2008 THOUGHT LEADERSHIP ROUNDTABLE SERIES

SHAPING THE FUTURE OF US TRANSITION MANAGEMENT

THE PANEL:

CAROL A McFATE, chief investment officer, Xerox

JAMES G CASHMAN, director, Mellon Transition Management Services

WILLIAM D STUSH, director, Transition Management, Merrill Lynch Global Markets & Investment Banking

KAL BASSILY, CFA, managing director and global head of BNY Global Transition Management.

PAUL G SACHS, Mercer Investment Consulting

MATTHEW E STROUD, practice leader, greater New York, Watson Wyatt Investment Consulting

Sponsored by

MARKET OVERVIEW

KAL BASSILY: One of the characteristics of the US market is a very high level of understanding on the part of asset owners of the transition process; what goes into effecting a transition; what goes into measuring the overall transition cost on a pre-trade and a post trade basis. We did not see this three or four years ago. Asset owners know exactly what they expect and we no longer hear the question:"What does opportunity cost mean?"You might get the question: "How do you measure it?" However, there is consensus among most providers on the measurement of the different components of transition costs. Consultants in particular have done a very good job with asset owners, explaining the processes involved in a transition. Additionally, we have also noted the trend to constitute transition management panels; a trend that we think will accelerate on the public funds side of the business

MATTHEW STROUD: We also note improving literacy. It is vital, as transitions are becoming more complex, driven in part by regulatory changes in the US that are having an impact on a number of qualified plans. Fixed income transitions are also more prevalent, though they present unique difficulties that perhaps many sponsors may not have seen much of the in past. Therefore, improving literacy is all to the good. We have not seen quite as much of the panel activity, as Kal has done, largely because one-to-one relationships are more typical in the corporate fund sector, than the public fund arena.

JAMIE CASHMAN: There is also heightened competition—especially at the higher end of the market. As well as putting together transition management panels, these multi-billion dollar funds also look to bid out their transitions, for one-off situations. At the smaller end of the market— in terms of asset size—there has been a wider adoption of transition management among foundations and endowments, corporates, and smaller public and county plans, which several years ago might not have even considered transition management.

FRANCESCA: Carol you did a mega-transition some time back. How difficult was it to choose the right transition manager?

CAROL McFATE: We transitioned $3.6bn out of a $5bn defined contribution/401(k) plan. Any plan sponsor will always say that their situation is unique. However, ours was especially unique! XEROX decided to outsource its plan investment management five/six years ago and our manager of managers decided to discontinue its fund offerings to the defined contribution marketplace, creating an urgent need to in-source the investment management of those assets. We did not have much legacy in-house experience with transitions and we had to come up to speed extraordinarily quickly as we had only seven months or so to complete the transition. We had a very short period to determine how we were going to take this suite of investment alternatives (which was a little dated) and update it to provide a good, complete and prudent selection for plan participants. Moreover, we only had a three-day window (black-out period) in which to accomplish the transition of all of these funds. As a result, we hired an investment consultancy and worked with their internal person— who works exclusively on transitions— to help us navigate this complex process. We needed their expert guidance because it was something that had not been done by the company for a long time and the company's investment committee was naturally nervous, given the size of the transition and the short period of time in which we needed to execute. We received excellent advice and in the end, it was a good experience. It required a tremendous amount of co-ordination—I wouldn't want to call it micro-management—but there was a need to focus on many minute details. At the end of the day, it all worked probably about as well as it could have, but it was a breathtaking process.

JAMES G CASHMAN, director, Mellon Transition Management Services Photograph supplied by Berlinguer Ltd, December 2007.

