TRANSITION MANAGEMENT IN FOCUS

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TRANSITION MANAGEMENT

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THE NATURE OF THE BEAST

Transition management has become an increasingly important and relied-upon service in an environment of increased market complexity and diversification of institutional portfolios. Today's environment raises some particularly pressing concerns about how to manage the risks associated with restructuring portfolios as yields continue to hit record lows, volumes are depressed and volatility picks up, particularly in currencies.

Investors are moving into increasingly complex structures, including multi-asset funds and the wider range of securities those vehicles can invest across. At the same time, there is a greater emphasis on higher-conviction portfolios where genuine alpha is to be found. Both entail more potential costs and risks where transitions are concerned, which need to be carefully understood and managed. The panellists at the *portfolio institutional* roundtable discussed these topics at length. A summary of the discussion follows on p10.

Another theme running through not just the panel discussion, but also conversations with independent experts and asset owners, is the need for the transition management industry to evolve its offering, given asset owners are having to do the same. There are calls from the investing community for a greater degree of expertise, for example, in working with liability benchmarks and the operational complexities of transitions involving pooled funds.

Talk of a 'TM-lite' offering is more widespread than in previous years, which comes through in the conversations herein. The considerably different needs of defined contribution schemes when transitioning assets is another point where evolution is needed by transition management providers.

Perhaps most fundamentally, however, it is the nature of the beast that appears to need much closer consideration. Given the risks associated with today's economic environment and the likelihood of imminent change to both monetary policy and therefore investors' portfolios, transition management warrants greater attention as part of investors' core investment and risk management functions. Those who are better prepared for changes as they occur, stand to do the best.

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Transition management has a perception problem not entirely different from that of Geneva. While the city can appear quite boring and peripheral on the face of it, if you take a closer look at its true nature, it quickly becomes clear that the outcomes of decisions made there means it is, in fact, a critical cog in how the world functions and in determining long-term outcomes for global populations. It's home to the United Nation's European HQ, the World Health Organisation, the World Trade Organisation and the World Economic Forum to name but a few.

Transition management is also often perceived to be a peripheral and largely operational task, but the compounded impact of transitions on the long-term outcomes for generations of pensioners and other investors globally shouldn't be underestimated. Transitions involve a complex web of risks and costs, all of which need to be very carefully identified, understood and managed during a period of change in a portfolio.

Alex Lindenberg, a senior vice president at Redington, who works with pension funds to coordinate and manage changes in their investment and risk management strategies, talks of a 'chain reaction' where a slip in one cog of the machine – whether that be liquidity, crossing opportunities, minimising out-of-market exposure, lining up trade dates, avoiding doubling up exposures and ensuring all the relevant people are available to make decisions at the right time – can quickly change the outcome of the transition event. "You only need one thing to go awry and a transaction can quickly become quite detrimental to a client," he says.

THE NATURE OF THE BEAST

The true nature of transition management is in need of much greater consideration, writes *Emma Cusworth*.

And even before the mechanics of changing the portfolio can grind into action, there is a process to undertake in terms of selecting appropriate help - commercial negotiations with asset managers, transition management providers and/or execution vendors. This involves a heavy dose of analytical and legal work and can take considerable time to work through. On top of that is the time it takes for a provider (or a number of them) to produce pre-trade estimates and a rough outline of how the mechanics will actually work.

The gap between deciding to implement change and getting the actual change process underway can therefore be considerable. At the *portfolio institutional* 2015 transition management roundtable *(see p10)* Max Lamb, senior investment consultant at Towers Watson said, for example, the gap could be a month, while John Minderides, State Street's head of portfolio solutions group, EMEA, said it could take as long as six months in some cases.

AND ALL THE WHILE RISK IS BUILDING.

As Redington's Lindenberg says: "All this pre-work adds more risk that the performance of the portfolio will suffer further versus the point at which the decision to implement change is taken."

The perception problem manifests itself as a lack of focus and therefore preparation on behalf of investors because they underestimate how central implementing change efficiently is to the long-term outcomes of their portfolios. Accordingly, the pre-work is often left to the last minute rather than making it a core part of their investment function.

The time pressure resulting from this can leave investors less

able to carry out the appropriate level of due diligence required, which, according to Graham Dixon, specialist transitions adviser at Inalytics, "should be the same as for an investment manager". Treating transition management as a last-minute operation means investors may be more willing to use firms they have existing relationship with rather than the best provider for the job. However, much of the pre-work can be done before a transition event creates an urgency to do so. Larger institutional investors have already begun building panels of transition managers where all the legal agreements have already been put in place. Doing so minimises the delay associated with implementing decisions and also allows for the speedy application of overlays, for example, to mitigate the risks of a performance differential between a legacy and target portfolio.

This needn't be the preserve of large investors however and even smaller institutions should be looking to set up these arrangements with one or more transition management providers. After all, although the overall cost of a transition may be smaller where the volume of assets being transitioned is also smaller,

> "You only need one thing to go awry and a transaction can quickly become quite detrimental to a client."
>
> Alex Lindenberg

