

IN TRANSITION

Topics in Transition Management

Mellon Transition Management Services

VOLUME 10 – SUMMER 2007

PAYING FOR PERFORMANCE

*Incentive Compensation &
Transition Management*



Performance-based fees for investment management have been around for some time¹ but have never been more in vogue than in this current “all-things-alternative” environment. The rationale for extending incentive compensation is, in principle, to better align the interests of the manager with the interests of the investor. In this manner, performance-based fees are intended to address the potential agency problem that arises when a manager is more interested in maximizing earnings than in maximizing investor return.² For example, with long-only strategies, performance-based fees have been designed to reduce the temptation for the manager to “benchmark hug” out of fear of underperformance (and ultimately, termination).

Viewed in this light, such incentive compensation seems inherently more equitable than an asset-based fee alone in that the performance fee does not reward mediocrity. It is a value-added compensation system where spectacular investment talent can earn spectacular rewards — presumably for both the investor and investment manager. While performance-based fees can result in substantial compensation for investment managers (hence the aphorism that hedge funds are more of a compensation scheme than an investment discipline), when properly devised, “pay-for-performance” should not inherently disadvantage one party over the other. But is that always the result, or are performance-based fees subject to the law of unintended consequences? More specifically with respect to transition management, given the typically short horizon of most asset transitions, are performance-based fees appropriate at all?

INVESTMENT BENCHMARKS AND TRADING GUARANTEES

In the investment management world, the client who elects to employ a performance-based fee arrangement may structure terms such that the manager receives a base fee for assets under management and is entitled to

¹ For more on the history of performance-based fees, refer to the Financial Analysts Journal of January/February 1987 which offers four articles on the subject. In November of 1985, the SEC relaxed prohibitions against compensating managers in this manner.

² As Rob Amott describes it: “The economics of our industry when fees are paid on the basis of assets under management favor asset acquisition rather than alpha maximization.”; Financial Analysts Journal July/August 2005; “Performance Fees: The Good, the Bad, and the (Occasionally) Ugly”; p. 12.

IN THIS ISSUE...

GUARANTEED PERFORMANCE?

IN OUR NEXT ISSUE...

DOES OPPORTUNITY RISK MATTER?

a percentage of any profit above some threshold level. This is an example of the familiar “2 & 20” quoted by many hedge funds, venture capitalists, or private equity managers who charge a 2% flat fee on assets under management and skim 20% of the upside above a certain benchmark. Performance fees are still asymmetric — the manager benefits from out-performance but is not typically obligated to reimburse the investor when he loses money. Nevertheless, when the base fee is set low enough to cover only the manager’s operating expenses, such an arrangement seems to achieve the goal of making sure that the manager has “skin in the game.”

This approach has also been utilized by trading desks where guaranteed volume-weighted-average-price (or “VWAP”) or guaranteed close deals are frequently struck between an investment manager and a broker-dealer. In the former, the dealer guarantees that the manager will receive at least the day’s VWAP for the security or portfolio that is being traded. To the extent that the dealer beats the VWAP, the manager and the dealer may elect to divvy up this out-performance. Similarly, for “beat-the-close” orders, the dealer receives a base commission for the execution of the trade and may offer to split any price improvement with the investment manager. Such arrangements had been commonplace with index “add/deletes” and index rebalance trades but are currently less prevalent due to concerns about transparency and potential for conflict of interest in achieving best execution. Nevertheless, the mystique of performance-based arrangements persists and investors, managers, and traders alike continue to consider them.

From the perspective of the broker/dealer — or even the investment manager — incentive compensation may be proposed as a competitive differentiator. Accepting performance-based fees requires clearing a certain barrier to entry in that only well-capitalized firms with an appetite for taking on the business risk of potentially volatile incentive earnings will agree to or solicit these types of arrangements. Firms anxious to “buy business” may consider performance guarantees as a toehold into a competitive industry.