PAUL SACHS: Collectively, the industry and its customers have a much better comprehension of the transition business now, which is reflected in improved transparency and vocabulary that is more standard. What helped that along is common agreement on using implementation shortfall as the evaluation framework. Moreover, if I look at the distribution of bids we would receive in a 'cost and risk discovery' three years ago, low-to-high might have been a range of 20 basis points (bps), which is huge. Today, we frequently see low-to-high in a range of 6bps. This clearly indicates that providers and their processes have become more competitive. On the client side, not only have they moved beyond looking solely at explicit costs such as commission, today the general recognition is that opportunity cost (market risk) is the single biggest factor that can make or break a transition. Controlling risk during a transition is now the number one priority, on the provider side and the client side.

CAROL: This was a world with which I had no familiarity until I moved into this job. You had to look at the issues in terms of people, their experience, and your confidence that

they could execute well on your behalf. There was a legacy investment bank attached to the transition manager selected. We had to look for areas of potential conflict and examine their experience. We also recognised that no one had done a defined contribution transition recently, let alone a transaction worth $3.6bn. It was a fairly Herculean task. Frankly, I did not realise how monumental an undertaking it would be when I joined the company. It was a tremendous amount to accomplish in a very short period of time.

FRANCESCA: Does any of what Carol says resonate with you?

BILL STUSH: It all resonates. What I am impressed by on the sponsor side is what Carol described in terms of the decision making process. Clients are looking deeper than just explicit costs when evaluating proposals—which is something we probably all appreciate. However, choosing the right transition manager is a challenge for them, because of the legacy relationships they might have, relationships they might be beginning, custodial considerations, and issues such as pricing models to consider. There are many factors involved in making that choice. Clients are fully aware of these issues and are cognisant of the factors are that important to them. They are making their evaluations based on all these factors and not just looking at commission, or impact or spread, or record keeping. They are looking at the bigger picture. It's an advantage and it is incumbent on to all of us to be able to demonstrate what we can bring to the table to help them.

CAROL McFATE, chief financial officer, Xerox Corporation Photograph supplied by Berlinguer Ltd, December 2007.

FOR LOVE, MONEY & SERVICES?

KAL: As asset owners better understand the nature of costs and how to measure cost, it is forcing providers to be very competitive. However, there are certain things where it does not apply. You cannot be competitive on, say, the fee that you charge. However when you talk about implicit cost, market impact, or opportunity cost, you find it in a very tight range but I wouldn't say it is competitiveness that is driving that: rather, it is the level of comprehension out there.

JAMIE: I would certainly imagine that, in a transition like the one Paul was contemplating, if you have a range of costs that are separated by 6bps, then the decision is not solely being made on whomever is the lowest cost provider. When there is some level of cost parity amongst the different providers then there is the question of what else can they provide, such as project management or operational support, for example. Part of that is being driven by the growing level of knowledge amongst stakeholders: whether it is consulting firms or the asset owners. There is also a greater acceptance that transition management is often times a prudent instrument to help plans to make the shift from A to B. Today, the business is often about the services that providers offer, rather than the relative merits of using a transition manager in the first place.

FRANCESCA: Carol. For you was it a case of 'deliver me this new structure of fund relationships?' or was it more than that?

CAROL: It was much more than that. Given that we were working with defined contribution money, which is participant money, the fiduciary standard to which you hold yourself, is rather high. You want to have your provider be cost competitive. You want transparency. You want an understanding of what is happening at every step of the process and concur with the way the transition is being managed. In our case, recognising that we had a bit of learning to do in terms of this particular topic, the advice that we got from our investment consultant was particularly valuable. What they did for us was take a similar portfolio to the one we owned, and effectively bid it out blind, so nobody knew that it was us, to get a sense of the what the cost dynamics would be. However, there were other soft factors around that. You want somebody who is going to be there shoulder to shoulder with you as a fiduciary, effectively to feel like they are in your shoes. You need to know they are going to be as careful as you would be with those funds, making sure that you have market exposure during the transition, and effectively you are doing the best possible job to try to makes sure that the participants' money is well managed and fully invested during the period.

FRANCESCA: Bill, how does what Carol says apply to you in practice?

