George Madrigal
Principal & Head of U.S. Transition Management, Barclays Global Investors

Lance Vegna
Director, Head of Portfolio Transition Services, Credit Suisse First Boston

Jamie Cashman
Director, Mellon Transition Management Services

Mark Keleher
President, Mellon Transition Management Services

Robert Werner
Managing Director, Implementation Services, Russell Investment Group

Russell O'Brien
Director, Head of Portfolio Transition Services, Credit Suisse First Boston

Ross McLellan
Managing Director, Pension Strategies Group, State Street

Troy Rucker
Director, Portfolio Transitions, Russell Investment Group

Geraldine Jimenez
Investment Officer, CalPERS

John Girard
Trustee, Boca Raton Police and Firefighters Retirement System

Christopher Ailman
Chief Investment Officer, CalSTRS

Alan Mason
Head of Transition Strategy, Barclays Global Investors

Investors Demand Transparency and Accountability When Moving Portfolios

Transition Managers Offer Technology and Disclosure as Volume Grows

ON JANUARY 20, SENIOR EXECUTIVES MET FOR A DISCUSSION about the transition management industry at *Institutional Investor*'s offices in New York. Participating were Alan Mason, head of transition strategy, Barclays Global Investors; George Madrigal, principal and head of U.S. transition management, Barclays Global Investors; Lance Vegna, director, head of portfolio transition services, Credit Suisse First Boston; Russell O'Brien, director, head of portfolio transition services, Credit Suisse First Boston; Mark Keleher, president, Mellon Transition Management Services; James Cashman, director, Mellon Transition Management Services; Robert Werner, managing director, Implementation Services, Russell Investment Group; Troy Rucker, director, portfolio transitions, Russell Investment Group; Ross McLellan, managing director, Pension Strategies Group, State Street Global Markets; Geraldine Jimenez, investment officer, CalPERS; Christopher Ailman, chief investment officer, CalSTRS; and John Girard, trustee, Boca Raton Police and Firefighters Retirement System. Bradley Meacham of *Institutional Investor* served as moderator.

Moderator: The volume of business going to transition management has doubled over the past three years, capturing as much as 20 percent of all institutional assets annually, according to estimates from the U.S. consulting firm TowerGroup. As more players enter the arena, and as choices increase, what do institutional investors look for in a transition manager?

Geraldine Jimenez, CalPERS: We have domestic equity traders in-house, so when we bring in a transition manager it is to handle international equities. Generally, we come up with an overall team strategy, with the intent to keep some information quiet from the market, and then we'll look for a transition manager. What we expect is a pretty high level of service.

That nasty word "fiduciary" is something a lot of transition managers don't like to hear, but we think pretty well of it. We are looking for a strategy to limit the costs. We are looking for daily dialogue. We are

This Sponsored Roundtable was prepared by the Special Projects Department of *Institutional Investor*

looking for an automated system that will give us some comprehensive reports so that we can see what's going on during the transition. Regarding transparency, I do think things need to be much more explicit and clear. Often the costs in a transition are subtle and hidden. We are also looking for active back office support to reduce operational risks. We're looking for a transition manager that will be willing to gauge it's own success through a third-party service such as that provided by the Plexus Group. We are looking for a benchmark for the currency, and we'll talk about that daily during a transition.

Christopher Ailman, CalSTRS: What we are looking for is just one word, and that is a fiduciary. I'm not talking about anyone here, but the bottom line is, plan sponsors are getting fleeced. This can happen with transition managers that have an open process, yet take their trade list, show it to a hedge fund, show it to their own trade desk, and while the transition is being done at a low cost on a commission side, the client is getting ripped off on a wealth-loss side in terms of where the stock trades. Oftentimes I see plans that do not track the trading closely.

Ross McLellan, State Street: All of these points are certainly what clients look for from us. Fiduciary ownership of the portfolio is becoming more standard. Many times we are asked to act as temporary investment manager. We are actually managing futures or currency overlays.
The client service department is also where we put a lot of our focus, since clients want to know just what is going on during the transition period. We are seeing more demand to showcase what we're doing on a day-to-day basis.

Mark Keleher, Mellon: As a fiduciary, you are putting your client's interest before your own, and with transparency you're disclosing how you make your money. This is a great source of comfort to clients.

"There is a disconnect between the transition management firms that say, 'Sure, we have to make money in other ways because the commission cost is so low,' and the buyer that has no idea of the other ways the firm makes money."
- - - - - - - - -
BOB WERNER, RUSSELL

Russell O'Brien, CSFB: I agree. From what we've been hearing, transparency certainly is the issue. How the transition management firm provides that transparency is an important part of what makes a manager competitive. At CSFB we use technology to achieve greater transparency. There is no question that client sponsors, whether large or small, at the end of the day want to know whether or not they received a good and fair transition.