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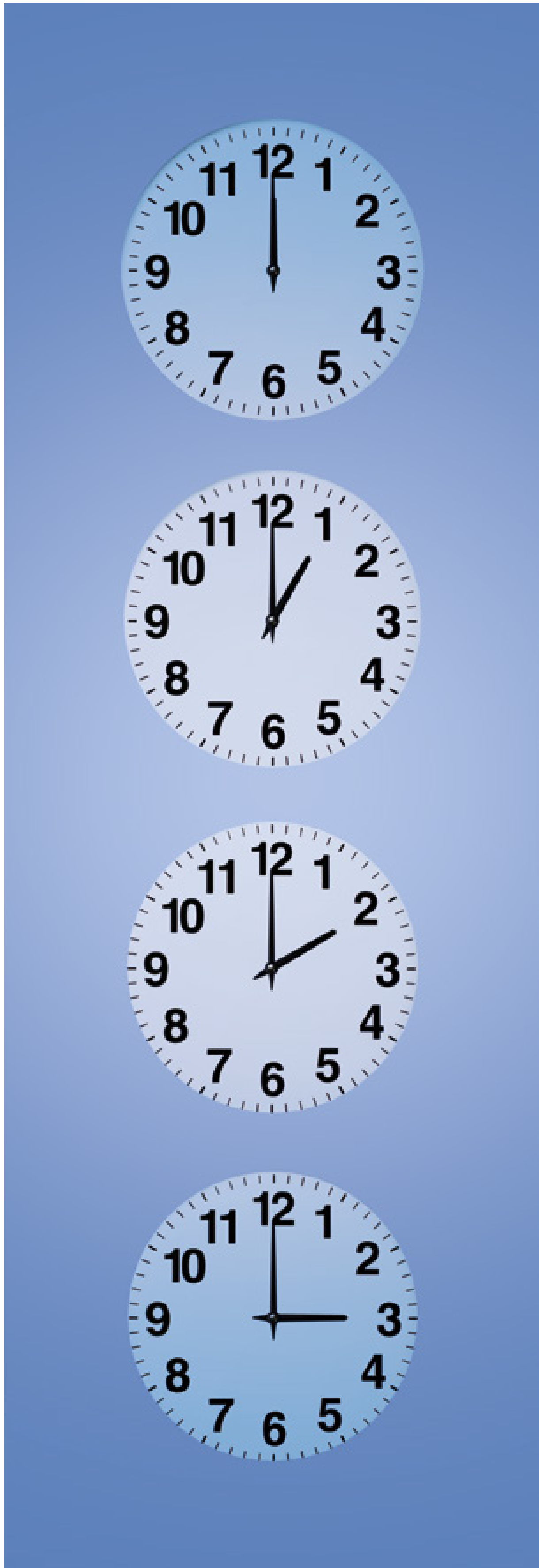

those assets may represent a much greater portion of the overall portfolio, making the impact of those costs all the greater.

In fact, there is a strong argument to suggest investors should be devising their exit plans as part of their due diligence for investing with a manager, especially where that manager is likely to have a big impact on market prices if they need to trade in volume.

As investors demand increasingly high-conviction portfolios from alpha managers, that comes with concentration risk. If a high-profile manager running a concentrated portfolio were to move firms, for example, that could precipitate significant volumes of securities being sold in a short period of time, resulting in a greater market impact and potential loss for investors. Those who are better prepared for this eventuality, with an exit plan already devised and ready to implement quickly, stand to lose the least.

In Dixon's experience the 'best in breed' transitions occur where an institution has looked at its investments and conducted a "what-if analysis", as he calls it, to determine whether a manager change, for example, would result in an immediate exit from the fund or a reappraisal of the remaining team, and has a course of action already mapped out should that event occur. But being prepared requires motivation, which is the root from which the perception problem stems – the impact of transitions on the long-term outcomes of portfolios are oft underestimated by investors.

USING YOUR BRAIN

Dixon says the difference between a good and a bad transition can wipe out the performance improvement resulting from the portfolio change for as much as three to five years. "This is why it requires the same brain power as broader investment management," he says.

Railpen Investments, the investment arm of the £21bn Railways Pension Scheme, is among the most forward thinkers in this regard. The scheme uses a mix of internal and external expertise for managing risks around transitions, but the critical difference lies in how it views these events. In his interview on p24, Rachit Sharma, senior investment manager at Railpen, explains how transition management is part of the scheme's investment governance because of the important impact the potential costs and risk-exposures can have on the long-term performance of the portfolio. Transition management, Sharma says, is "an asset management exercise" that is conducted over a short timeframe and is essentially about managing risks and execution during a period of portfolio change.

Say the words 'risk management' to most investors and they will consider that to be a core function of investment management. Transition management, however, still elicits a largely different response. In the context of today's market environment where volatility spikes are both greater and sharper, where investors have been increasing risk exposures in their search for yield and where central banks appear to be on an increasingly divergent path, change is coming for a huge number of portfolios. There is a considerable need for a change in perception surrounding transition management. Investors need to better understand the true nature of the beast and prepare accordingly.

As Benjamin Franklin famously said: "By failing to prepare, you're preparing to fail."

From
uncertainty

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TRANSITION MANAGEMENT

ROUNDTABLE DISCUSSION

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RUSSELL INVESTMENTS

MAX LAMB
HEAD OF TRANSITIONS,
TOWERS WATSON

CHRIS ADOLPH

What are the current trends in the transition management space?

John Minderides: We're in a market environment which is seeing market level highs, but actually with very little volume, so the environment for trading is less attractive than it could be for clients. It's also compounded by significant volatility in foreign exchange (FX), so most people are likely to be experiencing higher costs of execution than they would in the past.
Chris Adolph: We've seen clients moving into higher yield investments, in particular [during] the first part of this year. Emerging market debt has been particularly busy, and we've seen more in the first four months of this year than in the whole of last year.
Similarly we're seeing a lot of multi-asset transitions with clients moving out of a single or combination of asset classes into a mix of equities, bonds, total return, etc.

When it comes to the multi-asset side, does everything get compounded in terms of having different liquidities within different portfolios or different managers?