BILL: Clients see the benefit of somebody standing shoulder to shoulder with them, rather than treating the process as a transaction, or as an adversary. That is why we use the term partner or collaborator and why we focus on achieving our client's goals. Whether you are looking at fiduciary issues, pre-trade costs or some of the operational needs such as

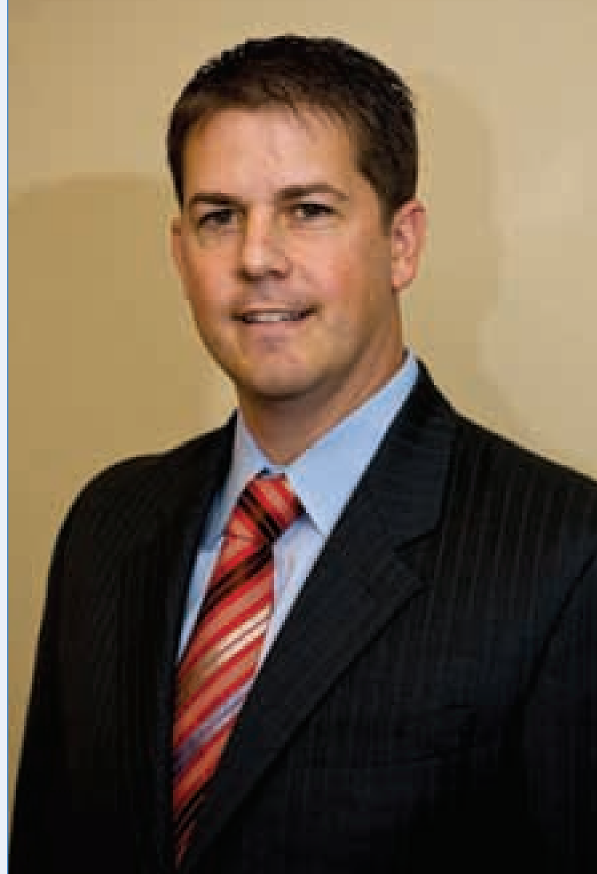
valuation and blackouts for 401(k)-plans, it is vital that there is an evolution of metrics. You can talk to Paul about the way they look at their business. You can talk to Carol and talk to her consultant about what they were looking at. I am sure it's no different with other firms. We benchmark transactions we do for our own clients, for our own trading, for transitions and we are using tools that are now available to everybody – and which are not unique to transition management. There are so many ways you can gather information now. However, what clients see, and Kal and Jamie will back me up on this, transitions are now about partnership—one that we hope is long lasting and might lead to other opportunities through the development of a discussion.

PAUL: One of Bill's points concerns the dramatic evolution of trading. We did a round of due diligence visits earlier this month just because trading technology has changed so much. Technological innovation needs to be taken into account. Looking at the big picture, for the average transition, explicit costs are something like 25% of total cost, and the remaining 75% are implicit costs, which are affected by trading technology. Unsurprisingly, we see about 75% of evaluation decisions come down to factors that do not involve explicit cost. The decision points may be implicit costs, they may have to do with the risk exposure, or they may have to do with some of the soft functions that Carol was talking about that could be essential to a client's transition.

MARKET TURBULENCE & TRANSITIONS

FRANCESCA: How have the last turbulent few months impacted on your business?

JAMIE: We have been blessed to live in interesting times. It has really made our jobs—having to solve all sorts of challenging investment problems—really invigorating. On the quantitative side, the recent environment has presented some issues. Like many of the people around this table, we use multi-factor models for estimating transition costs. In virtually all of these models, volatility is a key input into determining what the expected transition cost is going to be. In markets that are jumping around like this, you need to have sensitivity as to how that input is being incorporated into the rest of the model; and whether a model that is using historical volatility that has gone back 60 days or so, is appropriate in this kind of environment. Likewise, it has forced us all to re-examine the models that we are using, not only on the pre-trade side but also in real-time as each transition is unfolding. On the qualitative side, it has presented another challenge in that this business to a certain degree has always been about communication. There are lots of moving parts and lots of stakeholders (custodians, investment managers asset owners, and consultants) involved. Within an environment like this, communication a few times a day may not be sufficient. You may have to be talking to the investment managers much more frequently as circumstances dictate. We had a recent situation where a stock on a target manager's buy list opened down 20%. Naturally, you have to ask: "Do you still want to own this stock?" rather than blindly follow a mechanical trading programme.



