Consensus is key

Transition management is more than just shifting stocks from one manager to another, say *Julie Dickson*, director of Mellon Transition Management Services in Europe, and *Mark Keleher*, president. There are numerous issues, which everyone must agree on to save weeks of delay.

WHEN institutional investors consider restructuring their portfolios, the details that must be covered are numerous and complex. Transition management involves more than the simple selling of assets from the legacy portfolios and buying of assets for the target portfolios. It includes the planning, execution and total operational control of all aspects of the event.

While the execution of a trading strategy is a key component of cost control, operational planning and monitoring are equally critical, and without these, the client faces undue risk and often unnecessary expense.

A successful transition manager should be able to provide not only the pre-requisite order management systems and portfolio optimisers, but should also be able to provide low-cost trading avenues (such as crossing opportunities with index funds), custody expertise and a global trading platform. These are services that are frequently needed and used in the transition event. The ability to provide all of these services requires the application of skills that broadly span various disciplines of investment management. Without a fully integrated team that can address all of these aspects, the significance of trade execution itself may become meaningless.

Planning

The initial planning phase of a transition requires experienced project managers who can establish and manage realistic deadlines, and have sound knowledge of the operational issues associated with account set-up, asset transfers and the general regulatory environment applicable to markets in which investments exist.

The execution phase of a transition will require the skills of experienced portfolio managers and traders who will be tasked with formulating a transition solution that addresses the overall investment goals of the client. This involves evaluating the portfolio risks, identifying cost-effective trading strategies, and continuously monitoring the overall portfolio throughout the transition.

Finally, a properly managed transition will end with a full accounting and reconciliation of all transaction activity, holdings, and performance reporting that is clear and consistent with the stated objectives of the transition project.

Timeline

A transition begins, and ends, with a major operational review of the project. The first step of such transition planning involves working with both the legacy and target investment managers to understand their timelines and the client to create a project plan, with which everyone agrees to.

While this may appear to be an obvious task, many transition challenges arise from a lack of consensus on where, and especially when assets are expected to move from or to a legacy or target investment manager. Achieving consensus on asset management issues has an impact on when and how quickly assets can be traded, how cash will be raised or spent, and, critically, when asset allocation or currency hedges can be put in place, thus driving in large part the total costs and performance results of the transition. Any misstep can cause the transition to be delayed by days or even weeks, and force the client to trade at a time that is sub-optimal and less cost effective.

Communication is a key driver behind the successful implementation of a transition project. It is important for the transition manager to understand the timing and priority of events, and that there be a clear understanding of the overall transition goals among the client, transition manager, legacy and target investment managers, and custody groups. Legacy managers need to know when to cease trading and where to deliver the assets. Target managers need to know when and in what format to deliver their wish lists. Custodians need to know country-specific information in order to open the proper accounts and to prepare for receipt of different currencies into sweep accounts.

Assessing where the assets are located, how their transfers are impacted by local market regulations, and what infrastructure is in place to ensure proper delivery must be planned carefully. In most cases, at least one custodian is involved, but often, due to sub-custody arrangements, or the dispersion of assets across individual manager pooled funds, there are multiple custodians involved. It is therefore important to determine what assets can physically move from one account, or fund, to another, and if a liquidation needs to take place, to plan how market exposure will be maintained.

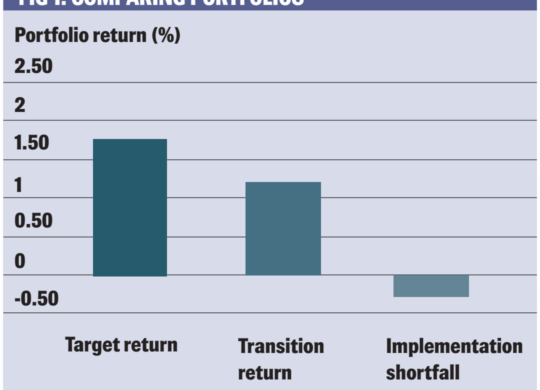
If a series of investment managers execute their own trading strategies independently of each other, this can lead to unintended asset allocation changes (albeit temporary ones), or leave the portfolio in cash instead of exposed to the proper market. For example, a common pitfall involves a cash redemption out of a legacy portfolio at a time when the proceeds are not ready to be invested in a portion of a corresponding target portfolio. Such a miscue can result in improper currency trading, lack of market exposure, or unnecessary trading (such as hedging) that can lead to significant losses.

Trading

In the execution, or trading phase of the transition, the strategy will be driven in large part by the overall investment objectives of the client. This can range from using a methodical, patient approach that seeks to minimise total transaction costs, such as market impact, or a more aggressive, expedient approach that seeks to minimise opportunity costs.

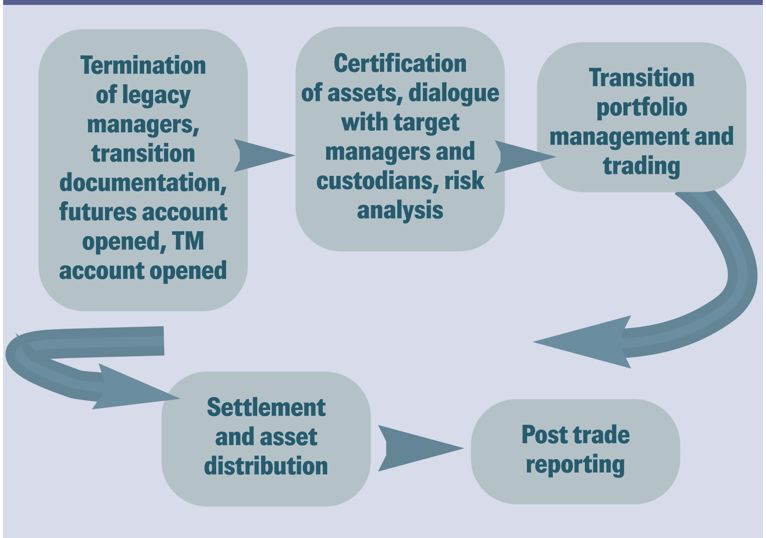
While avoidance of market impact is the goal of most transition trading strategies, care must be taken to avoid introducing unintended residual risk to the portfolio. For example, it is common for either the legacy portfolio or the target portfolio to contain a large basket of liquid stocks, that do not match the liquidity or sector profile of the other side of the trade.