Moderator: Have there been significant changes in the past year in the way you structure your fees or your business model?

McLellan: Our fees have risen slightly, back to the point where they were three or four years ago. We don't feel we need to compete on price with firms that are coming in and offering sub-penny or zero commission structures but are making money in the execution price.

Bob Werner, Russell: TowerGroup came out with a report this year that showed sources of revenue. According to the report, less than 25 percent of the revenue made in transitions is coming from commissions, while 75 percent of the revenue sources are not disclosed to the pension client. There is a disconnect between the transition management firms that say, "Sure, we have to make money in other ways because the commission cost is so low," and the buyer that has no idea of the other ways the firm makes money.

That disconnect has led to some bad performance results, and certainly to some clients feeling ripped off. I think this situation will continue until some standards are instituted. A year ago we were talking about the importance of the T Standard, which Russell Investment Group helped spur the creation of, as a consistent measurement for evaluating the performance of the transition. Many firms have adopted it, but we are still talking about mandatory standards. The T Standard doesn't deal with the disclosure of how firms make money, but at least it shows the end result in the cost to the client.

Troy Rucker, Russell: We have found a fee structure that works well. We provide full transparency to the client disclosing the total revenue Russell will receive for the transition. That seems to provide a level of comfort and safety for the client. Additionally, we've seen clients require contractually that the fully disclosed fee is the only revenue stream to be earned from the transition. Clients are becoming educated and more savvy about the hidden fees made by providers and how that might affect their investment returns.

"How much do transition managers really make off clients on currency trading or crossing? We have a responsibility to our clients to disclose all of this type of information."
- - - - - - - - -
GEORGE MADRIGAL, BARCLAYS

Lance Vegna, CSFB: Another trend we have seen is that clients want providers to have the ability to manage and execute a transition from beginning to end completely in house. That is important because if you hire a transition manager as a fiduciary, you don't want them outsourcing the execution to a hedge fund or to another broker/dealer that does not have fiduciary responsibility to the end client. Outsourcing is an area where oftentimes, clients are getting fleeced. You need to carry that fiduciary responsibility from the beginning of a pre-trade analysis all the way through to the actual execution point on the exchange.

Moderator: Is outsourcing necessary, though, for certain areas of expertise? And if you do outsource, is there less security for the client as the fiduciary role changes?

George Madrigal, Barclays: I think what clients are looking for in particular is how transition providers earn their revenue. Transition managers disclose what money is made off of agency trading, for example, but what about currency trading? How much do transition managers really make off clients on currency trading or crossing? We have a responsibility to our clients to disclose all of this type of information.

"You need to carry that fiduciary responsibility from the beginning of a pre-trade analysis all the way through to the actual execution point on the exchange."
- - - - - - - - -
LANCE VEGNA, CSFB

Werner: There is a polarization of business models. Certain providers are offering services and access to all sources of market liquidity, while other providers are saying their source of market liquidity is best. So not only does a pension fund have to hire a transition manager, but they are also selecting the specific liquidity sources as the same time. This is a critical point, because if you believe in the investment management model, where an investment manager has a fiduciary obligation to seek out the best possible execution for each trade, then any other model is inferior. Imagine if an investment manager placed all of their trades through a single brokerage firm, that would raise a lot of eyebrows. The pension community would question their investment managers as to why all trades are being made through that one source. It is common practice to have an obligation to access all sources of liquidity.

John Girard, Boca Raton: We get the report only at the end of the day. There is no one to monitor it, and no one to tell us how well things are going. The consultant takes a look at it and we get copies of it. Obviously, we care about the transition manager being a fiduciary, but while the transactions are going on we are in the dark.

Vegna: One of the things that has made it possible for us to be transparent is that CSFB owns what Euromoney has called the best electronic algorithmic trading platform in the industry. This enables us to give detailed information in real time. We are not engaging someone else to perform our services. Let's face it, when you engage an outside party in this business, no one will do anything for free. So there is definitely a spread cost built into an outside broker's price. If there is revenue being shared between a broker and a transition manager, it needs to be disclosed. All conflicts of interest have to be disclosed.

A third-party broker/dealer that has been engaged by a transition manager doesn't have any real obligation to disclose what their spreads are to the transition manager's client. At CSFB, we are using an agency model as our business model. We do not seek to use our books to execute transition management. Our model is to use our global algorithmic trading technology to provide the best execution we can. It is pure agency trading.

Jamie Cashman, Mellon: I think the distinction between agency trading and principal trading is a critical point. But maybe you can elaborate a little bit more on how you, as a broker/dealer, distinguish between the two approaches, and whether that also entails sales/trading transitions to a larger investment community.