WILLIAM D STUSH, director, transition management, Merrill Lynch. Photograph supplied by Berlinguer Ltd, December 2007.

MATTHEW: Broadly speaking, what we see is an increasing robustness in the fiduciary oversight process. Market volatility during 2001 and 2002 and then in the more recent past, as well as the legal and regulatory environment, has had an effect. We live in a world now where we are being asked questions in terms of manager selection. Clients want to understand who is a better fit with their needs and objectives more than they ever did before: rather than just deferring completely with a recommendation. They really want to understand how you get from A to Z. From a process point of view, while clients now understand the process they also want to articulate to their board what they did, why they did it and how it went.

MEASURING THE IMPACT OF MARKET COMPLEXITY

FRANCESCA: Kal, do you think that as markets become more complex, only those players that can provide an extensive range of services will ultimately dominate or control the transition management?

KAL: Players that will add value going forward are those that understand that the number one job of a transition manager is risk management. The market volatility of the last few months has taught us all that risk management is key. That is not to say that project management is not important, it is; communication is very important, but we have to take those as given and what we really want to focus on as providers is to manage the risk during the implementation period. Jamie talked earlier about stocks opening down or up 20% and how

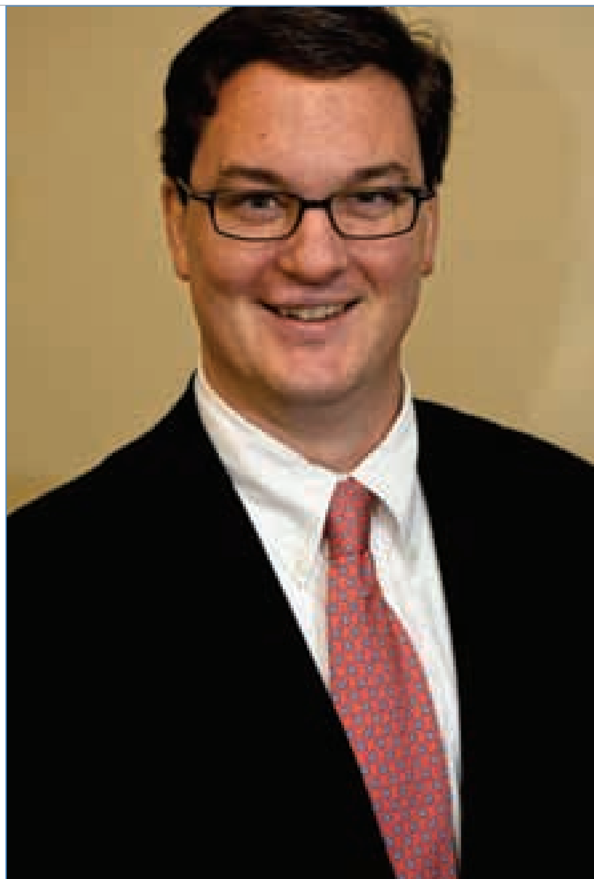
you should react to that. A transition is not a discrete event in the life of a pension fund, it is one point on that investment process continuum and whatever happens, while you are carrying out the transition it does impact on the investment performance of the whole fund. So you have to pay attention to risk, you have to measure it right and you have to manage it right, introducing hedge tools, be that futures or index option, or how fast you can access liquidity and what kind of algorithms you use to implement your transition.

