

Passing the buck

The transfer of complex portfolios between fund managers is no easy task, and is fraught with potential risks and costs. Thanks to a new breed of transition managers, however, the headaches of a transfer can be passed on to someone else

There comes a time, sooner or later, when it pays to fire a fund manager. For a financial institution (FI), protecting its assets under management, this event can be a dramatic one. Perhaps the fund manager has seriously underperformed, or perhaps he has breached contract in some way. On other occasions the need to terminate is driven less by fault on the manager's part, and more by a desire on the part of the client FI to revise its asset allocation strategies. Whatever the cause, if large volumes of assets need to be moved from one money manager to another, serious questions need to be asked about the costs and risks inherent in the transfer. The good news is that there is a small but growing band of professionals dedicated to answering these very questions; people now known as transition managers.

If you've never heard of transition managers, that could be

only about three Middle Eastern FIs are really making use of TMS. As awareness and regional wealth grow, however, he is confident that that these numbers will also grow significantly. In fact, he estimates that 30 to 40 Middle Eastern FIs could already benefit from TMS, if only they knew more about it.

San Francisco-based Mark Keleher is the President of Mellon Transition Management Services, and was in the Gulf this spring to explain his purpose and methods to prospective clients. "A transition manager is someone who steps in as a temporary investment manager, taking over the assets when a client has

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because you'll never need them. For the transfer of portfolios below \$100 million, it may be unnecessary to engage a professional transition manager as the value they can deliver will be correspondingly small. However, for institutions with large assets under management, such as pension funds and some banks, the use of transition management services (TMS) could mean the difference between millions of dollars saved or lost.

As Nigel Sillitoe, Director of Business Development MEA for Mellon Global Investments explains, his firm started offering TMS back in 1983, but it wasn't until 2001 that there was a critical mass of demand sufficient for the formation of a specific unit. "This service is fairly specialized, and won't appeal to every bank, pension fund and institution," he affirms. "You need quite a lot of money under management to consider transition management as a need."

The need for speed

Mellon first set up locally in Bahrain around two and a half years ago, initially as it won a mandate to manage assets for Ahli United Bank. Now it manages \$5.2 billion of assets from the Middle East, and as of January this year Mellon began to actively market its TMS capabilities to institutions in the region. Although some \$2 trillion of assets were transitioned globally last year, Sillitoe estimates that

terminated a legacy fund manager or managers," he explains. "As such, we step in to coordinate with the custodian and the client's target managers, to restructure the portfolio into exactly what the target managers want."

Of course while that may sound straightforward enough, any transition that does not involve a direct transfer of assets from manager A to manager B is unlikely to be so simple. Add in changes to the number of managers handling the assets and the type of assets held, and suddenly a new trading strategy is required. To minimize risk during the transition, it is also likely that the transition manager will need to hedge prices using futures, hedge currency exposures, and change the asset allocation profile built up by the legacy manager.

"The goal of a transition manager is to restructure the portfolio, limiting risk, reducing cost, and transferring in kind as much as possible to the new portfolio," Keleher



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Why TMS?

To see where TMS becomes necessary, one can take a theoretical example of a pension fund that decides to fire a manager who is managing equity assets on the pension fund's behalf. If the pension fund decides to sell the equities for cash, with a view to subsequent reinvestment elsewhere, it faces a number of potential costs. These costs include commissions, bid/offer spreads on equity prices, market impact, taxes in different countries if a non-domestic portfolio, and if cashing into one currency, the bid/offer spread on all the currencies the equities are held in. Even if these costs are acceptable, the transition process itself could mean the pension fund's assets are off the market for several days, meaning that the fund is totally exposed to changes in the market while it misses out on trading.

Once a financial institution (FI) has recognized a need for TMS, their first step is to request pre-trade cost estimates from various TMS suppliers. These estimates will include a range of potential outcomes generated by statistical modelling, and along with the institution's assessments of the quality of the TMS providers' project management skills, will form the basis of the TMS selection process.

At this stage, however, the FI should be aware that TMS providers can calculate their performance in different ways. Though the 'implementation shortfall' is the most common means of calculating TMS costs and returns, firms calculate the shortfall in different ways, for example using different definitions of when a transition begins and ends. Explaining implementation shortfall, Keleher says: "The idea is that by theoretically measuring the target portfolio before we begin trading, and then re-measuring at the end of trading, we can calculate that our shortfall between the original portfolio and the target portfolio might be 35 basis points (bps), for example. This will take into account all the trading costs, commissions, stamp duties and so on."