Adolph: There definitely is evidence of that, but the complexity is more the different types of instruments. For example, you've got a combination of segregated portfolios, which might be affected by liquidity squeezes, like on the fixed income side. You have pooled fund investments, so you're then managing a very different risk, in terms of just completing forms, and looking at the different timing of when those funds are priced, and when you have to get cash to them. So it becomes a combination of standard transition management on the physical side rolled in with a lot of project management on the pooled fund side, trying to look at the holistic risk of the whole portfolio and whether you've got to put an overlay in place to manage it.

What about from the client's perspective? Do they have to be more operationally involved in the process if the complexity of the deal is greater?

Adolph: It depends on the client. Some want to devolve that risk to you. If they want you to do all the paperwork, then you can have a power of attorney. Some clients don't want to give that power of attorney, so they become more involved and, therefore, the planning has to be particularly meticulous to make sure trustees are around to get everything signed in a timely fashion.

Graham, what particular trends are you seeing in the space?

Graham Dixon: There are two in particular. The first is manager change. For example, we recently had a big fixed income manager that lost their leader resulting in lots of money needing to be transitioned relatively quickly. There was also a leading UK asset manager changing firm. The question is what investors do about these events. Do they go early, do they go in the middle, do they wait for the end? So, that one I wouldn't ignore, but we have also seen a growing trend towards transitions involving boutique managers with highly committed portfolios in large size.
In these cases the transition managers have to be on their mettle because the risk of those portfolios is great. They can find themselves with positions that are going to take them some time to unwind.

That's an interesting point, especially given the context of the barbelling underway in the industry with LDI/passive on one side and a notable move towards boutique, much higher conviction strategies on the other. From transition managers' perspective, what is involved in transitioning a very high conviction strategy that investors should be fully cognisant of when they embark on one of these processes?

Minderides: One issue is the liquidity of dealing with those types of funds and how long it is going to take for an investors to join them. Another is how you actually estimate the cost of what

> “Some fixed income managers hate some transition managers. It depends whether they view you as a competitor or as a more neutral person in the market.”
> Graham Dixon

those trades are going to be, because they take a longer time, so the potential for error in your estimations goes up. But it’s just making that clear to the client, that you know the cost of this is going to be more variable than you might expect.

Adolph: We have seen the industry adopting some of the strategies used in the credit crisis on the fixed income side where there were pools of assets that you couldn’t trade, and you couldn’t find a bid for. We would build a ‘carve-out portfolio’, where you pull those assets aside, transition what you could so you could fund the manager, and you then have an on-going assignment to gradually liquidate the carve-out assets over a longer period of time.

We’re seeing that on the equities side for those high conviction managers, who might have big portfolios with only 25 names. So you have a similar sort of risk. There may be no bids out there for some of those names so there is no point trying to do the trade. In that case it may be that we take a portion of the transitioning assets aside and, if you want the new manager in there quickly, transition 90% and work the other 10% over a period of time.

Minderides: Another point to this, which is important for us to recognise on behalf of clients, is whether the manager has been transparent to the client in terms of whether they’re trading the stocks elsewhere, and whether you’re having different impacts on the market that you may not realise. There’s a lot of responsibility on those types of managers to be more transparent about what they’re doing.

Dixon: That’s probably a differentiating characteristic in transition managers now - just how closely they can work with existing and target managers. It’s probably something we wouldn’t have cared about 10 years ago.

Some fixed income managers, for example, hate some transition managers, but work perfectly professionally with others. It’s surprising

MARTIN MANNION AND GRAHAM DIXON

and depends whether they view you as a competitor or as a more neutral person in the market. And fixed income managers are the hardest to deal with.

Max Lamb: We're seeing greater use of private equity funds, and commitments which are made fairly late in the day. Which is quite challenging from the point of view of what to do with the out-of-market exposure on that - how do you equitise it? The documentation is often coming very late in the day and changing, and you don't have certainty over dates, or much visibility.

With our client base, we're also seeing an increasing number of managers in the typical portfolio. Where maybe 10 years ago you'd have five managers in the portfolio, increasingly we're having 20 or 30. What that means is the value-at-risk is much smaller in any one event. We do still get big events, but we're seeing an increasing number of small ones, where you need to lean on the transition manager, if you're using one, and you need someone who understands pooled funds, who understands spreads, who understands costs, and dealing and all of these things and is willing to be slightly flexible on timings.

Smaller transitions present clients with a potential problem as well because it can raise the question of whether a full transition management service is required and how much a particular manager would be interested in working on a smaller project. One institutional investor raised the question recently about whether a 'transition-lite' service could be developed to address these smaller events where clients could get the level of reporting their investment committee would still want to see, but not necessarily the fully-involved service.

Lamb: With the growth of DC, that is certainly going to be more of an issue going forward. The challenge is, even though it's a small transition, it's still quite important to the client, so while there may be a smaller budget to play with, it requires more attention. It is a difficult balancing act.

Roger Mattingly: We have statutory duties in terms of DC, which, as night follows day, will spill over into DB. And we have to make sure that the default funds in DC have been

MAX LAMB

"There can be very good reasons why you can't implement straightaway, but once you have made a decision around changing a strategy, changing a manager, de-risking or increasing risk, you're at risk versus your decisions. Futures, overlays or some form of interim exposure can reduce that risk and from that perspective is a very useful tool."
John Minderides

JOHN MINDERIDES

designed and are fit for purpose in terms of the members' best interests. And we also have to assess value for money, and that is causing a huge amount of intellectual challenge, in terms of what we mean by value for money, and of course transition costs, and the whole transition management side, will come under that same scrutiny.

Adolph: Transition management is very different in the DC space. In DB, if you don't transition it costs you more or you've got a covenant from the employer still to pay. But with DC you bear the cost, so it's a much more direct link.

