

Transition Management for challenging times

An invited panel of experts including providers and users of transition management services discuss the changing shape of the industry.



Martin:
Martin Mannion,
Director,
Pensions Finance
and Risk, GSK



Hari:
Hari Achuthan,
Director of
Pensions
Strategies
and Transition
Management,
Credit Suisse



Chair:
Andrew Williams,
Senior Associate,
Mercer Sentinel
Group



Penny:
Penny Green,
CEO, Saul



Tim:
Tim Wilkinson, MD
Global Head
of Transition
Management,
Citi

Chair: If we go to the providers to start with, I'd like to ask whether you feel the requirements of clients for transition management services have changed much over the years?

Gary: I think they have, but I don't think it's clear-cut. I don't think the requirements of the clients have necessarily changed as much, as the providers have offered deeper services.

Hari: Yes. We think that there will be a bigger change in how clients are going to manage risk when it comes to transitions. And we think with increased market volatility there's going to be a higher degree of emphasis on a qualitative discussion on managing on managing risks and completing transitions on a shorter time frame while delivering best-execution. And we see clients focused on risk management more than we've ever seen in the past, and obviously for the right reasons.

Chair: As Martin and Penny are users of transition management services do you



Mark:
Mark Dwyer,
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Gary:
Gary Spreadbury,
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Across the industry what people are doing is moving assets into much more complicated structures, which does demand I think a lot more from the transition managers

think what you require from a transition manager has changed or is it still to get assets from A to B in a cost-effective way?

Martin: We want the same thing you ever wanted, clear transparent movement. It's what you're moving to has changed over time which has upped the game a bit really. You're now not moving between one global equity mandate and another, instead you have diversification, you have de-risking, so it makes the industry's job harder.

Chair: Penny?

Penny: Yes, I would agree with that. Now the transitions that we undertake are complicated in that there are a number of moving parts, but the assets that are coming and going are not complicated as such. But I think that across the industry what people are doing is moving assets into much more complicated structures, which does demand I think a lot more from the transition managers.

Mark: You've got new developments definitely coming from the clients. We have transitioned pension fund buy-outs this year which were completely new to us, and actually completely new to everyone else involved, being a new industry. In these cases we found that we were doing much more in a buy-out than we'd ever done in a traditional transition. In particular we found that as a transition manager we understood the practical implications of the buyout contract or were able to advise the client on how to achieve their objective.

Tim: Penny, when you talk about getting advice vis-à-vis whether to implement a board decision regarding a revised investment strategy, are you actually asking the transition manager to advise on when to make the asset allocation switch or are you talking about the speed or otherwise with which the transition manager moves once mandated?

Penny: I was talking purely about once we have said this is our asset allocation decision, this is our manager line-up that we desire, now we need you to help us to get from where we are to our desired position, what are the trade-offs we're going to have to make within that move?

Tim: I thought so, and I think that's where one should draw the line, otherwise transition managers would be stepping into the discretionary asset manager and the investment consultant space as opposed to being in charge of the getting the Client from A to B.

Chair: Tim, are you seeing more demand from clients for interim transition management?

Tim: We are, and in increasing numbers. Several years ago clients started coming to us with the conundrum of having decided to terminate the incumbent manager, but not having yet decided who to appoint. We would recommend and then transition them to an interim index solution, typically an optimised index to minimise turnover and costs. Because these structures were seen to work so well for certain client, one or two of them kept these

interim solutions as an enduring part of their future investment strategy. Again however, I think important for the transition management industry to steer away from getting involved in taking discretion investment decisions.

Chair: Are other providers comfortable taking on these interim mandates that can last indefinitely?

Hari: A big difference we're seeing now than what we've seen in the past is increased risk management discussions and transparency around trading strategies. The role of a transition manager, whether it's the Pension Act here or the ERISA rules in the United States, are pretty clear, we do not make any decision on positions in the target portfolio or legacy portfolio. And all we're being hired for is to effectively move the portfolios once you have made the determination. So now the question is 'Are we going to do it quickly or are we going to do it slowly?' What are the consequences of doing it quickly versus slowly? And what is the cost benefit analysis of impact cost versus opportunity cost of waiting too long to execution a volatile market?

Tim: One thing, Hari, which I picked up on there, I think what's always been different has been the mind set of the asset owner versus the asset manager, and I think that there are definitely some asset managers out there who take a great deal of care in how they manage the restructure. But there are also asset managers out there, who we've all come across who focus on performance only from the point they're accountable and being measured; who don't worry too much



I think there is a trend where more and more fixed income assets, and especially the public market fixed income assets, are being moved over to the alternative space. That's probably the primary trend that we're seeing

about what's going on prior to that in terms of asset performance.