Bowing to demand from major Western pension funds, Russell Investment Group took the lead last year and produced a set of standardized TMS calculations, known as the T-Standard. While several funds and TMS providers have lauded Russell's efforts, however,



Mark Keleher, President of Mellon Transition Management Services



Bahrain-based Nigel Sillitoe, MGI's Business Development Director for the Middle East

debate over the finer details of the T-Standards methodology still continues.

Calculations on the ability of TMS to save costs vary from around 30 bps to 100 bps as a rough guide. Needless to say, cost savings vary dramatically depending on asset sizes, the number of legacy and target managers involved, volatility, and the amount of assets that can be transitioned in kind. Julie Dickson, Director of TMS at Mellon Global Investments, describes 'in kind' transfers as the "matching of everything from the legacy portfolio to the wish list of the target manager". "Portfolio matches can be transferred in kind," she explains, "and then the transition manager evaluates the selling and buying needs of the rest of the portfolio. So, the transfer of an S&P 500 equity portfolio to another manager investing in S&P 500 stocks might mean the whole portfolio can be transferred in kind. Conversely, if the target manager wants to invest in emerging market debt, very little will be transferable in kind."

Once the transition manager has been settled on, a new trading strategy will be devised, that may or may not include the use of futures and hedging. Guidelines are agreed with the client FI, to ensure that anything the client expressly wants excluded from the trading strategy can be identified – for example, a ban on holding tobacco stocks or using derivatives. From here, the transition itself can take anything from a day to a month, depending again on portfolio complexity and the number of fund managers involved. Typically a transition takes one to two weeks, according to Keleher, but that can be reduced to a day for a very liquid portfolio, such as UK equities, or extended to a month for an illiquid fixed income portfolio.

Definitions of responsibility

A transition manager will not make target manager recommendations to the client, as that will be the role of an investment consultant, such as Mercer, Watson Wyatt, or Fortunis. Given that the transition manager will work with the legacy manager(s), and any custodians and target manager(s) specified by the client, most will argue that there are no risks of conflicts of interest involved, even if one of the fund managers is part of the transition manager's organization. Where difficulties can arise, however, is in the methods of paying the TMS provider. While some charge transparent commissions, others take a cut of the income generated by trading the client's assets. In the case of Mellon, Keleher says that his costs can be structured to meet client preferences – whether they choose fees or a portion of transaction commissions.

Operational risks and costs are the major focus area for a transition manager once portfolio risks have been assessed, says Dickson. The transition manager can do a great job in terms of trading, and managing currency and market risk, but problems in the operational stages of the transfer will nonetheless result in a displeased client. Such operational risks include the settlement of bonds, for example. Failure to settle a Japanese government bond in due time results in fines of 100% per day outstanding. Registration issues are also important, as in some countries like India the transition manager must register himself as the new investment manager while the assets are under his control. In the

UK, even if assets are transferred in kind, the transfer could nonetheless trigger liability to pay stamp duty.

Then there are opportunity costs, which essentially mean the investment gains that could have been made if the assets weren't in transition. According to research conducted by the Plexus Group, while commissions and bid/offer spreads take up 21% of average block trade costs, market impact, missed trade and opportunity costs account for a massive 79% in aggregate. If a transition's market impact and opportunity costs are reduced by just 20% through trading, the result can be a saving of \$1.5 million in implementation costs on every \$1 billion transitioned.

To illustrate this point, Keleher cites an example of when a client with \$600 million in US equities wanted to change to a global balanced portfolio. The decision had been driven by a corporate restructuring that was due to take place in 30 days time, but the client had not hired any target managers. "The deal then got moved forward, and they found on Thursday that they needed their pension fund restructured by Monday morning," he recalls. "We constructed a hedge to get them out of US equities and into a portfolio that lived and breathed like a global balanced portfolio. This bought them the time to find new managers, and to avoid being stuck in the wrong asset class for 30 days."

Though still a fairly niche business, TMS is likely to receive greater acceptance as awareness and wealth build, and as restrictions on assets that may be held, particularly for state pension funds, are gradually relaxed. In the past an FI may have muddled through a transition, particularly when moving assets in kind between single managers. Even seemingly straight swaps, however, throw up questions of their own: When does the new fund manager's track record start? From the time he receives the legacy assets? From the time he's converted the assets into his new portfolio? What happens with multiple manager shifts?

Transferring large volumes of assets is a risky business for all concerned, and if an investor is taking on risk, the received wisdom is that he should have an expectation of increased return. In order to achieve that heightened return, effective cost control and risk management is crucial. At the end of the day, Keleher suggests the use of a transition manager boils down to answering a simple question: "Why make Wall Street richer?" ■