Mattingly: I agree. And there are other logistics in terms of member communication. You can't just go ahead without considering whether you have to go into consultation, whether you actually have to get member consent etc.

Martin Mannion: There are two structural issues in DC. One is they tend to be insured pooled products, so the transition would be insured pool to insured pool, which means you have to interfere to an extent you're probably not used to. Dealing with insurance companies in that way is often tricky. And secondly, when you do the project plan for a transition in DC, you say: 'well I can't trade for a week, because I'm doing the preparatory planning, I can't trade for a week, because of the trading cycle, and I can't trade for a week because of the post trade and reconciliation'. But you can't stop running a DC scheme for three weeks so you end up doing it quicker than you should, which admits risk. And there is always a compromise because people join, they leave, they die, and you can't say: 'well sorry, we're not functioning at the moment'.

Mattingly: And you can't pool assets, so you've got lots of fragments of money, and they all need to be in the right place at the right time. I'm not suggesting DB is not as controlled, but you can have a bit more pooling along the way, as opposed to having to have everything individually allocated.

Mannion: Despite all the maintenance done over the years on DC, there's still a considerable amout of legacy products and these are not easy things to unpack when you come to it.

Mattingly: Especially when you find that the original terms actually don't exist any more.

Mannion: Another issue would be the visible cost of movement, which might seem quite low, but it will look quite high in a low yield environment. If somebody's near to retirement and loses half a percent that may be six months' return.

We are also seeing increased complexity within DC products and I sometimes think: 'don't go into something that is expensive to get out of because these things won't last forever'.

Are the transition management service providers up to speed in DC? Are you getting as good a service as you are in DB?

Mattingly: It's no different from the whole advisory community, which has understandably polarised. To be experts in both DB and DC is a challenge, so you get DC advisers and you get DB advisers. Obviously a lot of actuaries tend to still be DB rather than DC. You get the auto-enrolment experts etc. It can be frustrating

because as trustees we have to do as much as we can to know as much as we can about everything. And obviously that is a slightly fruitless quest, but we have no choice.
It's quite compelling from a trustee point of view, and a governance point of view, when you come across advisers who actually know quite a bit about both.
Hybrids are also attractive because a lot of the schemes we oversee have both DB and DC.

How much has liquidity changed and what impact is that having on transitions and how to manage risks during these processes?

Adolph: If people have been chasing yield into things like emerging market debt and then want to get out when yields change again, one of the challenges might be an environment where since '07/'08, US inventories, certainly on the broker dealer side, are down 60, 70%.
So there's far less liquidity in the market, but it has not hit a crunch point yet.
Where it'll hit at a crunch point is when people suddenly want to get out of these things and find they cannot. So it's not so much an issue now, but if we see another period where investors start trying to get out, that might be a serious issue.

What about the use of overlays as part of managing a transition? Do they help to deal with these risks?

Adolph: Overlays are a separate issue and that's a function of how you look at risk in a transition environment. It's something all of us do in the transition management world - look at the relative risk between the portfolios, and then decide if an overlay is appropriate. Sometimes it is. Sometimes it might be just to reduce the risk and therefore the volatility around that.
Other times it's helpful for managing a trading strategy. So if you're going into Asia and coming out of the US

for example, and if you don't want to leverage, if you hedge that with derivatives at the start, you can actually manage your trading strategy better. So there are different uses of derivatives within transition management, some are for risk management purposes, some are for trading purposes, but the key thing I say to clients is the cost is typically very, very low. It's a couple of basis points.
So I typically explain to clients that we can reduce certain risks, we can reduce the volatility. Their mean estimate, i.e. the cost estimate we're giving them, is going to go up by a couple of basis points as we've put an overlay on. But the range around the expected outcomes is much more narrowed. And so for a couple of basis points, why wouldn't you use an overlay?

Is the use of derivative overlays becoming more standard practice?

Adolph: It depends on the risk appetite of the individual client. Some are very concerned about it, and actually want to see what different strategies you use, others are just focused on cost. So it depends on what's driving the client.

Martin, what's your view on the use of overlays?

"We see a very clear trend to taking as much risk off the table as soon as you can possibly do it, and what I think that comes down to is regret risk."
Graham Dixon

Mannion: We've not used them actively because we haven't had the opportunity to do so. But if it's going to cost one or two basis points and reduce the volatility around the trade, then why wouldn't you? That seems eminently sensible.
Lamb: We see pre-trades and trading from a number of different transition managers. I think it's fairly safe to say that most big competent transition managers will put in place futures overlays, particularly for a one-day, two-day or one-week transition. Where this topic is probably more interesting, and there's some talk among transition managers at the moment, is about measurement. Trustees might make a decision on the first of the month, but that might not reach the transition manager until the 15th of the month. The manager needs time to prepare a pre-trade, so it's the next month before they start trading. There's more talk now about actually having your transition manager in place, signed up, ready, so at the point a decision is made you can then put an overlay in place, which takes a lot of that allocation risk off the table at the start. That gives you the luxury to trade the assets over a longer period of time, which might be useful linking back to the previous point about volumes and trading liquidities not being so high.
Minderides: What Max is referring to is event shortfall. The period between a decision being made to actually implementing it can be very, very long. We see that as uncompensated risk, and an overlay or an interim strategy can actually help a client and take that risk away immediately, as opposed to letting it run. There can be very good reasons why you can't implement straightaway, but once you have made a decision around changing a strategy, changing a manager, de-risking or increasing risk, you're at risk versus your decisions. Futures, overlays, or some form of interim exposure can reduce that risk and from that perspective is a very useful tool.
Mannion: One of the reasons why you might get a 15-day gap as Max explained is often because investors realise they need to get a transition manager. I think you're better off having providers that are already available, you've done the due diligence, you've done the legal work, so you're able to just press the button. A lot of the time people decide to do a transaction, come out of the room with the lawyers and they say: 'right, let's go and sort out the mechanics