Chair: And Penny and Martin, as clients, do you ever feel frustration about the time it takes once you as a client have decided to terminate an existing manager's contract, to get a new manager in place?

Penny: I think it can be, it is a process that can be done quickly and effectively if you are willing to do so. We have gone from beauty parade to funding, albeit a very straightforward mandate and we didn't need a transition manager in this particular instance, for all sorts of boring reasons. And we did that in three weeks. But the way in which we have always approached it is that when we send out the RFI, we put our IMA in the RFI and say 'What are your issues with this?' so that we know up front before we even get to the interview, the selection process, where we're going to have to talk to the manager about the IMA. So all of those sorts of things that can be brakes on fast implementation are dealt with up front.

Martin: Well we totally divorce appointment and removal, so if we want to get rid of one for under-performance, it goes passive. We've got the luxury of having a passive satellite arrangement whereby we've got passive funds, that if the subsequent appointment we choose to make is slightly different we can usually find we can populate it from the passive funds anyway.

Tim: We've had several clients approach us and say 'Okay, here's where we're at and we've decided to get out of this active mandate and move to passive, but we haven't

decided who to appoint yet, so we need an interim solution'. If we, take the client into an interim portfolio carrying 100 basis points tracking error versus say 10 basis points, there will be materially different costs in those alternative solutions, with turnover being much higher to achieve the lower tracking error. What's important here is to understand the Client's strategic objective, because that will ultimately determine which of those two interim portfolios is the optimal solution.

Penny: I think the clients have to be really clear about what it is the transition manager is doing for them. I can see how it happens, but I would be worried, were I a trustee of a fund that had had assets with a transition manager for three years.

Chair: Okay moving on to the question of more exotic asset classes and investments that clients are now investing in. What implications does that have for transition management?

Gary: Fundamentally one of the jobs of the transition manager is to manage the exposure of the portfolio that's in transition relative to the strategic benchmark or a tactical benchmark for the period. So even if you have say a private equity allocation, which is inherently difficult to immediately find an opportunity to invest in, it could be that the solution would be to move that allocation back to the benchmark so that the fund is currently sitting in a benchmark for that particular segment, and then gradually unwind.

Hari: It is very difficult to come up with

hedges or an overlay in the current public market space for the alternative and the LDI. We see a trend where more and more fixed income assets, and especially the public market fixed income assets, are being moved over to the alternative space.

Chair: Mark are you seeing more movement into LDI portfolios and to swap mandates from clients? Does this pose specific problems?

Mark: Well the transition manager can control the risk so much better when we're moving from similar assets to similar assets, that's the basic thing, and we add a tremendous amount of value there. When we're looking at complete reallocation of those assets it gets more complicated. I think then it's on an advisory aspect, what are the risks involved, what is the timing, looking at cash versus the alternative assets we're looking at, looking at those risks.

Tim: One trend I think that's here to stay is clients getting used to a sustainably lower fixed costs base. Even though there may be significantly higher risk in trying to make 20% of your assets generate all of the return (and we're not the advocates of that solution) I think clients will get used to that lower cost structure and I don't think we'll necessarily see a move back towards the old structure of deploying five or six long only managers targeting 3% alpha.

Chair: And Penny, when you're looking at your asset allocation, your investment manager structure and maybe moving into some of these newer asset classes. Is transitioning into them a key considera-



What really hurts in a transition is when liquidity is so poor that you can't achieve a realistic value for an asset. Now, there's a big discussion about 'What is fair value?'

tion when you're looking at alternatives or LDIs and other bond mandates?

Penny: Yes, I think our approach would be very much to look at the strategic allocation, to determine what it is we want, to determine where we want that to be, and then to look at the cost of the transition. If the strategy is right then it's going to have far more benefits to the portfolio, to the health of the fund, which will outweigh any cost of the transition. Having made the strategic decision, then when we're doing the allocation, or did the implementation, then it's right to look at what a transition manager can bring and how much that's going to cost.

Chair: We mentioned briefly illiquid assets and I just wanted to touch on for a few minutes the fixed income marketplace in 2008 - particularly corporate bonds. A question perhaps for the providers to start with, just how bad is it out there?

Hari: Fixed Income execution is challenging, but we are able to execute transactions. It's going to be dependent on how efficiently one can source liquidity and getting creative about finding that liquidity. Now, that being said, we're not talking about any of the assets that are distressed. And here's what we think it takes to get a fixed income transition successful. Not only does the transition manager need to be housed in an organisation that's got liquidity, but you also have to have the capability to delve into the market and find a network of broker-dealers who can source liquidity and also offer you a better price. But where we think the difficulty is

going to lie is price discovery. And that we think price discovery is the most challenging part of fixed income transitions, especially in the US.

