a portfolio.

- Trading costs include both *explicit* and *implicit* costs. Implicit costs are the hidden costs of trading and include market impact and spread costs. Spread cost is the difference between the bid (sell price) and the ask (buy price). Market impact is the movement in the price of the stock caused by the trade order. Other implicit costs include timing risk and cost of liquidity. Please refer to Beacon Pointe's *An Introduction to Equity Trading Costs, December 2002* White Paper for more information regarding implicit trading costs. Explicit costs, which are associated with accounting charges, although easy to measure and compute, are often overlooked.

- Managing expenses is crucial in the management of the overall portfolio. Beacon Pointe understands the importance of lowering expenses and helps clients by negotiating investment manager and custodian fees. Beacon Pointe is also sensitive to the costs associated with trading and has recommended the use of third party commission recapture firms and investment management firms that utilize electronic trading systems to help reduce trading costs.

- The following pages are presented to give our clients a better understanding of commission recapture programs, how commission recapture works, and the characteristics of a superior recapture program.

Commission Recapture - Background

- *Explicit costs* are costs such as commissions, SEC fees, taxes, and clearing charges. These fees are normally associated with accounting charges and are easy to measure and evaluate. Commissions are the largest explicit cost and thus have received much focus in the investment community.

- Commissions are fees paid to a broker in order to execute a trade. Mr. Hans R. Stoll (*The Importance of Equity Trading Costs: Evidence from Securities Firms' Revenues,* 1995), Mr. Donald B. Keim, and Mr. Ananth Madhavan (*The Cost of Institutional Equity Trades: An Overview, 1998*) estimated that commission costs range from 0.20% to 0.25% of total trade value.

- Commissions paid for equity trade transactions vary widely not only by broker but also by market mechanism. For example, discount brokers may charge lower commissions relative to full service brokers. Full service brokers may charge 12-15 cents per share while an electronic crossing system may charge 1-2 cents per share. Commission costs have dropped substantially over the past years due to the implementation and greater utilization of technology in trading and electronic crossing networks. In 1982, according to Stoll, commissions were almost 18 cents per share. This represented 0.58% of total trade value.

- Today, institutional commission rates are typically 4-6 cents per share and reflect investment managers' opinions that these rates fairly compensate a broker for trade execution and research (soft dollars).

- Trading institutions are under pressure by clients to lower commission fees. The Fund sponsor ultimately bears the commission costs. According to ERISA Technical Release 86-1, Fund sponsors have the fiduciary responsibility of managing the Fund's commissions.

  - The Fund sponsor has a fiduciary responsibility to monitor and control commissions
  - Commissions are an asset of the plan
  - Commission recapture is consistent with fiduciary responsibility

- Commissions are an asset of the Fund and not the investment manager.

- Commission recapture is a form of institutional discount brokerage and can reduce expenses and increase cash flow to the Fund.

- Simply put, the greater the brokerage commissions, the less there is for the Fund to invest.

- In addition to the above stated reasons, Beacon Pointe has recommended third-party commission recapture programs to our clients because:

  - Endowments and Foundations have minimum spending rates which need to be met
  - Although the capital markets have been positive recently, the past few years have been difficult for many Endowments and Foundations
  - Although Fund market values have dropped, the need to spend has continued to grow
  - Fund expenses, including trading expenses, detract from spending
  - *Commission recapture reduces transaction costs and increases cash flow to the Fund*

Commission Recapture – How Does it Work?

- *Main Points*

  - Investment managers can trade at their normal commission rates. A superior recapture program should not disrupt the investment manager's normal or usual pattern of business and trading.