> "You're better off having providers already available so you're able to just press the button. A lot of the time people decide to do a transaction, come out of the room with the lawyers and say: 'right, let's go.' "
> Martin Mannion

MARTIN MANNION

ROGER MATTINGLY

of how we do this', and realise that doesn't take a day.
There's a large chunk of the pre-work you can do so you have someone available so that if you want to act quickly, you can.
Minderides: Some of those gaps are six months.
Dixon: We see a very clear trend to taking as much risk off the table as soon as you can possibly do it, and what I think that comes down to is regret risk. There was a time when trustees might have said: 'well, we've lived with this risk for a huge length of time, why should we crystallise it in this moment, and take it out at this point?' You've only got to be on the wrong side of that once for it to be really painful. A lot of transitions get measured by the benchmark of perfect hindsight, so trustees could be asked why they didn't do something about it when they could have. And it's hard to argue against that point. So we see the use of hedging and putting currency overlays or market overlays in place as something you could do well in advance of a transition. We see a lot of clients doing that now.
Minderides: This is a very important point – de-risking on behalf of a client. From their own portfolio return and risk point of view the strategy should be the best way to reduce risk as much as possible.
Where that approach is causing problems, is that those strategies are not being represented as a de-risking exercise necessarily, in the context of the portfolio and the client's perspective. They're still being represented as implementation shortfall from a transition perspective and this is completely un-transparent to the clients.
Any hedging or trading that you carry out before a benchmark is set when that benchmark is then used to represent an implementation shortfall measure, is trading ahead of the benchmark. It's impacting the benchmark, and is unmeasured cost, and that trend is unfortunately out there at the moment.

Is trading ahead of the implementation shortfall benchmark growing?

Minderides: It seems to be. And all it's doing is creating representative, headline low cost, but it doesn't represent what risk and real cost the client is actually engaging in.

Is there any way to measure that cost?

Minderides: It's difficult, but any trading ahead of a benchmark, which you include in the benchmark calculation has impact. It may be small, but it

CHRIS ADOLPH AND EMMA CUSWORTH

has impact.

Adolph: It's a question of materiality, of looking at the asset class and how much that might impact your benchmark. So for example, if you're trading an illiquid portfolio and you start selling part of their stocks ahead of [the point at which the benchmark is set], you're likely to impact that particular name. If you're buying 100 S&P stocks, and there's 10,000 traded every hour, you're not going to impact it, or that impact is negligible, even to a basis point.

I don't think it's something to be afraid of, just for clients to be aware of that there is impact and whether or not that is measurable.

Minderides: I think it's more fundamental, if you trade ahead of a benchmark, [that] unless you take out that trading as being part of that measure, it is not implementation shortfall. The transition business has grown on the basis of providing a fiduciary controlled environment, which is measured by implementation shortfall. Implementation shortfall doesn't mean necessarily the close on a particular day. It could be any point. But anything that you do ahead of that point is not part of the transition, and we cannot include it as part of the calculation.

Dixon: One of the qualities of a good benchmark is that it is not influenced by anything that you're doing, so John is unequivocally right, but materiality does matter.

If we're talking about a small pot of money, that's not going to move the sterling dollar so therefore is it material? If that's the case, then I would probably let that go.

But if it is £3.4bn of futures, and you decide to do that at the previous close and then do your implementation shortfall calculation after that's gone through, that's clearly below the whistle. You've got to have as strong metrics around that change that you've made there, as you have around the transition itself.

So I think it's one where I can't argue against John, but there's a lot of transitions where I wouldn't feel sensitive about that at all. But when we get to something that is potentially material, then I think you do have to bring that into the equation.

Minderides: The materiality is a very interesting point, but the key is transparency. Whether it's going to have a

> "The materiality is a very interesting point, but the key is transparency. Whether it's going to have a large or small impact, transparency is what matters."
>
> John Minderides

large or a small impact, transparency is what matters.

Martin, as the chairman of the T-Charter Committee, do you have a view on this?

Mannion: I partly agree with Graham. It is a matter of materiality. The majority of transitions that go through aren't going to move the market, even some of the big numbers that we've done over the years, so it's something you would be aware of, and worry about if it's a very large amount or very abnormal time, or you've chosen to do something very quickly. We are aware that markets can react to relatively small volumes, but I think you've just got to have some transparency around it.

Dixon: The biggest problems with transitions that have gone wrong have not been about implementation shortfalls. They've been about fundamental misunderstandings as to what was a cost, and what was a fee, or whether something has been measured correctly.

It's right to put the spotlight on this particular area, but for the big things that have gone wrong, don't look there, look elsewhere.

I've spent a lot of time in recent years looking at where transitions have gone wrong and I can genuinely say that in the terms of the implementation shortfall and trading ahead of the benchmark point, or crossing the previous day or putting hedges on, it's in the wash.

Where something goes massively wrong with a transition it's because something has been cloaked up as one thing, when it was something else, or there's been an error that's undisclosed, or the transition manager wrote down a very careful strategy document, gave it to the client, everybody agreed to it, and then didn't do it.

All of those have created far bigger issues, and had a far bigger impact on the losses to the client.

Minderides: Except, if we're not dis-

MARTIN MANNION AND GRAHAM DIXON

ciplined in our benchmarking transparency, we'll end up with other issues that are bigger.

How can the T-Charter help on this issue?