JAMIE: The one thing that I would say to that Kal is that there is a slight danger in characterising risk management solely as quantitative in nature; *i.e.* only managing the risk of the tracking error in portfolios. There is also management of operational risk, especially in defined contribution transitions, that has got to be integrated in the whole process. I could not agree with you more that this business is fundamentally about risk management, however, it is a comprehensive risk management. In certain transitions, the high risk of that transition is because of the high tracking error between portfolio strategies or illiquid securities that present a quantitative problem. However, in certain other transitions— such as a multi-billion dollar defined contribution transition with a three day blackout— that is operational risk that no multi-factor model is going to be able to help you solve! However, it is no less important to the success of the transition. We have had clients that have come to us and told us that it doesn't matter what the implementation shortfall might be, if the transition screws up their accounting, it was not successful. We need to take a more holistic view of what risk management is and be able to deliver solutions that address all sides of this.

PAUL: For a sponsor such as Carol, both investment risk and operational risk translate into reputational risk, which is a huge exposure for many investors. You do need to take a broad view of transition managers, even into such things as the organisational stability of the parent organisation. There are nine major categories that we are looking at when we look at transitions, and only one of them is execution.

BILL: People are asking those nine questions and more. Now clients spend as much time on evaluating the service as they do everything else. We have not done anything new. Yes, we have new algorithms and new techniques, but it is the evaluation process, it is what Matthew and Paul bring to it. Everyone is now collaborating to get all the right information out in the open.

MATTHEW: It is not just consultants. There is a general improvement throughout the industry. A lot of clients are saying, "Look I have a separate account component to the transition. Talk to me as much about your project management skills, with respect to that as well as giving me the 20 pages on your trading expertise and algorithms." Therefore, if you blow the operational aspect, you now have a problem and it is focusing attention on where it should be. Consultants are part of it, clients are part of it, transition managers are part of it and increasingly the environment we are in is a part of it, not just the volatility in the marketplace, but also the legal and regulatory environment with respect to the US and the changing regulations around the world.



MATTHEW E STROUD, practice leader, Greater New York, Watson Wyatt. Photograph supplied by Berlinguer Ltd, December 2007.

IN THE UNLIKELY EVENT THAT SOMETHING MIGHT GO WRONG ...

KAL: The best way to avoid those ugly situations is to have an open dialogue with the asset owner up front. Again, we take a page from the asset management book, where you take objections and constraints and you try to optimise a solution for them for whatever the situation is. You do the same for a transition. If the client says his priority is to get this transition done in a week or for you not to mess up his accounting, we take that as gospel. Of course, market conditions can change mid way through a transition. You can start a transition and then the liquidity goes away. Things happen. Years ago, we all saw some providers come in with proposals that looked attractive: that the transition was going to be easy; that it would be done in three days and the overall transition cost was going to be real low. I personally no longer see these kinds of proposals from any serious provider. However, when market conditions change and you find yourself stuck, you talk to the client and the investment manager. Does the target manager want cash instead and they can build the tail end of the portfolio in their own good time?

MATTHEW: The understanding of how objectives get rank ordered by client preferences is key. Exigencies often resident with a transition often force people to rank order competing objectives. Is speed key? Or is cost management

mission critical? Yes or no? Do I want to pull out of this right now? Can I live with it for a few more days? That is when you really learn to define what your preferences are in the face of competing investment objectives.

BILL: A famous consultant used to say many years ago that difficult times were as important as good times as they gave you a chance to reach out to your customers. They teach you that you cannot look away from tough times, you have to face them down. So if you adopt that approach and pick up the phone, personalise it, draw people's attention to it, you will go a long way. It is easy to get information out.