O'Brien: We do not take a portfolio and shop it, per se, the way a traditional block trader would. It's a different style of trading in transitions. You really want to maintain the risk profile of the portfolio. If you go out to investors that are looking to buy it in a block fashion, you could have some unintended effects that might increase the risk profile of the transition. Basically anything that's going to be done in the transition should be known in advance. There should be no surprises to a customer in a transition.

Moderator: What technology platforms are most important in performing the best execution and in setting a transition manager apart from the pack?

Madrigal: At BGI we are very much a quantitative shop. We have leveraged technology and research to build a multi-period optimizer that is specifically designed to address implementation shortfall. The multi-period optimizer has brought us a great deal of success with respect to accuracy of forecasts and actual trade implementation. This application has been so successful that we've expanded it beyond U.S. equity to include international equity and, soon, fixed income securities.

Keleher: Our approach has been to seek out the best-of-breed systems. We have some 23 different systems that we need to reach out and touch on every single transition, whether it's screening for corporate actions, risk analysis or some type of trade optimizer. We have built an in-house platform for this purpose that also gives us an audit trail so that we make sure that everything that needs to happen in a transition has happened. We are also very focused on applying technology to the back end of the transition, making sure that we're able to deliver the assets to the new manager in a timely, accurate fashion. We think that's very important, as well.

"As a fiduciary, you are putting your client's interest before your own, and with transparency you're disclosing how you make your money. These are a great source of comfort to clients."

MARK KELEHER, MELLON

Rucker: We have seen a shift in the types of systems being used for transition reporting from trading-related systems to an investment advisor focus, being able to report portfolio performance on a dynamic and real-time basis for the client. Not everyone has this kind of system in place, but it's definitely something that's needed. Transition managers should be using the same kind of performance accounting systems that investment advisors use.

Alan Mason, Barclays: One of the most important things technology can provide is the ability, particularly through pre- and post-rate reporting, to disclose upfront all sources of potential revenue to the transition manager, and all sources of costs to the client. We believe that the T Standard, especially as it has been modified in response to industry evaluation, is really the type of reporting that everyone in the industry needs to be providing.

I think clients are also looking for consistency between the expected performance variability put forth in the pre trade, and the actual realized transition cost and performance. Unfortunately, until we have a number of the major providers all using the same standard for calculating the post-trade performance, this data is going to continue to remain ambiguous for investors. We are on board with using the T Standard for calculating the post trade performance, because in our view one of the main differentiators when it comes to quality is consistent results that are in alignment with the predicted costs.

Moderator: We are still a long way from being able to measure the performance of the transition provider with any meaningful consistency. Are you concerned about establishing industry-wide standards?

Werner: Absolutely. Until there is a standard for the industry, the measurements we have will be purely a marketing exercise. We are in a position that is not unlike the investment management industry in the 1970s, when they had no performance calculation standard until Peter Dietz came up with a standard that the whole industry adopted.

Jimenez: I always get concerned when a transition manager provided me with both the expected cost and analysis of the cost. It is somewhat like having the fox guard the hen house. We do need standards so that I can be assured that the analysis I'm seeing is consistent.

Ailman: We adopted the T Standard for all transitions a year ago. We are going to require that in all of our contracts, the T Standard and the fiduciary requirement are going to be critical. In just

"As we begin to standardize processes going forward, maybe the next thing that we have to do is standardize the contract."

ROSS MCLELLAN, STATE STREET

about every other area of the financial industry there are common standard measures, and this is the one space that has lacked it for so long. That may be part of the reason that there are so many players in transition management; there is too much hidden money being made.

The bottom line on selecting a transition manager is not unlike selecting an investment manager. All we can do is look at past performance.

Moderator: While disclosure is important, isn't security also an issue, especially when you're dealing with pre-hedging or anticipatory trading?

Keleher: You have to be very careful with any information that you disclose to the market. There is enough pattern recognition software and enough smart people that it is not that hard to guess which stocks might be on the list. We saw that in the U.K. recently where a dealer pre-hedged a principal transition that moved some stocks by as much as 10 percent. The broker/dealer didn't know the actual names on the list but they guessed. So confidentiality is of the utmost importance to both the transition manager and the client.

Anytime you have information flow, even if everyone concerned is being very honest, unless you can actively control that information people will trade around it. Traders everywhere will try to take advantage of flow. And as far as pre-hedging goes, it only takes one or two people to be pre-hedging a trade, and they may not even win, to affect the cost.

"I would say further that a broker/dealer may or may not have an appetite for making a risk bid for a given transition, but there should be a practice of examining whether they have the capacity to do so for transitions in general."