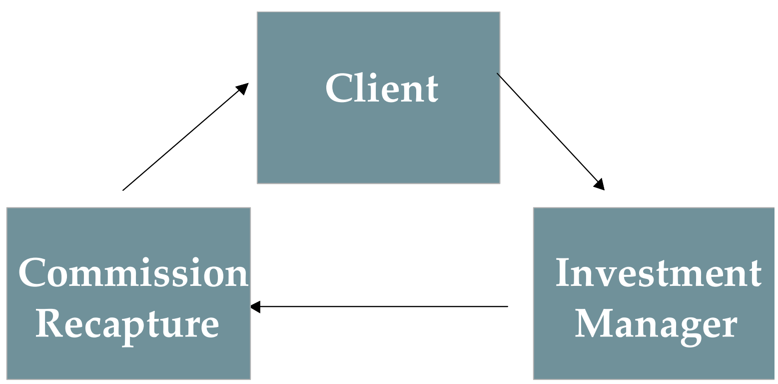
  - The commission recapture program will credit a portion of the commission back to the Client.

  - The commission recapture program can rebate cash back to the Client or pay Client expenses. Typical uses of fund expenses which can be covered by recaptured commission include, but are not limited to: audit fees, custodial fees, legal fees, master trust fees, investment management fees, and conference fees. Note that the permissible uses of recapture commission should follow the guidelines set within the Fund's governing documents and applicable laws.

  - The objective of commission recapture is to help control commission costs—decrease expenses, and avoid conflicts of interest.

- Exhibit 1 below presents the commission recapture process and cycle:

Exhibit 1



- Client instructs investment managers to direct a percentage of trades through a commission recapture firm—usually 30%-40%. Depending on specific client objectives, Beacon Pointe typically recommends that Client not direct over 50% through a commission recapture program. Beacon Pointe understands that soft dollars and the flexibility to trade through specific brokerage institutions may be of great importance to certain investment managers and investment styles.
- Investment managers trade at their normal commission rates.
- Commission recapture program rebates a portion of commission back to Client.

Commission Recapture – Components of a Commission Recapture Program

- Flexibility should be a key factor of a superior commission recapture program.

  - Commission recapture programs should be analyzed in terms of fees, required volumes, or trade minimums.

  - The Client and its consultant should implement a program that has non-binding agreement letters and provides direction letters to the investment managers.

  - Commission recapture programs should be specifically designed for each Client:

    - Depending on Client characteristics, some Clients may specify that only certain investment managers work within the commission recapture program
    - Some Clients may direct smaller or greater trade percentages through the commission recapture program

- The Client's consultant should review the trade execution of the commission recapture firm. Recapturing commissions should not overshadow the importance of trade execution.

- Some investment managers may be concerned that commission recapture interferes with their ability to execute trades efficiently, by breaking up a sequence trade or dividing a block trade.

  - Only a certain percentage of trades will be directed through the commission recapture program

  - Investment managers should have the ability to trade with their preferred broker. A flexible program will allow for "step outs". This process has the investment manager give another brokerage firm credit for a portion of the order. An example of a "step-out" follows below:

    - Investment Manager ABC places a trade order with Broker XYZ. The order is to buy 1,000,000 shares of Company T. Broker XYZ places and completes the buy order of 1,000,000 shares of Company T for Investment Manager ABC.

    - Investment Manager ABC then directs that 300,000 shares are "stepped-out" to the Fund's commission recapture firm.

    - The commission recapture firm will then settle the 300,000 shares of Company T and thus will collect the commission associated with the 300,000 shares of Company T. Broker XYZ will settle the remaining 700,000 shares of Company T.

Commission Recapture – Soft Dollars, Are They Different?

- The process of directing certain commission dollars to pay for third-party research is called soft dollars. Soft dollars are commission credits that brokers give to investment managers as part of the "bundled" package, including research and trade execution.

- The SEC, "has defined soft dollar practices as arrangements under which products or services other than execution of securities transactions are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer."

- The Securities Exchange Act of 1934, Section 28(e), protects the soft dollar practice. "Safe Harbor" allows investment managers to pay more than the lowest available commission for research and other services.