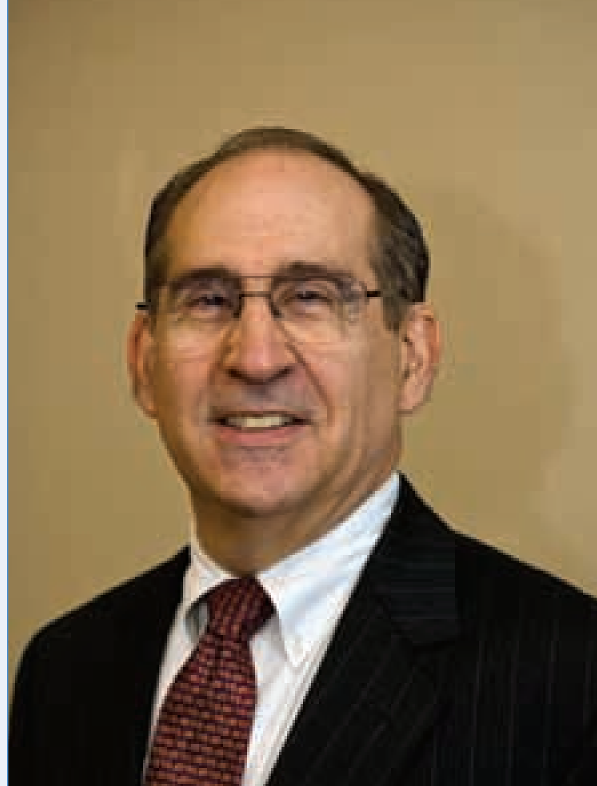
JAMIE: This speaks to the role of the fiduciary in the whole process. People often think that being a fiduciary simply means that a transition manager is not going to front run your trades. Beyond that, it means, among other things, that I am not going to be anything less than transparent in the way I handle your trades. However, there is more to it. A fiduciary is someone who tells the client when they, as a transition manager, cannot do something. Let's say we have a portfolio with two Lithuanian stocks, and we have never traded in Lithuanian stocks before: we have to tell the client that and say, "Look I am not in a position to unwind this Lithuanian stock portfolio as we have no expertise there. You don't want us, you want somebody else, a Lithuanian transition manager perhaps." That mindset is critical to this whole discussion process about the role of a fiduciary.

PAUL: What struck me when you talked about this is the thought of somebody discovering three or four weeks into a transition that liquidity is a problem. It re-emphases the point that the most important part of the transition is the strategic planning, weeks in advance of the actual event. If you are surprised by an illiquid tail, I would say, if I were in that position, "Shame on me." The whole point of the planning process is to consider contingencies and to have a strategy in place. If you have a substantial small cap portfolio and you are in a defined contribution environment, your transition manager should already have an idea about possible strategies for dealing with it. Where a transition manager can truly add value for a client is for the transition manager to come up and say, "We anticipate a problem. We have three possible strategies to address it." and then they go into the dialogue that Bill talked about. That is essential.

FRANCESCA: Let's turn it on its head. What happens if a target manager gives you an optimum portfolio, an ideal portfolio of stocks that are hard to source.

PAUL: What you describe almost never happens in equities, but it happens more frequently in fixed income. Upon occasion, a fixed income manager may say, "I want some of these seven and five-eighths of 2019", knowing they trade very infrequently. He would love to have the transition manager buy them because he can't buy them!

BILL: It kind of marries what Kal and Paul talked about. There is a comfort level dealing with a fiduciary. The ability to transact in futures, in principal trades, and other derivative type contracts that maybe would not have happened, if they had not had vetted the process of what they were doing and hired an advisor. However, I don't



PAUL G SACHS, Mercer Investment Consulting
Photograph supplied by Berlinguer Ltd, December 2007.

think you are finding counterparties that are trying to put you in a difficult spot. I like to think we are working on even ground. If we are not, the whole pre-trading process should vet that and give us the chance to say, "Hey, here is what I have uncovered through my analysis and what I am looking at, and this is the challenge if we walk down this road, so we will adjust here and adjust there."

JAMIE: Whereas a fundamental investment manager three or four years ago might not have really focused on what the cost really was because they are picking the right stocks, they are sensitive to it now. That ties into working with managers in transitions. They recognise the value and role that the transition manager can provide, and they like the idea of inheriting a portfolio of stocks and not having to incur all those transaction costs, so it is much more of a collaborative relationship than something that is combative.