Still, whether in trading or investment management, distinguishing between investment skill and luck generally requires a long time horizon. Such a condition rarely is satisfied with the typical transition management assignment. Also worth noting is the fact that generating out-performance — regardless of whether one is try to beat an investment or trading

bogey — requires taking risk. Does the client really want to incent the transition manager to take risk — isn’t transition management an exercise in **risk management?**

BENCHMARKING PROBLEMS — “SHORTFALL ILLUSION”

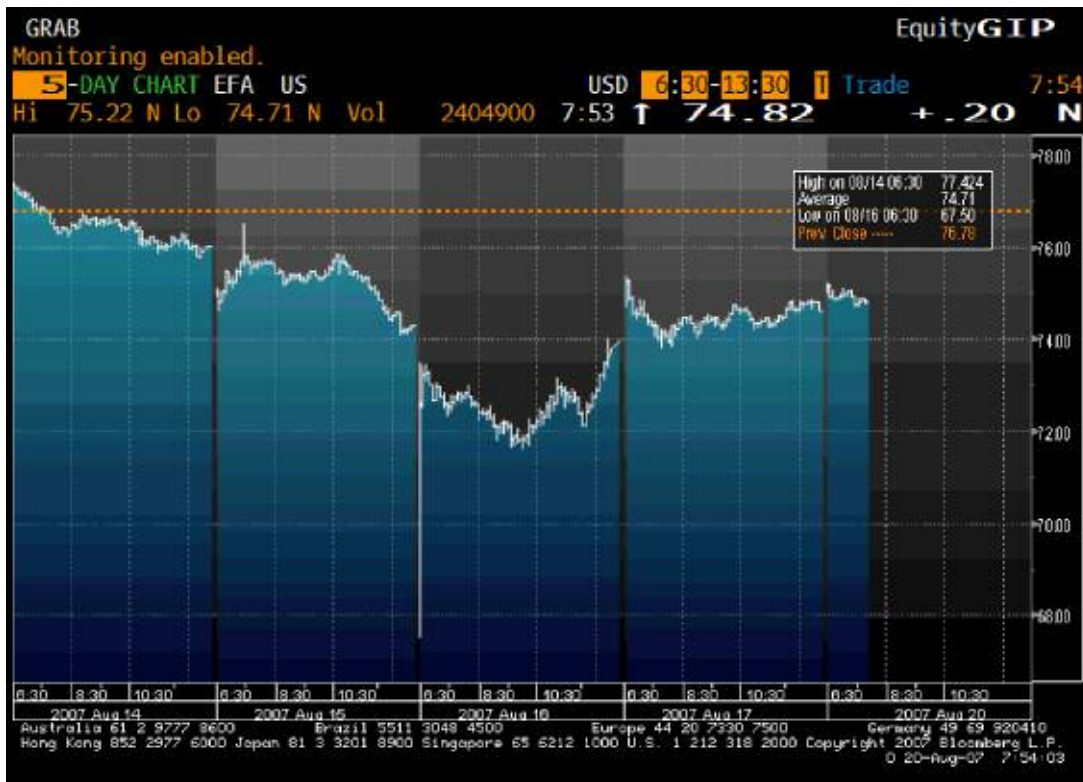
Two scenarios below illustrate the challenges of using performance-based arrangements for transition management. In both cases, the implementation shortfall³ — the accepted benchmark for most transition trades — exceeds the ex-ante forecast due to exogenous market shocks beyond the transition manager’s control. Multiple standard deviation moves are always a possibility in the capital markets, but price jumps are particularly difficult to manage in multi-asset class transitions. In both examples below, activity in the US markets translated into volatility on the Asian and European bourses and contaminated implementation shortfall results.

August 2007 proved to be a particularly treacherous month for transitions. The sub-prime mortgage meltdown created outsized volatility across the capital markets. Rattled bond and equity investors drove prices sharply lower one day only to be trampled by frenetic buying the next. The last hour of US trading was particularly nerve-wracking as frantic investors wondered whether the markets would close down 2% or up 2% in the final sixty minutes of each session.