Mattingly: The T-Charter and the T-Standard are really helpful and the methodology in there, to me, seems to provide the answer. The standardisation of the pre-trade reporting in terms of the guesstimates to the cost, and the risk side of it, in accordance with the T-Charter and the T-Standard is very voluntary at the moment. If all transitions were conducted in accordance with the T-Charter and the T-Standard as a minimum the FCA would struggle to find too much fault, as would trustees. But my understanding at the moment is there's not even a 'comply or explain' type overlay to the T-Charter. I was actually quite impressed how good it is. So I think it's a shame, and it wouldn't take much for the transition management industry to tweak the T-Charter for it to become much more standard, and for trustee boards to be much more aware of it, which I'm not entirely convinced they are.

As a trustee, is a transition manager's adherence to the T-Charter a critical factor for you when you're deciding between transition managers?

Mattingly: It will be going forward. I would be very comforted if the transition manager made a statement upfront that it will abide, as a minimum, to the requirements of the T-Charter. Everything about it is just common sense and it's so in keeping with the mood at the moment for high level audit trail governance, which is only going to get more heightened.

Mannion: To some extent, the T-Charter is like an MOT. By way of a example, I recently got an MOT on my car. I drove it off the forecourt and two miles later the front wheel arch bearing came off because they'd undone it to check the brakes. Now, I thought: 'Oh dear, is the concept of the MOT flawed?' No, it isn't. I'd rather there's the MOT around for vehicles generally, it was just bad luck. I have a piece of paper in my hand, it doesn't mean everything's perfect, but I do think it's a good idea to have it there.

Mattingly: It concentrates the mind.

Mannion: Indeed. As did the wheel coming off. I see people embed the T-Charter principles, it educates them, they ask another question, so that's the value of it. It's not a prescriptive thing, which will protect you from all risk. We've had debates about how to progress it and whether it should be more prescriptive or more comprehensive. But making it larger runs the danger of it not being model agnostic and clients want access to a thriving, healthy market.

STAYING ON TRACK

Rachit Sharma, senior investment manager at RPMI, the investment arm of the £21bn Railways Pension Scheme, explains the fund's approach to transitioning assets.

RPMI has been working on an Investment Transformation Programme over the last 18 months. Has that resulted in much transition work?
We are moving more towards direct investment rather than external managers and where we have the portfolio management capability, we are similarly doing more transitions ourselves. A lot of the changes associated with the recent transformation programme have involved strategies like hedge funds, which, given their legal structures, do not lend themselves well to traditional transition management. Others have involved pooled funds. Accordingly, our use of transition managers has been more limited. There have also been instances where an asset manager is able to provide liquidity by crossing their clients' assets, for example. We try not to impose unnecessary urgency on transition projects so in these cases we have allowed the manager to run matched trading over a longer period.

How do you normally manage transitions?
We have used transition managers where we have needed their trade execution capability and expertise in certain types of assets or where we are not as convinced of the legacy managers' trading capability, or where a particular transition has been more about timing. We have also used them where we have carried out a single, large termination event, but we try to avoid liquidating assets in large blocks and generally break them down into smaller chunks to reduce the overall impact on costs. Where a big mandate is broken down into five to seven tranches, those may no longer warrant the use of a transition manager.

"Transition management is just an asset management exercise over a shorter period of time and with a different level of discretion, but it can have an important impact on the portfolio."

Rachit Sharma

Does allowing the manager to match trading mean a cost benefit from a transition perspective?
Yes. And it has also bought us some time as we have been building out our new process incrementally.

Given that must mean a slower transition from the legacy to target exposures, have you used overlays in those circumstances to limit the potential performance differential?
Yes. We have built up some expertise in using futures where we are ready to begin liquidating some legacy assets, but have not laid down the shape of the target allocations or where research is still ongoing. In the meantime, we run overlays, some of which are executed through a transition manager but directed by us. This is inline with our general move to do more internally.

What are the main reasons behind bringing more of the scheme's investment management internally?
As a scheme, our size means we can benefit from scalability to lower costs. If we were outsourcing, we would be giving that benefit away to an external manager, which means there is a net cost saving of bringing it in-house. There is also a greater need to be flexible and dynamic in how we allocate our assets today, which means taking more control so we can be more responsive to markets and manage risks better.

Do you look at transitions as an operational issue or an investment issue?
Transition management is just an asset management exercise over a shorter period of time and with a different level of discretion, but because of the potential costs and risk-exposures during the process of changing a portfolio, it can have an important impact on the long-run performance of the portfolio.
Essentially, at its core, it is about managing risks during that period of portfolio change and managing execution well. We therefore look at it as part of our investment governance. There is an element of operational logistics, but that shouldn't take away from the fact that transitions present material investment risks and there are significant costs involved.
It's important people working with transition managers and overseeing the service they provide understand those parts of the process and know how portfolios work, how trades get done, what the economics and fees are, and where things can go wrong. We were very aware, for example, of issues like agency vs. principal trading before they came to the fore across the industry.

What is your view on the agency versus principal issue?
It needs to be absolutely clear what capacity a transition manager is operating in. There is a conflict where a transition manager is acting as a principal so we need to ensure our interests are looked after. Handing over discretion to someone also permitted to act as a principal opens up a number of issues. Unless we are absolutely clear whether a manager is acting as an agent or principal, we don't work with them. The reason for using a transition manager is to delegate. Looking at every line of every trade defeats the purpose.

Do you have a preference for the investment bank or asset management model of transition management?
We're fairly indifferent as long as the service is treated in an objective fashion within the firm's business model. There are advantages and disadvantages to both models, but as long as a client is clear about which model they are using and understand the detail behind that, then it is fine.