BILL: They are sensitive not only to building that portfolio, but also to the fact that at some point they might want to unwind their positions. They are sensitive to re-evaluate their portfolio and not just look at these core statistics, but at the cost of transacting in and out. It is a round trip. Therefore, if I am a micro cap manager and I am going to be the largest holder of a particular stock and I will have to hold it forever, I might not buy it. I may be able to replace it with something else. I might be able to source the exposure via derivatives, I might hold some cash for a period of time, accumulate a smaller position, whatever alternative that might minimize my transaction costs yet deliver alpha.

MATTHEW: In terms of the formal inclusion of T-cost analysis in standard buyside portfolios, we have definitely seen more of that. What is driving that? Part is the increasing performance sensitivity in light of modest expected forward returns for equities. Added to that is the recognition that T-cost is something that has to be carefully managed.

THE ONE ABOUT THE T-CHARTER

FRANCESCA: I know you have all signed up to the voluntary code that is the T-Charter. I wanted to garner your views on what you think its impact will be?
MATTHEW: Like any marketplace, you have an expectation that is dynamic. A lot of the major players anticipated this, once it became clear that it had some traction behind it. So disclosure had been improving, the client confidentiality clearly is being taken very, very seriously, and you can actually argue that it always has been. All the things called for in the T-Charter, have been recognised and provided for by all the major players in advance of the formal recognition. So, like any robust marketplace, where there is a very active competitive element, the anticipation of its has served its purpose in advance of its formal adoption.
KAL: If you look at a list of the participants many of them have been conducting their business in exactly the way that the T-Charter prescribes. What the T-Charter will do is make it easier on the asset owners to hire a transition manager. When they shop around, for lack of a better term, for a transition manager, they know that group of participants operate under a certain code and that I assume will give a certain level of comfort to asset owners knowing that everyone is playing on a level field.
PAUL: Various people have asked me what will be the impact of the T-Charter in the United States. A few have suggested to me that maybe we need something like that in North America and Asia. How many global standards do you need? This is it. Investors in the United States ought to become familiar with the T-Charter, because it is going to have a big impact on the transition business here over the next 18 to 24 months. I don't think it is a fanfare situation, or that we will see the impact over a few weeks. Matt's point is that providers have already begun to raise their level of conduct in anticipation of it and if a global organisation signs a document in London, it reflects and represents what they are doing in Sydney, Singapore, Chicago and Dubai. The announcement of the T-Charter is a great event because it really does lift not only conduct, but also it makes it more measurable.
BILL: Competition in general drives all of us continually to improve our overall offering and the benefits we provide to clients: whether that is in the principles of the T-Charter or outside them. The adoption of the T-Charter will of course give comfort to the participants that are using the service that there is collaboration; that providers are working together to try to define standards. However, it is not limited to the T-Charter prescriptions. Transition managers continually improve their product to distinguish themselves; to offer a better service and to help their clients by providing solutions. It is a combination of factors: transition managers moved to accommodating the T-Charter and putting a code of practice around the principles and having an awareness of it, even before it was signed. After all, the more education that is out there the better.
FRANCESCA: What happens to institutions that don't sign up?
JAMIE: To Paul's point. Obviously it has been a UK initiative, but has global implications. There was an element of peer pressure at play. No one wanted to be off the list for fear of it becoming an 'us versus them' issue. Transition managers that hesitated endorsing the T-Charter may have envisioned having to defend the untenable position of having client say to you: "what don't you like about transparency and serving the best interests of the clients?" It is a good first step in terms of a common agreement. It is an extension of one of our earlier themes about the evolution of the industry. Despite heightened competition, I do not feel that there is any rancour in the transition management community, the T-Charter is a good example of our ability to come together for what is in the best interests of the client.