This volatility appeared to wreak havoc with the performance of a transition conducted in the middle of that month when an investor terminated an active international equity manager and parked the money in the iShares MSCI EAFE Index Fund (EFA). As the US market sold off sharply during the afternoon before the transition, the EFA traded lower in sympathy (see the graph on top left of the following page). On the following day, as expected, the global equity markets opened lower as a reflection of the late-day selling in the US. The legacy portfolio (active international equity) opened down nearly 2% vs. the implementation shortfall benchmark prices of the prior night’s close.

Typically, one would expect the target portfolio to react similarly so that while sales of the active portfolio were being made at lower levels, the investor would be at least partially compensated by purchases at more attractive levels than the benchmark. But in this instance, because the EFA shares had already been marked down in the US, they opened relatively

³ For more on “implementation shortfall,” please refer to *In Transition* Volume II, Summer 2005; “Before & After — Did Your Transition Have a Happy Ending?” Available at <http://www.mellon.com/transitionmanagementservices/newsletters/intransitionSummer05.pdf>



Source: Bloomberg, L.P. 2007

flat compared to the active portfolio. This made the transition performance look significantly worse than anticipated, but this effect was more an illusion of misplaced benchmarks than true economic effect.

This can be seen more clearly in Figure 1. In this case, the catalyst was the same — US market activity the afternoon before a transition influenced the trend of markets on the following day. While the direction of the markets in this event was different, the outcome was the same as the implementation shortfall significantly exceeded expectations. Here, a statement from the US Federal Open Market Committee sparked a late day rally on the day before the transition. As the client was moving from an all US benchmark to one equally weighted between US and international equity, minimizing implementation shortfall faced the same challenge as in the first example. The US market closed on its highs on T-1 with the rest of the world catching up on T. In this case, the legacy was flat with respect to the target on transition trade date which created a benchmark mismatch and transition performance, in implementation shortfall terms, that, on the surface, looked appalling (see Figure 1).

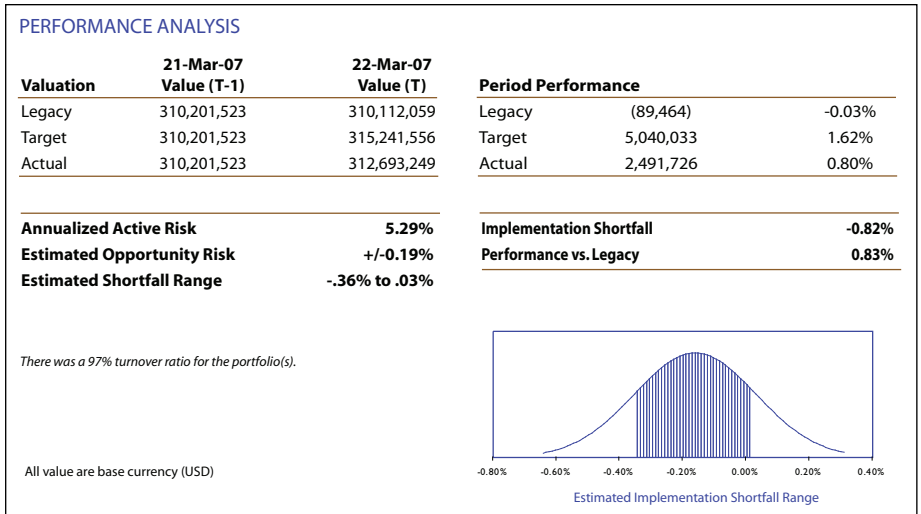
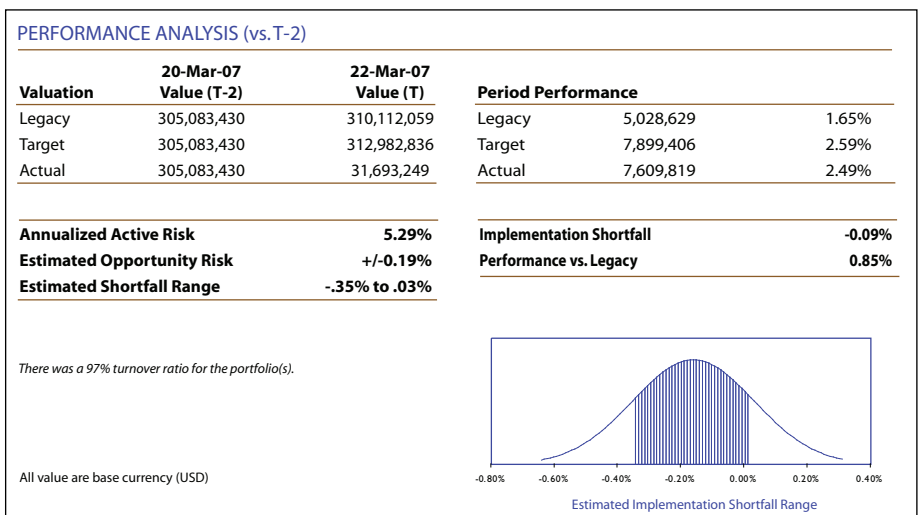