Do you have a panel of transition managers in place despite your plans to do more transition management work in-house?
We do have a panel in place. It is not large, but it is sufficient for our needs. We have not done too much work on reviewing the panel recently, but it has remained intact despite the departures of some firms from the industry.

Is the transition management industry functioning better as a result of recent scrutiny from the regulator?
It's hard to say, but the customer base is more aware of the issues. The FCA drawing attention to the principal issue has been a very constructive step. The regulator needs to keep doing this.

GETTING THE CULTURE RIGHT

Sally Bridgeland, senior adviser with consultant Avida International, trustee for the NEST Corporation and Lloyds Banking Group pension scheme, and former CEO of BP Pension Trustees, shares her experience of transitions.

To your mind, do transition managers generally add value to a transition process?
The main problem is that it's not easy to tell. There are always concerns about whether you're getting deals done at the best price, whether there are any hidden costs. Also, particularly in a de-risking transition where you're moving from equities to bonds or gilts, for example, the different asset classes have different liquidity and trading patterns, so it is more difficult to convince yourself someone externally is doing a good job. At BP, we tended to manage transitions ourselves, which meant all our interests were aligned and the whole team was working for the common good.
Given the recent scandals in the transition management industry, it has some way to go to regain investors' trust.

How did you go about managing those transitions at BP?
Having an in-house team we used different processes depending on the timeframe and purpose of the change. Being flexible is important when you are dealing at scale. When we moved into emerging market equity, for example, we did so in a two-step process that involved getting the market exposure by moving into an ETF temporarily while we selected a manager, ready to transition into an active emerging market equity mandate at a later date. Using an ETF is much simpler than buying a portfolio of assets as it's like buying a single share and if you're doing so for a short enough time period, it can work out cheaper. This is essentially the modern equivalent of what transition managers used to do in the 1980s and 90s when they would take on a portfolio, undertake the transition and manage the exposures passively in the meantime.

Do you think investors will increase their use of ETFs to transition assets?
I don't see why not. While they might be too costly for long-term asset allocation positions, for a transient position they can be cost-effective and also operationally efficient.
It's also always good to have an alternative to a particular service to provide competition.

You mentioned the transition management industry has some way to go to regain investors' trust...
Yes, although I get a sense that because people are more alert to the issues, they are monitoring and measuring things more closely, and know what questions to ask. That, in turn, should prompt providers to improve their service as it creates much more alignment of interests.

Do you think asset owners are taking their responsibility for ensuring good transition outcomes seriously enough?
It's difficult. On so many things the buck is passed back to the trustees, requiring them to deal with ever-more complex issues because they have to act in the best interests of beneficiaries. It feels a bit like a cop-out. Asset owners should be entitled to place some reliance on the professionalism of expert providers. It is more a question around ethical codes – like lawyers and accountants have.

Does the T-Charter fulfill that role in your view?
It is a step in the right direction and gives investors something to focus on. Like most things negotiated under consensus with the industry it may not be as hard hitting as it could be. The spirit is spot-on in terms of best execution, but things may break down if there is not the right cultural backdrop at the provider.

ENHANCE YOUR RETURNS THROUGH EFFECTIVE IMPLEMENTATION

By Chris Adolph

Head of Transition Management – EMEA

"Prior to the two bear markets of the last decade, 80% of portfolio returns came from intelligent asset allocation. Since then, that figure has reportedly fallen to 50%. The rest is attributed to implementation."
– Professor Amin Rajan[1]

EXECUTIVE SUMMARY

Without effective implementation, a great strategy can easily yield mediocre outcomes – or worse!

Managing every aspect of your implementation is one of the most reliable and easiest source of return. However, this task is getting harder because:

- investor strategies are getting more complex,
- there is greater scrutiny of costs,
- stakeholders are more sensitive to the impact of unexpected risks.

Investors need to reduce unnecessary costs and manage risks in more areas to ensure that the good work they have undertaken in setting strategy is not lost through gaps in implementation. Here we review some of the most reliable sources of where costs savings can be found.[2]

RELIABLE SOURCES OF COST SAVINGS

In our experience, the aspects of implementation which offer the most reliable and easiest sources of investment return relate to the following three areas:

- Managing changes effectively. You make many changes to your investment portfolios, for example changing managers, but in many cases there are more cost-effective options available to investors relative to the methods that they currently employ to manage changes.
- Reducing deviation from target asset allocation. You spend a lot of time setting your strategic asset allocation (SAA). However, without the proper monitoring, it can be easy to introduce unintended exposures, and thus risk, at the total-portfolio level.
- Attaining ongoing best execution. It's not always easy to have visibility into transaction costs, however, these costs exist (e.g. foreign exchange costs) and managing them helps to preserve performance.

THE BENEFITS OF USING A SPECIALIST IMPLEMENTATION MANAGER TO ACHIEVE THESE COST SAVINGS INCLUDE:

1. **Specialist advice.** Beneficial for even well-resourced in-house teams, an implementation partner can provide guidance based on its practical experience.
2. **Efficient execution.** A pure agency execution provider has a business model which more closely aligns with investors compared to a traditional investment banking model.
3. **More nimble implementation of investment decisions.** An implementation partner is able to act as a natural extension of your in-house team,
4. **The ability to implement more ambitious strategies.** An implementation partner can help you extend your implementation capabilities so that you can pursue your desired strategies.

In short, an implementation partner can help you strengthen your current governance structure and help you extend your implementation reach.

SUMMARY

Today, implementation has a greater impact on the total return of your fund than it had in the past. The good news however, is that one of the easiest and most reliable sources of return is to apply greater focus to implementation. With finite resources, working with a specialist implementation partner can help you extend your implementation capabilities. This will enable you to manage costs and risks in more areas, implement decisions more swiftly and adopt more ambitious investment strategies.