Mark: What really hurts in a transition is when liquidity is so poor that you can't achieve a realistic value for an asset. Now, there's a big discussion about 'What is fair value?' Is it the value of the asset relative to similar assets, a model valuation or the best bid in the market? You may say the best bid is the asset value, but what if the market is not efficient at that time? One thing we have seen in the last few months is that inventories in fixed income are nothing like as large as they were 12 months ago, and consequently liquidity is going to be very different from day to day. We have been providing clients with the option to move such liquidity impacted assets into a specialist asset manager whose responsibility is to continually evaluate that portfolio using their own models and liquidate the portfolio over a much longer time horizon than that available from a transition manager. It's not a way of putting off an investment decision, just a means to extend the trading time horizon to reflect unusual market conditions.

Tim: What about, if you can get buy-in, also having the asset managers, both legacy and target, work with transition managers prior to execution to improve price transparency and assist on appropriate benchmarking?

Mark: I agree, they are often one of our first port of calls. For example you can approach the target manager and say 'What do you

think of this asset? Would you want it in your portfolio?'. And even if they don't they will usually have something very intelligent to say about their asset.

Gary: I think our approach is somewhere in between. We like to be very holistic about it. Fixed income transitions, they are very different in nature, they're very subjective, like the composition of the portfolio. In the equity space you know what you've got to buy if you're buying an index or, even if you're buying an active portfolio, you know what you can and you can't buy. In the bond space there really is no constraint in the same sort of portable fashion and, as a result, if you're inheriting a portfolio that has got an absolute load of toxic waste in it, then if there is the opportunity to discuss with the outgoing manager. You've got to be in the situation to have a conversation with them that 'you've given it to us, how about you buy it back?', because fundamentally the relationship with the client may have terminated in the near term, but in the longer term that asset manager, the cyclical nature of the investment industry, on the next cycle they could be the one winning the money again.

Chair: Penny and Martin, are these issues making you as clients look more closely at your corporate bond portfolios? Are they putting you off doing any transitions in credit at this moment in time?

Penny: No, having just completed one! I think you've all made some very simple points, but at the end of the day if you want a transition you want a transition. I think this is where the risks of the alter-

natives come in, where you are going into high yield and emerging market debt, if you want to transition out of those asset classes, having gone into them, it is going to be extraordinarily difficult.

Chair: And were you happy with the concept of a fair value for a bond?

Penny: No, I kind of think that fair value is what the market will pay for it. The only thing that does hold good is that prices have something is worth something that someone will pay for it, and that's what it's worth at that point in time. And that's where you as an asset owner, be it your own personal house or your bond and your portfolio, had to make a decision, Do I want to take that one on the chin and move into the new, my new asset allocation, my new regime? Or do I think that that's so offensively low I'm prepared to sit and sweat it out until some kind of "normality" returns, whenever that might be? My view is that there comes a point where, if you can't find what you think is fair value, just get whatever you can for it and move on.

Martin: I agree entirely with Penny. It's an accounting concept really, fair value. It is what someone will pay. Fair enough, if you choose to believe someone will pay more later, okay, you put your capital into it. No, you don't want to, you want us to put our capital into that value proposal that it's going to be worth more later. I think you're best walking away then.

Chair: Martin and Penny, has the existence of the T-Charter made any difference to you in terms of the transition management industry?

Penny: No, not particularly, to be quite honest with you. I think that it is a shame that a lot of work has gone into developing this, and yet it's just it doesn't seem to have any traction, it's there and people may use it or may not, but it doesn't seem to have the profile that many other standards have. I think that given how much work and development went into it, I think that's a real shame, I think that it should be something that's much more high profile. When we looked at appointing a transition manager, we didn't even look at the T-Charter.

Tim: Have you considered turning it to your own advantage and incorporating the defining principles of the T-Charter into the contract that you strike with your provider? Because that's how I think it gains real teeth. As a voluntary code we can all say 'Yep, I'm signed up to this', but



if we're taking it upon ourselves to educate the clients, then there's every reality that you're going to educate your potential client base to your business model, you orientate them towards your business model. So we still have to be careful about it from that perspective

within the document there are several key defining principles: 'thou shalt not pre-hedge without full prior disclosure, thou shalt not price-adjust, thou shalt report all errors promptly; thou shalt have a completely separate transition team etc'. If you take these key principles and insist upon embedding them into the contract, you may well find certain providers can and will, but that others can't or won't do so. I think this is how the T-Charter becomes a really powerful tool in helping to differentiate between different providers.

