

AVOIDING THE RAW RISK OF EXPENSIVE DELAYS

A transition manager must be able to coordinate all of the multi-faceted aspects of what is a highly complex undertaking. The sheer number of parties involved in portfolio transitions makes a project management approach imperative, say **Mark Keleher, Julie Dickson and Jamie Cashman**



Transition management should address much more than the simple execution of a portfolio list. In today's marketplace, technology and quantitative risk methodologies are imperative. They are also ubiquitous. Order management systems and portfolio optimisers are not differentiators; they are prerequisites for transition managers.

Transition management clients are not looking for an index fund, or a trading desk, or even a custody expert when they transition assets: they are looking for, and need, all three. A transition manager must focus on managing all of the multi-faceted dimensions of an often-complex undertaking. The sheer number of parties involved in a transition guarantees that even the simplest of transitions will require planning and communication to execute the transition in an efficient manner.

Transitions involve the beneficial owner of the assets (the client); at least one custodian (but often more, especially when sub-custodians become involved); any number of investment managers (some of whom may have multi-asset class mandates); the client's consultant and, of course, the settlement and regulatory bodies in every country where assets will be traded.

If a transition manager does not or cannot handle and coordinate all of the operational, custody, portfolio management, trading, and trade settlement issues, the client faces undue risk and often unnecessary expense.

PLOTTING THE CRITICAL PATH

Each transition begins with the decision to reallocate assets among investment managers. Every transition ends with the new assets being safely delivered to the new managers, but it is important to remember that a tremendous amount happens in between.

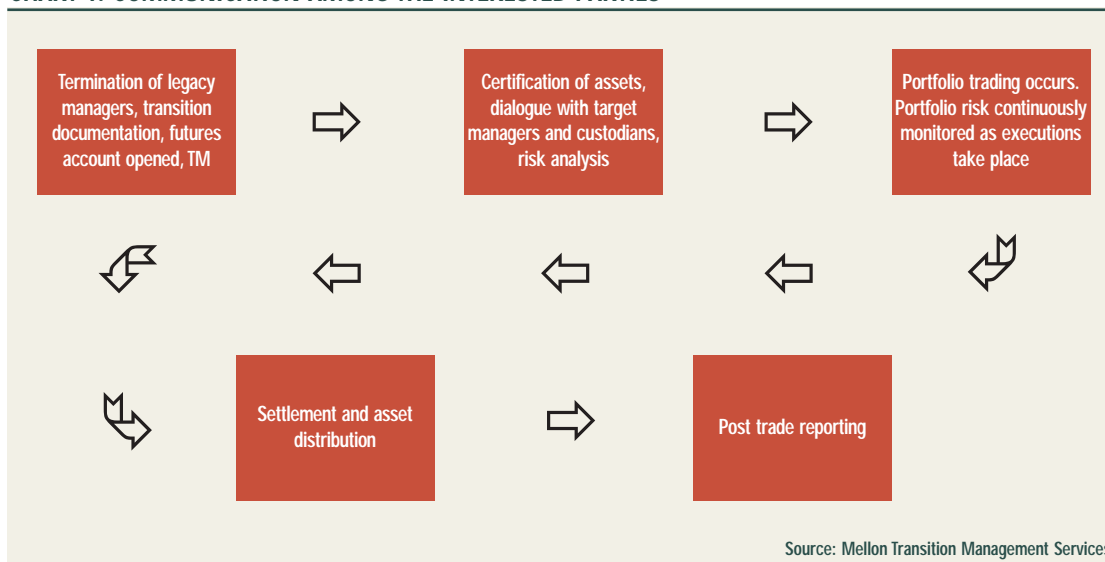
Transitions typically need to be completed by a certain date and some, due to the nature of the manager termination, need to start as quickly as possible. Any confusion stemming from a "mis-step" can cause the transition to be delayed by days or even weeks. These delays can be quite costly – if the legacy and target portfolios have a tracking error of 8 per cent relative to one another, the expected tracking error between the two portfolios is slightly more than 50 basis points per day. That is 50 basis points of raw risk on a daily basis – without any increase in expected return to offset that risk. The potential costs associated with a delay require a transition manager to carefully map out all of the issues to address and items to complete before the trading can even begin.