- Consulting firms may also implement soft dollar programs to "rebate" trading costs back to the Fund. ***Potential conflicts of interest, however, may arise when a consulting firm is a registered broker/dealer and directly offers commission recapture to their clients:***

  - Revenues generated from a broker dealer service may represent a significant revenue source to a consulting firm
  - Investment managers may direct trades to the consulting firm's broker dealer unit to gain "preferential" status
  - A consulting firm may prefer to work with investment managers that do direct trades through the consulting firm's broker dealer

- Commission recapture, unlike soft dollars, rebates the Client directly, rather than the investment manager.

- Rebates are normally in the form of cash, which can be re-invested or used to pay for qualified Fund expenses.

Commission Recapture – What Can You Expect?

- Beacon Pointe has created a hypothetical commission recapture program with the following assumptions:
  - $100 million portfolio
  - 50% equity exposure, 50% fixed income exposure
  - 60% annual turnover
  - Commission Rate: 6 cents per share
  - Directed Rate: 40%
  - Recapture Rate: 67%
  - Average annual market return: 8%
- Exhibit 2 below presents a commission recapture analysis for the hypothetical case.

Exhibit 2

for *US DOLLAR PORTFOLIOS*

- 10-year view -

		PORTFOLIO VALUE	PORTFOLIO TURNOVER	YOUR TOTAL COMMISSIONS	YOUR COMMISSIONS on DIRECTED TRADES	YOUR COMMISSION REBATES	YOUR REBATES REINVESTED*
		$ million	$ million	$	$	$	$
Start:		50.00					
End of Year:	1	54.1	62.46	96,088	38,435	25,752	**26,703**
	2	58.6	67.64	104,063	41,625	27,889	**57,839**
	3	63.5	73.26	112,700	45,080	30,204	**93,959**
	4	68.8	79.34	122,054	48,822	32,711	**135,677**
	5	74.5	85.92	132,185	52,874	35,426	**183,672**
	6	80.7	93.05	143,156	57,262	38,366	**238,700**
	7	87.4	100.77	155,038	62,015	41,550	**301,598**
	8	94.6	109.14	167,906	67,162	44,999	**373,292**
	9	102.5	118.20	181,842	72,737	48,734	**454,809**
	10	111.0	128.01	196,935	78,774	52,779	**547,287**
				1,411,968		**378,407**	
Assumptions:		Annual Return	Annual Turnover	Commission Rate	Directed Rate	Recapture Rate	
		8.0%	60%	6 cents/share	40% at start, 40% by end	67% at start, 67% by	
					in equal annual increases	in equal annual	

** Assumes rebates are reinvested monthly and compound at market return.*

Commission Recapture – What Can You Expect?

- Exhibit 2 on the previous page identifies that the hypothetical case would result in the following characteristics:
  - Total commissions paid over 1 year: $96,088
  - Commission paid on directed trades: $38,435
  - Total rebates to the Fund: $25,752
  - If re-invested, commissions grow over 1 year to: $26,703
  - Average commission rebate per year: $25,752
  - *Assuming re-investment and an annual investment market return of 8%, the Fund should capture in excess of $547,000 over 10 years*

Commission Recapture – Summary

- Beacon Pointe believes that commission recapture can significantly reduce Client expenses and increase Client cash flow.
- Commission recapture not only helps reduce expenses, but also helps fulfill fiduciary responsibility.
- Consultants should help clients evaluate a commission recapture firm's trade execution and seek competitive commission recapture rates. Commission recapture firms should also trade large volumes in different markets and assets, as well as have established relationships with multiple investment managers, brokers, and clearing firms. Detailed reporting and record-keeping capabilities are also crucial factors to evaluate when selecting an appropriate commission recapture firm.
- Beacon Pointe recommends that a Client implement a commission recapture firm.
- It is the consultant's responsibility to recommend appropriate and flexible commission recapture programs to the Client.
- Please feel free to call your Beacon Pointe consultant should you have any questions.