Exploring the Myths of Transition Management

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Transition management is a discipline of the investment management world that is necessarily shrouded in secrecy. Long established in the United States and Europe, the industry is still relatively new to many clients in other regions, such as Asia and the Middle East. The combination of this level of confidentiality and transition management's relatively recent introduction to these markets naturally creates the potential for a number of myths and misconceptions to arise and be perpetuated.

Below, we address some of the more common myths associated with this specialized field.

MYTH 1: COMMISSIONS & FEES ARE THE KEY TO A LOW-COST TRANSITION

It is tempting to focus on commissions and fees when assessing the cost of a transition. First, these costs can be readily identified and measured, and second, a client is frequently able to negotiate these charges with a transition manager. However, to focus solely on commissions and fees is very misleading, as these costs typically account for less than one-fifth and sometimes as little as one-tenth of the cost of a portfolio restructure.

In practice, commission and fees are usually just the tip of the iceberg, and to fully assess the total potential cost of a transition and make a meaningful comparison between competing quotes, a more holistic view of cost must be taken. Costs can be incurred either directly (commissions, taxes, and fees) or indirectly (spread, market impact, timing). The transition manager should be able to supply a comprehensive implementation shortfall cost estimate broken out into these sources of cost. Within the estimate it should be clear what remuneration or other benefits will accrue to the transition manager (whether via a direct fee, commission, or other source). These costs should be placed in the context of the total cost of the transition and not viewed in isolation.

The T-Standard and T-Charter code of best practice adopted in the U.K. can be of use in assessing the total cost of transition and in comparing quotes. In seeking to standardize the estimation and measurement of transition cost, the T-Charter equips the client with the correct questions and knowledge to enable an informed choice when deciding on how to proceed with a transition.

MYTH 2: TRADING VOLUME IS THE KEY TO LIQUIDITY AND LOW COST

The core roles of a transition manager are the reduction of cost and control of risk during a period of significant portfolio turnover. In assessing the merits of differing execution options, it can be tempting to focus on those factors that are more easily measurable, such as access to trading volumes. While this can be an important indicator of access to liquidity, and therefore the ability to minimize market impact, volume statistics do not determine best execution or the lowest-cost result.

The trading skill of the transition manager and the risk management process that is applied should be accorded far more importance than access to trading volume alone. The ability for the transition manager to analyze and assess the characteristics of the transactions required, the sources of cost, and risk across multiple countries, sectors, and asset classes is crucial in determining the trading strategy employed.

Another important point to consider is that for many transitions, a single source of volume or liquidity is not sufficient. A good transition manager will have the ability to access liquidity from a variety of venues and counterparties in order to achieve the best price in each security being traded. The importance of this will increase as the liquidity of the security being traded decreases and become more important in markets that have less transparent pricing structures such as fixed income. Indeed, the ability to access multiple counterparties and manage exposure in this respect has become of even greater concern as clients increase their focus on counterparty exposure.

Finally, in any discussion about access to liquidity it is worth considering the role of crossing. Crossing can be an important tool in minimizing cost, but this importance can easily be overstated. If a cross is available at the point of trade, it can save valuable spread and market-impact costs. However, there is a trade-off between these potential savings and the price movement between the start of the trade and the time at which a cross is available. The price movement over this period could easily offset any potential saving in spread and impact. Therefore, while crossing is an important means of reducing transaction costs, it should not be seen as the driver of transition strategy.

MYTH 3: TRANSITION MANAGEMENT IS AN EXTENSION OF THE CUSTODY FUNCTION

Transitions can range from a simple single portfolio or asset class event, to highly complex restructures involving multiple asset classes, multiple layers of portfolios, and many asset managers and custodians. Each event is unique and may require a different mix of skill sets from the transition manager to successfully execute the restructure.

While each transition is different, the underlying principles are the same. Regardless of size or complexity, each transition has the potential to generate considerable additional cost if not managed correctly. Good project management is a prerequisite. The transition manager will be required to coordinate with all parties to the transition, including the client, the client's consultant, legacy and target asset managers, custodians, and other service providers. For this reason, it may be tempting to view the requirement for transition management as a byproduct of the custody function. Nevertheless, aside from overlooking the importance of trading skills, a client will soon realize that custody and transition management are interdependent but very different skill sets.

Clearly the role of the custodian is fundamental to a transition. A client should expect the appointed custodian to ensure that the correct manager and market subaccounts are open and all documentation is submitted, that asset movements take place as instructed, and that positions are available to the transition manager to trade on the correct dates. In addition, the custodian may perform important accounting functions for the client. The transition manager must coordinate, and where required instruct, the custodian on these matters. However, the transition manager must also take responsibility for coordinating the other parties involved in the transition. This coordination role requires much more than an understanding of custody, for the transition manager is also an asset manager, operational control point, risk manager, execution agent, and performance measurer.

To ensure an ideal combination of specialist skills, the client should preferably engage the services of a world-class transition manager instructing a world-class custodian. Both should have a clear understanding of their responsibilities and should work together to achieve the client's objective of minimizing cost and controlling risk through the transition process.

In appointing a stand-alone transition manager, a client should not have any reservations about introducing another organization into the list of participants as there should always be stringent confidentiality exercised in all transitions. The benefits of experience, trusted independent advice, and specialist transition management skills will add significant value to the transition process.

MYTH 4: A TRANSITION MANAGER IS NOT REQUIRED WHEN FUNDING A MANAGER IN CASH

As noted, all transitions are different, but the underlying principles are the same. This applies equally to funding managers from new or existing cash balances.