Chart 1 shows a common timeline with the different tasks needed to complete a transition. By necessity, some of these items form a critical path. Items on the critical path include terminating the legacy managers early enough so that an orderly certification process can be executed by the custodian, completing all the necessary legal agree-

“THE COSTS ASSOCIATED WITH A DELAY REQUIRE A TRANSITION MANAGER TO MAP THE ISSUES TO ADDRESS AND ITEMS TO COMPLETE BEFORE THE TRADING CAN EVEN BEGIN”

sponsored report transition management

CHART 1: COMMUNICATION AMONG THE INTERESTED PARTIES



ments (including transition management contracts, futures documentation, and target manager contracts), and setting up the necessary custody accounts.

COMMUNICATION ISSUES

Once the critical path has been determined, it is imperative that every interested party has the information necessary to successfully complete their role in a transition.

A custodian needs to have country-specific information to open up accounts and to prepare for receipt of different currencies into various sweep accounts. Target managers need to know when and in what format to deliver their wish lists. The client needs to know how and when to instruct their legacy managers to cease trading and, in the case of partial terminations, when to deliver out the legacy assets to the transition account.

Confirmation of how trade executions are going to be delivered to the custodian is also important to establish before trading begins as trade notification can range from faxed trade tickets to uploading executions electronically into a custody system.

Furthermore, communication about specific timing issues is critical. In a transition where some managers may be cashing out the client, or running their own buy or sell programs, understanding the timing of the transaction is compulsory in order to avoid introducing unintended asset allocation changes (albeit temporary ones), or leaving the portfolio in cash instead of exposed to the proper market.

For example, if a legacy manager is going to cash out a client from a commingled or pooled fund – and it uses the market close as a benchmark – and the transition manager does not coordinate the purchase of like valued assets at the same time, the plan's asset allocation stance will change. Depending on the subsequent fluctuations of the markets, this could be a disaster.

MANAGING AND TRADING ASSETS

After all the pre-trade planning has been completed and the transition manager has obtained certified buy and sell lists, the investment management and trading portion of the transition begins. The transition manager's portfolio management team will analyse the lists for the liquidity and risk characteristics of the legacy and target portfolios, incorpo-

rate any timing issues related to cash redemptions or fundings, scrub the lists for corporate actions and then hedge out any macro-asset allocation issues using futures and forwards.

Once the lists are ready to trade, a great deal of care must be taken not only to avoid market impact, but also to avoid any unintended increases in the residual risks between portfolios. For example, if the legacy list has a large allocation of liquid technology stocks, and the target list has a large allocation of illiquid technology stocks, the temptation exists to quickly sell off the liquid stocks and slowly buy the illiquid technology stocks. This would result in a reduced equity exposure overall and the possible loss of exposure to the technology sector in particular.

Once again, this has the unintended affect of increasing risk without any increase in expected return. A good transition manager will optimise the balance between market impact and residual risk, and trade the buy and sell lists in tandem.

SETTLING THE TRADE

Once trading is completed, trades need to be settled. This is often overlooked but constitutes a critical component of the transition. Not only do many countries have automatic buy-in policies for failed trades, but in addition, overdraft charges can be substantial. Without a carefully considered and coordinated approach to settlement, buys in Hong Kong (a T+2 settlement standard) could fail because dollars were not available from sales in the US (a T+3 settlement standard). The automatic buy in/close out in Hong Kong would then result in a total loss of exposure to the Hong Kong market. It is likely that in this case there could be currency fails, penalties, as well as additional overdraft charges.

Even after the trades are settled, the transition manager still needs to distribute the assets to the target manager as quickly and efficiently as possible. Only then has the majority of the transition been completed. At this point, only performance measurement and reporting remain.