Hari: As an organisation that has been involved in T-Charter, we think it's important to note that we should not police ourselves, and let the respective authorities manage regulations. That has to be made very clear. We think what this business needs is education for our clients who can distinguish between a variety of different strategies and the execution process. But the US market has operated quite efficiently without having a T-Charter or a T-Centre

Gary: I think that's one of the underlying reasons why the T-Charter was developed. To give you an example, the local government pension funds, often you find that the person running them on a day to day basis is somebody who works in the finance department, they're not an investment expert, they're not an investment professional, and they're engaging with you on an investment level, so they have to have a

degree of information, if you like, protection that enables them to understand what it is you're doing, as opposed to you walk in and say 'Don't worry about it, we'll look after you.'

Penny: I think that's where the powers of the T-Charter is. So many trustee groups don't have finance professionals, let alone investment professionals on them, and don't know the right questions to ask on what should be going in a transition management agreement, they just don't know. The T-Charter gives you a set of principles where, when you're trying to choose a manager, you've actually got a set of principles that anybody can look at and say 'Look, it says in here you shouldn't pre-hedge. What on earth do you mean by that? And why is it important? And do you sign up to it?'

Gary: I actually think there's a risk of me saying I agree we shouldn't be policing ourselves, but if we're taking it upon ourselves to educate the clients, then there's every reality that you're going to educate your potential client base to your business model, you orientate them towards your business model. So we still have to be careful about it from that perspective. So I agree with Penny, this has to move to a level where the provider says 'Okay, we've had our discussions, our forums and input, and we've all agreed it', it has to move to a level where there is sponsorship from a regulator or whatever it might be, I think the whole education part of it has to be in



conjunction with the T-Charter at a level that moves you away from the providers.

Hari: Clients will have to drive this process of setting expectations and a standard and not the providers. But again, we still think that there needs to be an educative tool that we provide for our clients a guideline and a set of explanations on a variety of different transition topics and help them understand the complexities with risk management and execution.

Chair: Moving on, I want to ask if there are still very different business models in transition management? Are transition managers ultimately delivering the same product but is their underlying business model still quite different?

Gary: Yes, I would say so. You've still got the differentiation between the old terminology, sell side / buy side, pure investment management orientated providers, custodian providers, versus your broker-dealers, and I would say that the product may look similar, but the way that

they execute on the product is different, it has to be different.

Tim: The models have been converging for some time now, but not everyone has fallen into line. Investment banks that have powerful access to liquidity, particularly those that have such in both equities and fixed income clearly argue the advantages and merits of that direct access. Non-investment banks conversely tend to argue in favour of their apparent impartiality and ability to act as a fiduciary. You've accordingly seen some of investment banks remove themselves from the dealing floor and structure themselves in such a way as to be able to offer a fiduciary service, for example by teaming up with their custodial arm. On the flip side of that you've seen the several non-investment banks move to be able to directly access market liquidity - albeit not as powerfully as the incumbent broker dealers. Within this there's been an inherent acknowledgement by some, on the one hand, that direct access to liquidity is a powerful selling point, and on the other a recognition by others that being able to act as a fiduciary is advantageous to certain situations. The inevitable result is a more level playing field, but as I say several providers are not there yet in terms of being able to offer both.

Mark: One thing that pension funds have is a very competitive transition management industry. We have several different business models and clients can determine which is best for them or for the particular transition. We do not have industry standard pre-trades, which I know is a frustration for clients, but there are many similarities with all pre-trades so direct comparison is possible. The key factors are usually the risk management process, the



business model and the relationships

Chair: Penny and Martin, is business model something that concerns you when looking at a transition manager?

Martin: I slightly dispute the transparency of them, because they're still not that understandable. We know the basics and we know that none of you started off being a transition manager, you were other things and you came to the transition industry by different routes. You'll happily all send letters out saying a brief summary over the last five-years but they don't actually tell you what you moved, where you moved it to, so it's hard.

Martin: Is the T-charter capable of increasing this common ground?

Hari: It has to be originated from the independent community, like an independent cost analysis provider or a client who is driving a process and is driving it for other pension funds. There's something very interesting going on in the US. The PBGC has established a set of guidelines for transition management that their providers would need to follow. And it has taken the initiative to drive this process, which we support. Again it has to be driven by the client.

Mark: I think what we've been saying about the T-Charter is that it was a compromise. Obviously, it didn't go as far as ERISA - some of us would've liked that, some of us wouldn't. But what it has done is provided this set of principles that you can put in a contract. When you're looking at those pre-trades you can talk to the different contenders and say 'Will you sign up to the T-Charter? Will you put it in your contract? And what does this mean?' and go through each one. And it's an incredibly valuable tool for opening up really what you're being offered. **E**