1 'The Alpha behind Alpha: Rebooting the pension business model", 2014, by CREATE-Research

2 'Further reading see article with the same title – Russell Investments 2015.

EVOLUTION, NOT REVOLUTION

Alex Lindenberg, senior vice president at Redington, outlines when it is necessary to use a transition manager as part of the de-risking journey, as well as how the industry needs to develop.

What is Redington's approach to whether or not to use a transition manager when you are transitioning clients' assets?

Transition management has traditionally centered on large, segregated equity portfolios so it makes sense for pension funds, for example, with a traditional asset allocation that is largely allocated to equities.

Many of our clients have shifted towards absolute return-based strategies, often accessed via pooled vehicles, where there is limited scope for in-specie transfers from a legacy to a target portfolio. This kind of transition requires coordination, but usually less actual trading than the 'traditional' transition management so requires quite a different skill set. Transition managers can still be used, but they are adding value in a different way.

Pension funds also used to be more asset-focused, but recent years have seen a shift to LDI. The instruments used for those structures tend to trade over-the-counter, which is not suited to the transition management model that is based on earning commissions on exchange-traded securities. LDI transitions also require an expertise in liability benchmarking and updating these, which has not traditionally been a transition managers' speciality.

We think it is worth running through a cost/benefit analysis and always ask the question of whether a transition manager would add value though.

It sounds like the transition management industry needs to evolve in order to keep up with asset owners.

Yes. There is a lot of value that transition managers could add to those situations, not least in reducing the stress for clients and ensuring processes are as efficient as possible, but they would need to adopt a different charging model to that used historically.

They need to evolve their offering to meet the evolving needs of pension funds, and be able to evidence where they are adding value in these situations.

They could also add a lot of value to the de-risking process where there is a significant change required to a portfolio as a trigger is hit. That can involve considerable opportunity cost if not implemented in a timely manner and transition managers could add value by quickly stepping in to mitigate risks.

There is a role for a light-touch transition management service to ensure someone is taking overall responsibility for the process.

When you do use a transition manager, what are the main criteria for selection?

We would look for managers that have the people, process and systems in place to deliver the service they are being asked to for our clients.

Being able to evidence experience in similar types of transition, and give us assurance around the processes in place to mitigate risk would also be key.

We favour fee arrangements that are as clear and transparent as possible.

Track records have been a point of hot debate in the transition management industry for a while. How do you go about establishing the track records of the managers?

It is very difficult and involves looking at specific case studies. All transitions are very different so a more qualitative approach is needed.

VERSION OF EVENTS

By Steve Webster

Head of Portfolio Solutions Sales – EMEA

EXECUTIVE SUMMARY

When planning a transition, any unintended delays between decision and implementation can impact returns. A new way of measuring these “opportunity costs” can help asset owners calculate — and mitigate — the full scale of the risk.

Investors decide to reallocate portfolios for a wide array of reasons. But the associated implementation costs and risks of these reallocations, if not carefully managed, can erode or even eradicate the projected benefits of the target investment allocation.

While there has been some focus on implementation costs in the investment decision-making process, the delay cost between the investment decision point and implementation is often underappreciated. This delay can result in uncompensated risk when an underperforming active manager continues to fall short in the period between the decision to change and termination.

According to a new study conducted by State Street (“Event Shortfall – The often un-measured administrative opportunity costs”), asset owners and pension funds may be running significant unmandated and unrewarded risk through unintended delay in implementing changes to asset allocation and investment decisions.

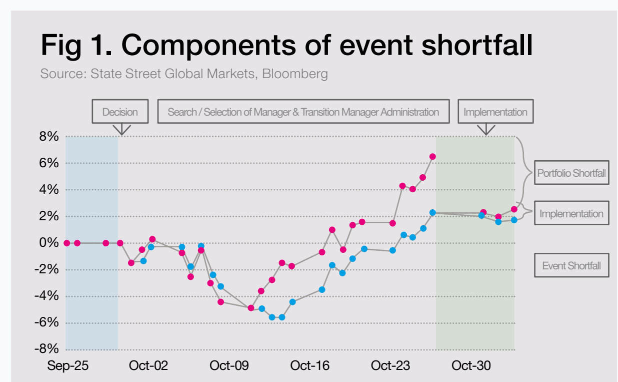
Analysing almost 6,000 transition events over nine years, we examined the delay between first enquiry and agreed implementation. The average period was 23 days, which extended to three to six months for one in six events. And this may be only a fraction of the total delay in organising the change of investments.

State Street took André Perold’s concept of Implementation Shortfall (IS) — intended to measure the cost of effecting investment decisions — and extended it to focus on the costs incurred before the “execution benchmark” (i.e., trading-period costs). Event Shortfall is a composite of IS and Portfolio Shortfall — a measure of the opportunity cost incurred between the time the investment decision is made and the execution benchmark. When these two measures are calculated separately and taken together, an asset owner can better understand the total cost of a reallocation event — i.e., the total risk — from decision to settlement and more effectively organize decision making.

Figure 1 shows an example of Event Shortfall from the decision point on the left, through the period where the existing legacy assets are no longer tracking the agreed new target allocation. It culminates in the implementation start point, where the legacy assets and target benchmark are re-aligned to measure IS.

Fig 1. Components of event shortfall

Source: State Street Global Markets, Bloomberg



Failing to measure and report Event Shortfall may lead to inaccuracies in a fund’s statement of investment risks. Actively managing these risks through effective transition and interim management can help to address this shortfall.

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