PERFORMANCE MEASUREMENT

Measuring the overall success of a transition can be difficult, and the measurement should be simple to understand

and all costs transparent to the client. It should also be comparable to any transition portfolio analysis conducted before trading began. No single number simultaneously captures the complexity and cost of a transition. The most popular methods for measuring the cost of a transition are based on work done by Andre Perold, Professor of Finance and Banking at the Harvard Business School. Mr Perold suggests that the transition be measured against the hypothetical target portfolio's performance over the transition. Most transition managers value the actual portfolio and the target list using the previous evening's closing prices on trade date.

Both the target and actual portfolios are revalued at the end of the trading period. Any return differential is termed "implementation shortfall". This method accurately captures the taxes, commissions, market impact and slippage of the transition from the close of T-1 to the closing prices on the last day of trading.

It may or may not, however, accurately capture the skill of a transition manager. For example, if a transition manager starts off with a portfolio that is overweight a country or sector relative to the target portfolio, and that country or sector rallies strongly, the resulting outperformance has more to do with the exogenous market movement than any skill on the part of the transition manager.

Because of this, it is best to look at the transitions from as many angles as possible. Were the operational details handled correctly? How do the target managers feel about the transition? Was the custodian satisfied? Did the consultant feel the transition went well? Once these questions are answered, then the overall success of a transition can ultimately be determined.

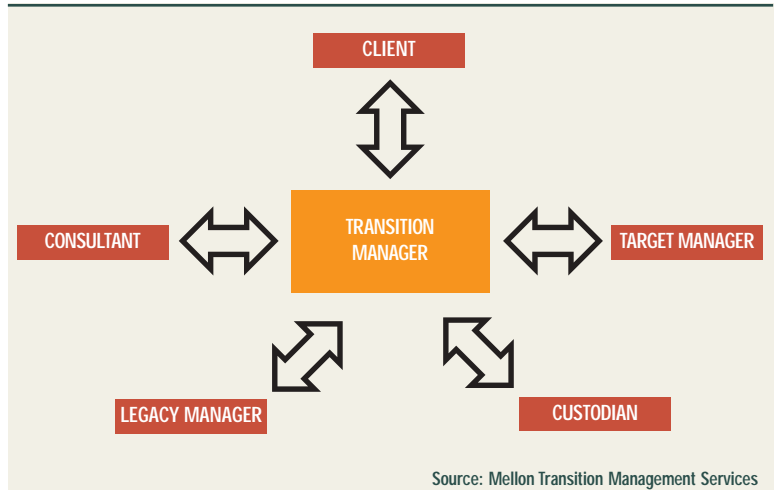
CO-ORDINATED APPROACH

Transition managers should focus on reducing operational risk, minimising trading costs and delivering world-class service. Consequently, Mellon's transition management services take a project management approach to transitioning assets.

Each client has an assigned transition manager who is responsible for the overall transition. The transition manager works with an investment coordinator, a portfolio manager, trader, and trade operations specialist. This team will coordinate all of the contractual details, work with the custodian and target managers, perform in-depth analysis on the portfolio, develop a unique timeline for the transition and then execute that plan.

The plan encompasses the entire restructuring of the portfolio including the liquidation of legacy assets and the construction of the exact target portfolios requested by the newly hired investment managers.

CHART 2: MANAGING AND TRADING ASSETS



Clients should look for transition managers that use state-of-the-art transaction cost models and trading systems that allow for the real-time monitoring of not only absolute risk, but also relative risk.

Every transition is managed separately, and no queuing issues can impact the execution of a trade. Every portfolio is traded as a discrete event with the standard benchmark being the target portfolio. Technology is the key to enabling the highly rated operation of transition management services.

Since inception, Mellon's transition management team has aimed to capitalise on the opportunity to build its transition management technology infrastructure from the ground up, by leveraging the latest in best of breed software and by employing state-of-the-art implementation methodology. The company has abided by an implementation strategy that integrates systems following a hub-and-spoke model, and has avoided point-to-point interfaces: a potentially costly pitfall.

Specialised software components tied to a central data hub, have enabled a tightly integrated and risk controlled electronic workflow. Technology encompasses the entire transition management process from account set up to portfolio management, trading, settlement, and reporting, positioning Mellon to achieve straight-through processing.

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