FIG 1: COMPARING PORTFOLIOS



Source: Mellon

FIG 2: TRANSITION TIME LINE



Not only is it critical to maintain cash neutrality by matching sales with purchases, it is equally important to control portfolio risk by trading in sectors, markets and/or currencies that closely match between the sell and buy lists. Such issues need to be identified and addressed in a pre-trade analysis that details the time it will take to complete trading, the total estimated cost, and the estimated relative performance results of the transition. After all of the pre-trade planning has been completed and the transition manager has obtained the certified buy and sell lists, the trading occurs. As Figure 3 indicates, the transition manager should be able to estimate not only the estimated trading costs associated with a transition, but also the estimated opportunity cost (or gain).

In balancing the trade-off between opportunity costs and transaction costs, the transition manager is effectively seeking to minimise total implementation shortfall. The most popular method for measuring this cost is based on work done by Andre Perold, Professor of Finance at the Harvard Business School. Mr Perold suggests that a transition be measured against a hypothetical target portfolio's performance over the transition period. Most transition managers value the legacy and the target portfolios at the closing prices on the day before trading occurs and compare trade execution on the sales and purchases against those prices (see Fig 1).

The goal of the implementation shortfall (or gain) measurement is to attribute the difference in returns between the transition portfolio and the target portfolio. The difference is driven by the total costs, such as commissions, taxes, bid-offer spread, market impact and slippage incurred during the transition. If the target portfolio can be created instantaneously at the close on the day before actual trading begins, and at no cost, the implementation shortfall (or gain) would be null.

One limitation of only using implementation shortfall as a measurement of transition management success is that it does not reflect either the qualitative factors involved in the transition or other factors that were outside of the transition manager's control. This

FIG 3: ESTIMATED IMPLEMENTATION SHORTFALL

Source: Mellon

may be the case where the legacy portfolio outperforms the target portfolio during a time-extensive trading period. In that case, the resulting outperformance of the transition portfolio over the target portfolio may be tied more closely to the exogenous market movement than any skill on the part of the transition manager.

As a result, this means the transition manager needs to make skilful use of all available sources of liquidity and types of execution, such as matching assets, crossing, and trading on an agency and/or principal basis. The trading strategy must be consistent with the stated investment objectives of the client and flexible enough to be adjusted for market events that may arise during the trading period. Having the right technology infrastructure to handle the various trading angles and to monitor the returns of the portfolio, is a basic requirement that ensures the successful execution of the trading programme.

Pitfall

Once trading is complete, the settlement and reconciliation phase of the transition occurs. This will ensure that all assets that have been purchased are available for delivery to the new investment managers. A common pitfall is to underestimate the impact this step has on the overall cost of the transition, the ability to meet the project deadlines, and the successful conclusion of the transition event.

Failure to properly monitor the pending trades across all of the markets can lead to overdrafts, currency fails and penalties, and sometimes automatic buy-in policies. Such issues can arise from an ill-considered approach to settlement differences across markets (for example T+1 for purchases in Taiwan, or T+2 in Hong Kong). Buy-in activity will effectively eliminate the original intended exposure to a market and introduce market risk to the portfolio.

At the end of the transition, performance measurement will be key to understanding the success of the overall project. Measuring the overall success can be difficult. The performance measurement should be easy to understand and all costs should be fully transparent to the client. It should be comparable to any pre-transition analysis performed prior to the commencement of the transition trading, and incorporate all of the key elements: trading costs and opportunity costs (or gains).

Performance measurement goes back to some of the basic operational and project management issues that ultimately influence the timing and method by which the trades are executed. Because of this, it is best to look at the transition results from as many angles as possible, such as whether the operational details were handled correctly and how the target managers feel about the transition.

Meeting objectives

At the end of a transition, as in the beginning, a major operational review of the portfolios, the process and the project must occur between the transition manager and the client. The goal of this review is to ensure that the overall investment objectives have been met, that the costs experienced were consistent with the pre-transition estimates, and that the relationships between the client, the custodian, and the target managers were preserved.

A portfolio transition is not just a specialised trading programme; it involves the careful evaluation of all of the aspects of the restructuring event. While the trading activity is the most obvious part of the transition project, it cannot occur successfully without a properly planned and integrated process that covers all of the other activities that support it.

Mellon Bank assigns each client a transition manager who is responsible for the overall project, and who will pull together a transition team to address all of the steps in the transition event. The team will include an investment coordinator, a portfolio manager, a trader and an operations specialist. All investment management functions of the transition will be handled by individuals in the team with the expertise relevant in those areas. As the investment objectives of each client and the portfolios being restructured inevitably vary across each transition event, the trading solution and project plan are custom-tailored.

The team will coordinate all contractual details, perform in-depth analysis on the portfolio and develop a timeline for the client. Every transition is managed separately, so 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, and the basis upon which implementation shortfall is calculated.