JAMIE CASHMAN, MELLON

Vegna: This is a particular type of principal trade, the risk bid, where clients send the characteristics of a portfolio to a few brokers and say, "I'm not going to give you the actual holdings of the list until the market is closed, but I want you to guarantee me today's closing price." There is risk for the winning broker because they don't know what they're going to be buying or selling to the customer. But when you show the characteristics to too many people, even those who don't win the trade have the opportunity to try to guess at the stocks in the portfolio. So I think that the risk bid process is inappropriate for transition management. CSFB does not pre-hedge and does not plan to, but I cannot say that is the case for other broker/dealers who are in this business.

Cashman: I would say further that a broker/dealer may or may not have an appetite for making a risk bid for a given transition, but there should be a practice of examining whether they have the capacity to do so for transitions in general. The fact that the capacity exists is something that plan sponsors and consultants should continue to scrutinize.

McLellan: As we begin to standardize processes going forward, maybe the next thing that we have to do is standardize the contract. The best practices might dictate that the transition manager does not conduct any proprietary trading of stock during the transition period, and it does not trade any asset, be it a fixed income security, currency, or equity, with any portion of the firm's own capital.

Moderator: Does crossing provide enough upside for clients to cover increased risk?

Mason: I think it's really important for all providers to distinguish between internal crossing that is regulated by the Department of Labor and other forms of crossing that is public and external crossing on various networks. It is extremely important to have clear definitions of each type of crossing that a provider plans to use, as well as what types of funds and accounts participate in each type of crossing, and what kind of compensation the transition manager gets.

Werner: Over the last few years one of the biggest abuses we saw in the transition industry was some of the pre-hedging and principal trading. In these cases clients really didn't understand what was tak-

"From what we've been hearing, transparency certainly is the issue. How the transition management firm provides that transparency is an important part of what makes a manager competitive."

RUSSELL O'BRIEN, CSFB

ing place. Then there were abuses in foreign currency. Today the problem revolves around some of the miscommunication around crossing. Over the last year we have spent more of our time and worked with more clients on understanding that what they thought was a Department of Labor cross, was actually another cross done by the brokerage group of the firm that was anything but free.

For example, the client might have thought they were trading with the index funds of that provider when in reality they were trading with either other transition clients or other money managers, or other brokerage clients of that transition provider. The prices they achieved weren't closing prices and they weren't free in that they incurred impact and spread costs. There were some issues with the pension funds, in which they thought they had one very specific type of free transaction when they had actually bought the services based on misinformation. In the end their performance suffered drastically. In most cases, the crossing that is not Department of Labor exempted are not free transactions but are being touted as free to most clients. They are not free when it comes to looking at the investment performance erosion associated with them.

Vegna: This ties in perfectly with the benefits from advances in trading technology. Systems today are able to time stamp executions and record quotes. This is essential if a client wants

"Clients are becoming educated and more savvy about the hidden fees made by providers and how that might affect their investment returns."

TROY RUCKER, RUSSELL

a third party analysis of an execution. Also transition managers should be able to show which trades were crossed in the open market with other customers. You should also be able to show what price was given relative to the spread.

These details are transparent now. If a client wants that level of transparency it is available with the current technology.

Madrigal: You do, however, have to be careful that you don't save the client a penny at the risk of losing a quarter. One of the things that we do at BGI is evaluate portfolios to determine which securities are the largest contributors to risk. These high-risk securities might be better served being traded in the open market rather than by crossing. You should make use of crossing only when appropriate to the overall investment objective

Moderator: What sort of transitions is likely to drive growth?

Mason: I think that there will be much greater focus on fixed income transitions, the clarity of business models, and the development of crossing techniques around fixed income. As investors look more at the structure of the bond portfolios and match that against liabilities, that is going to drive the transition industry to look at the fixed income asset class more seriously than it has in the past.

Madrigal: There is a real perception out there that the fixed income market is very opaque. Many providers are concerned with how to evaluate fixed income transactions. The more we are willing to disclose with respect to transparency, specifically for fixed income, the more room for growth there will be.

Moderator: What potential ramifications do you see, near term, in the news from Washington? For example, how big an impact would privatization of Social Security have on the industry?

O'Brien: The Secretary of Labor, Elaine Chao, spoke recently about protecting the retirement security of American workers. She touched on three things that the President is going to do: reform funding rules, reform premiums, and increase disclosures. Those are similar to the issues we have been discussing, so Washington is going to have an effect. The issues that affect defined benefit retirement plans could affect the asset allocation decisions of clients, which in turn affects the transition management business. It will be interesting to see where it all falls out. ■