The main concerns for a client funding managers from cash should be performance and market exposure. A specialist transition manager takes responsibility for performance and supplies transparent pre- and post-trade reporting that clearly quantifies and attributes all sources of cost in the transactions. By contrast, an investment manager typically reports on direct costs such as commissions and taxes only, but is unlikely to be able to provide a full picture of cost (implementation shortfall). Furthermore, it is not uncommon (or entirely unreasonable) for a manager funded with cash to request a "performance holiday" where due to the costs of investment, performance will not be measured against the benchmark. The investment manager then implements the transition on a "best endeavors" basis, but this risks leaving the manager lacking an incentive or suitable measure of the transaction process.

An additional consideration is that there is frequently a time lag between taking the decision to invest cash in an asset class and appointing a manager and completing the legal and operational steps necessary to fund them. During this time, the client may have no market exposure and risk significant opportunity cost while waiting for the funding process to be completed. The transition manager can cover this gap by providing asset exposure, perhaps using derivative instruments, until such time as the transition can commence. The derivative exposure can then be unwound in favor of the new manager's target portfolio in a manner that not only minimizes any out-of-market exposure but also reduces transaction costs. These considerations still apply where (for example) a client is intending to invest cash into a unit trust or pooled fund vehicle. In this instance the transition manager can add further value by providing a thorough assessment of the investment options by comparing the spread charge applied to a cash investment to the cost of delivering an in-specie application of stock.

Finally, if multiple portfolios are being funded from cash within the same asset class, then a coordinated approach to dealing is required. The prospect of two independent asset managers competing for the same assets at the same time has the potential to unnecessarily drive up prices. A single transition manager transacting the total position in each security will be better able to manage execution and achieve best price.

MYTH 5: TRANSITION MANAGEMENT IS AN EQUITIES ONLY SERVICE

A considerable number of transition managers have evolved their service from an equity program trading desk, and by extension many clients see transition management as an equity business. To some extent the exchange-traded nature of equity trading makes the pricing and commission structure of equity markets more transparent than fixed income, given that the availability of data has historically focused attention on equity trading costs. As a result, fixed income and other asset classes are often considered as an afterthought to a larger equity transition.

However, the same core principles of minimizing cost and managing risk apply equally to fixed income, and indeed foreign exchange. It can be argued that the opaqueness of fixed income markets requires a greater degree of oversight and specialist trading skills than equities. Within bond markets the transition manager has much scope to control costs by carefully structuring market orders and sourcing pricing and liquidity from multiple counterparties. In addition, risk in fixed income transitions must be managed by duration and across investment products and credit ratings.

More recently, clients have turned to alternative assets in search of additional performance, and as a result transition managers have had to extend their skills to these areas. Today the ability to understand risk across multiple asset classes using sophisticated analytical tools and trading strategies is a necessary part of a transition manager's tool set. Additionally, the requirement to transition hedge funds more efficiently through prime broker platforms and apply an increasing range of sophisticated derivatives products are challenges that will be the industry's focus in the near future.

The myths explored in this article highlight the need for asset owners and plan sponsors to take full account of the potential costs and risks of the transition and the role a transition manager can play in managing the operational and financial requirements of the process. Although clients can be forgiven for baulking at the complexities involved, they will quickly find that by asking the right questions they will soon identify the transition management process best suited to their requirements and the considerable benefits that this can bring.

Next we discuss two recent transitions and how they benefited from the expertise of a transition manager.

CASE STUDIES

Managing Operational Complexity & Market Risk

A $1.7 billion fund undertook a reorganization to restructure its domestic equity and global equity investment managers. The restructure involved moving the fund away from an existing active manager-of-manager structure to a core/satellite approach across 14 different legacy and target investment manager portfolios.

All legacy and target holdings were within pooled unit trusts rather than segregated mandates. Our quantitative analysis of each individual trust revealed that with the exception of emerging markets, when compared to the costs of cash redemptions, it was most cost effective to undertake in-specie redemptions from the legacy unit trusts and reorganize the assets for subsequent in-specie transfer into the target unit trusts. An additional consideration in this process was that the fund had no permanent custody arrangements to facilitate the transition dealing. BlackRock worked closely with two custodians to establish a project timeline and account structure that met the demands of the transition and the client's legal requirements, which involved undertaking a two-stage domestic and international equity transition.

As part of the international transition, a large value of cash entered transition. This cash was equitized with a basket of index futures to replicate the exposures of the new managers and maintain market exposure prior to dealing commencing. Following settlement of the assets at the custodian, dealing was able to commence and the futures were unwound in tandem with trading, to maintain market exposure. In addition, there was a requirement to hedge the currency exposure of these assets. This currency hedge was also opened as part of the transition and continued to be managed for a number of months afterward while the client appointed a currency manager.

Significant project planning with the client and custodian and effective risk management resulted in a transition that effectively navigated through the client's operational issues and completed the transition within the pre-trade estimate of costs.

Managing Market Exposure and Transition Cost Through Volatile Markets

A government fund undertook an exercise to fund a number of equity managers. Prior to funding investment managers, the transition manager was engaged to adjust the asset exposure of the fund over a number of months in order to price-average entry to investment markets and minimize market impact. A series of optimized baskets of index futures were devised to manage and adjust exposure on a daily basis across all of the fund's assets and fund managers. A daily procedure and reporting process was developed with the custodian and fund.

Once the target exposure had been met and fund managers appointed, the transition manager was able to undertake a series of transitions from the synthetic portfolios to new manager portfolios. This involved simultaneously unwinding the overlay positions in favor of the new fund manager's desired physical portfolio.

As the transition involved moving from index positions to a highly concentrated mandate, a dealing strategy was devised with the aim of both minimizing market impact and mitigating the effects of differential intra-day performance between the index and individual stocks. A combination of electronic trading and single stock dealing across a number of counterparties was used to match the optimal execution strategy to each security and produce the lowest total cost outcome.

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