Some Thoughts on Transition Management

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Let's talk about transitions and your approach to them. To begin, they are not as complex as you may have been led to believe. To put this into perspective, I like to think of how managers normally trade. With large institutional orders, managers are armed with several usable facts as they approach a trade, such as percent of average daily volume (ADV) and volatility. These factors help determine a position's overall liquidity, and comprise the core of good pre-trade analytics. For example, a manager about to trade a one-million-share order in a very liquid stock with high volatility may opt do it very quickly, because the market can absorb his trade and because by moving quickly, he minimizes the risk associated with the stock's volatility. Faced with the same number of shares in an illiquid stock, the manager is forced to take a different approach because the market does not allow him to move quickly. Large orders in thinly traded stocks can take days to complete. Such decisions are the norm for institutional traders. And since most keep their cash position to a minimum by mandate, most sell, and buy, in equal dollar amounts when they trade. So, how is it, when it comes to transitions, transition managers now present their prospects with pages and pages of documentation explaining the issues they will face during your transition? These sales documents are full of graphs and charts that tell you how much you can expect the transition to cost, within a very wide band, based on Wall Street's method of calculating pre-trade costs. One would think that a firm that can produce all of this information must know what it is doing. With our markets in disarray, you already know how smart the Street is. So, in this forest of sales material, the real issue often gets lost. Just how difficult is your portfolio to trade?

Managers of institutional assets trade alike, for the most part. That is because they have found, over years of collective experience, that trading against the Street can be costly if they are not careful. Most managers measure their trading costs, which are usually much lower than the costs transition managers will tell you to expect on their portfolios.

Therefore, it is in your interest to understand what you are being sold. You will have decisions to make as you approach your transition, and some of them will impact your ultimate costs. If your transition is really not a transition, but rather a one-sided liquidation or buy-in, you should expect costs from strike to be more random than you would incur with a two-sided list. That is because your costs from strike will depend largely on the market's direction on trade date. So, if your list is one-sided, pick the right day. Good luck. But you can eliminate some of this risk by knowing the basics: How liquid is my list? How volatile are these stocks? Armed with this knowledge, you'll be able to make better decisions.

I encourage all sponsors to plan appropriately. We are in the business of safeguarding "other people's money." Plans, endowments, and foundations have goals that do not depend on what happens over the next day, week, or month. So, if you are firing one manager to hire another, get all the paperwork for both done so that you can transition from one to the other at the same time. That, all by itself, can be the best way to reduce the costs of transitioning.

I also encourage all sponsors to get more than two or three bids. That will enable you to negotiate the best commission, and to learn more about how each transition manager would approach the list. If you don't clearly, and honestly, understand the logic of the sale, eliminate that bidder. If you are not staffed to review all the volumes of data that they will supply, ask them to put a description of the transition, their commission, and their recommended approach on a cover letter not to exceed more than a page and a half in length. If you don't understand the cover letter, move on to the next proposal. You can narrow the search to the best two or three and then have a conversation with each, armed with the things you like about the other finalists. By asking the right questions you will become more knowledgeable, and you will be more comfortable with your final selection. However, when selecting bidders, you should be mindful of providing explicit details of a pending trade to a broker with the capacity to profit from this knowledge.

I have heard some reasons for picking a transition manager that make no sense. For example, a custodian should not have the inside track because they "hold" your securities and, therefore, "know them" better. The way transitions really work has nothing to do with that. The idea of using an outside transition manager requires your custodian to send a couple of emails to transmit information that they would have to compile anyway.

Some providers sell the fact that they are in a better position to "cross" your names, either internally or through proprietary crossing products. This can be a good thing, but it can also hurt your executions. One issue to be wary of is that if your transition manager is passive in his approach to crossing, while your stocks sit "awaiting" a possible cross, you could be disadvantaged from a price perspective. It makes no sense to save a 1.5-cent commission differential if a stock is moving and you could have sold it more quickly 50 cents higher.

Some other thoughts: Although all portfolios are unique—and you will be told exactly why—you may want to remember some facts about equity trading. Only 71 of nearly 11,000 U.S. stocks represent 50% of all dollars that trade each day. By the time you reach the 324th-most-liquid stock, ranked by dollars traded per day, you find that they represent 75% of all dollars traded. Therefore, there is a good chance that your portfolios hold many of these names. It goes back to the basics: Are your portfolios liquid? On most occasions, they will be. When they are less liquid, that will change the implementation strategy.

Over the last two or three years we have been asked if the T Standard is a part of our post-trade analysis. It can be. But most of the cost that this "test" picks up has nothing to do with things that you can control. Depending on how the analysis is presented, it can cover up things that maybe should have been controlled. At its core is the old concept of paper portfolio versus reality. Does it add color and more volume to your transition analysis? Yes. Does it tell you whether or not the transition manager actually did a good job? That is another issue.

Post-trade reporting should answer the following question: Did my transition manager accomplish the goals that you and he agreed to in the planning stages of the transition? Knowing clearly, up front, what those goals were arms you with the information that you need to measure the outcome. If it was decided to try to get a liquid list done quickly, for example, then you can use the opening price as a benchmark. Last night's closing prices were used in the past, but closing price, with the gap openings that we have observed for the past few months, now often distort your outcome. If the trade doesn't start at open, you can measure the cost of that and pinpoint responsibility. To determine the transition manager's success, measure from when the list was ready to trade (typically called a strike or arrival price). There are many ways to measure, and most transition managers have tools to do it. The important thing is that you understand the approach going in. If you do, the process will become simpler. The market may wreak havoc on your plans, but that should be demonstrable. If the transition manager presents a post-trade analysis that is difficult to understand, or confusing, be wary.

Transitions can be more complex operationally. But for the most part, the basics of the trading function remain the same. How liquid and how volatile are your portfolios? Armed with this information, you can make a more informed decision and better preserve your plan's asset value.