Figure 1; Source: MTMS 2007



Past results are not necessarily indicative of future results and are no guarantee that losses will not occur in the future.

Figure 2; Source: MTMS 2007

Again, this shortfall was an illusion rather than an economic reality which became apparent when the benchmark was moved back an extra day to smooth the exogenous effect of the US gap move (as shown in Figure 2). Here, the true economic impact of the transition becomes apparent. The portfolio did indeed benefit from the robust US market; it's just that those gains were already reflected in the legacy portfolio on the T-1 move.

UNINTENDED CONSEQUENCES

As both of these examples highlight, transitions implemented over short horizons are inexorably subject to the whims of the market environment in which they are conducted. For this reason, performance-based fees contingent on reducing implementation shortfall as benchmarked to T-1 closing prices are generally inappropriate for transition management. At the very least, such arrangements may place onerous monitoring burdens on clients trying to keep score of the performance of the transition. At worst, such a fee structure may devolve into a contentious debate about what constitutes an equitable benchmark in a volatile market climate.

If a transition manager's compensation is linked to managing shortfall, in circumstances like the above when market conditions stack the deck against him, the transition manager is incented to "swing for the fences" in a desperate effort to beat an occasionally arbitrary benchmark. The transition manager may be tempted to time trades or leverage the account in order to satisfy the terms of the performance-based agreement. Encouraging such an outcome clearly runs counter to the intentions of the typical client who tends to view a transition in terms of managing risk not in terms of generating alpha.

To address the issue about how best to align the interests of the client with the interests of the transition manager, it makes sense to utilize only those transition managers who will serve as a fiduciary. When managing transitions, whenever possible, MTMS seeks to act in a fiduciary capacity. As a fiduciary, MTMS is obligated to act in the best interests of the client and consequently has its interests aligned explicitly with those of the client. It is our belief that performance-based arrangements tend to be counter-productive by incenting managers to "game" benchmarks and undermine genuine cost transparency.

MTMS offers global transition management services designed to assist clients rebalance asset allocations, enter new investment strategies, or liquidate existing portfolios. Mellon has provided transition services to clients since 1983. Headquartered in San Francisco and with a global presence, MTMS offers a proven process designed to mitigate operational risks, lower transaction costs and reduce the administrative burden for client sponsors.

Please feel free to contact us should you have any questions or desire additional information.

Jamie Cashman, CFA
(215) 553-4436
jamiem@mcm.com

David Hanlon
(617) 382-1048
davidjh@mcm.com

John Egar
(416) 643-5137
johneg@mcm.com

Pat Hughes, CFA
(415) 975-2331
patrickh@mcm.com