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Question 13 of 75

Review Ansv

This Question: 03:30 Total: 19:32 Done Practicing

Topic Area: Portfolio Management

Incorrect

| Correct Answer | Your Answer |
|---|---|
| A | x |
| B | |
| C | |

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## Galina Fund Case Scenario

Galina Fund is an investment fund focusing on small-cap Eastern European equities. Lev Svoboda is the senior portfolio manager for the Galina Fund, which employs its own traders. Svoboda gives head trader Mislav Varga an order for an initial purchase of 2,000 shares of Szabo Technologies (ST), a thinly traded stock, at a limit price of EUR80.10.

Varga and Svoboda view the electronic order book for ST at 9:47:00, just after the day's first 5,000 shares of ST have traded at a price of EUR79.70. Varga buys 1,000 shares at a VWAP of EUR79.86. Two trades immediately follow: one for 500 shares and another of 400 shares, both at EUR79.95. The next trade occurs at 9:47:15, with Varga buying the second lot of 1,000 shares at an average price of EUR79.99. The limit order book for ST at the time of the first purchase is shown in Exhibit 1, with the four dealers in the stock coded A through D.

EXHIBIT 1
ST Stock Limit Order Book Extract

| Dealer | Time Entered | Bid | Bid Size | Dealer | Time Entered | A |
|---|---|---|---|---|---|---|
| C | 9:46:50 AM | 77.65 | 300 | D | 9:46:55 AM | 7 |
| B | 9:47:00 AM | 77.65 | 400 | C | 9:46:50 AM | 7 |
| A | 9:47:00 AM | 77.65 | 200 | A | 9:47:00 AM | 7 |
| D | 9:46:55 AM | 77.65 | 600 | B | 9:47:00 AM | 7 |
| C | 9:46:55 AM | 77.55 | 1,200 | C | 9:47:00 AM | 8 |

Reviewing the trade with Varga, Svoboda observes, "Trading expenses consist of both explicit and implicit costs. The fact that the first purchase of 1,000 shares was executed at a price higher than

prior to an execution represent implicit costs.

**Factor II** The difference between the initial ask price and the purchase price is essentially the price concession you made to fill the trade.

**Factor III** The 6 cent difference between the execution price and the initial ask price is measurable and, therefore, considered to be an explicit cost."

Varga comments, "The market has been moving up this morning, and I see that ST's CEO is scheduled to speak at a government-sponsored investment conference about the company's short-term sales outlook at 10:00 a.m. Electronic traders will likely be on the alert for any new disclosures."

**Q.** Compared with Varga's first trade, the second trade had an effective spread cost that was:

A. greater but was executed within the quoted spread.
B. less but was executed outside the quoted spread.
C. greater and was executed outside the quoted spread.

Incorrect

| Correct Answer | Your Answer |
| --- | --- |
| A | x |
| B | |
| C | |

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## Solution

**C is correct.** The effective spread cost estimate for buy orders is calculated as

Trade size × {Trade price − (Bid + Ask/2)}

or as follows:

For the first trade: 1,000 × (79.80-77.65)/2) = 1,075.

For the second trade, there are still 200 shares offered by Dealer B at 79.95. Therefore, the effective spread cost is 1,000 × (79.95-77.65)/2) = 1150.

The effective spread cost was larger for the second trade, and the execution price of 79.925 was within the quoted spread at the time the order was entered.

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B. is incorrect. The effective spread cost was greater for the second trade.

### Trading Costs and Electronic Markets Learning Outcome

**b.** Calculate and interpret effective spreads and VWAP transaction cost estimates

Incorrect

| Correct Answer | Your Answer |
| --- | --- |
| A | x |
| B | |
| C | |

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