KAL BASSILY, CFA, managing director and global head of BNY Global Transition Management. Photograph supplied by Berlinguer Ltd, December 2007.

NEW FACES, NEW MARKETS, NEW PROBLEMS

FRANCESCA: Can we talk a little of new markets please? There are new pots of money that are approaching transition management market to help them implement changes in investment strategies, such as central banks. How are these new markets changing transition management?
MATTHEW: It is a very interesting area. We are seeing large, professionally managed asset pools outside of the United States transitioning not so much from very exotic strategy to another, but from large domestic market-oriented strategies, say as in the case of South Korea, having principally South Korean equity exposure, towards broader market exposures. This is not confined to any one segment of institutional investors. We've seen this across large insurance companies as

well as sovereign funds and now looking overseas from their home markets. We are seeing a broadening then of investment agendas basically, both by asset class exposure within equities and then extending to alternative and advanced strategies. Large sovereign funds for sure are behind a lot of this and growing rapidly, in Asia and Australia and it is not just sovereign funds, but also insurance companies as well.

KAL: We see a broadening of the user base of transition management. Traditionally, central banks managed debt but now they also manage reserves. Most of them are in fixed income investments right now, but as Matthew said, many of them are experimenting with equity investment and cross-border investment. They are leaving South Africa, South Korea, and Malaysia and investing overseas and in equities. The other trend we are seeing in terms of the user base of transition management is financial institutions, such as multi-managers, mutual fund complexes or any situation where money is sub-advised, such as life-cycle funds, professional investors, because they go through exactly the same exercise that a pension fund would go through when they reallocate money from one manager to another and increasingly they use transition managers. Over the last 18 to 24 months this trend is definitely on the rise. How it has changed the way that we do business? You have to remember that those are institutions that have centralised dealing desks; they are very well schooled in trading and dealing with them has its own set of requirements and challenges and because many of them do daily accounting; they have to strike NAV on a daily basis, nobody stops trading the portfolio while you are effecting the reallocation. Again, it is not the same as a pension fund saying "Here are the assets, I will segregate them in a transition account and no one will touch them until you build a new portfolio." It has been a challenge, but most of us have adapted to that challenge.

JAMIE: The numerous fund of fund products that are out there are often a perfect fit for the use of a transition manager. A few years ago, there were very few of them that actually realised that. The other element of your question was how transition management has evolved to cope with the rise of new markets and alternative products. In other words, to the extent that clients are moving away from say large cap US equity and not replacing it with another large cap US equity manager, but putting on a sort of a Liability Driven Investment (LDI) strategy, or earmarking the money for a hedge fund of funds, or a 130/30 or something like that. No one of the transition managers around the table is purchasing timber! It might yet happen, but we are certainly thinking of different ways that we can hedge an exposure for a client. Assets may be earmarked for an alternative asset allocation or for a fixed income portfolio where it does not make sense for us to purchase the portfolio because of the level of substitution that Paul cited. In those cases, we have to think of different ways in which we can hedge this exposure for the client. What instruments are out there that serve as a good proxy for what they want to accomplish?

BILL: There is broad acceptance, understanding if you will, of the transition manager as more of a generalist. Seeing what we do, we don't just see large cap active portfolios moving into an S&P index. We see fixed income, we see that sponsors are moving into alternative assets and we have to figure out a way to overlay cash into some product while they do that. We have broad knowledge and we bring in specific expertise depending on what we are doing and tools to help people out and create solutions: whether it be central banks or fund of funds. Transition management has escaped from simply buying and selling equity or selling and buying fixed income. We are seeing global bids that go from equity to fixed income, and when they go into alternatives, we have to consider, for instance, what to do with the cash?

PAUL: One of the biggest areas of new opportunity for general investors is still in the area of fixed income and multi-asset class transitions. Equity-to-equity is something that, I would say, the industry has addressed effectively. They do that extremely well; but asset class shifts and the exposures that are involved, the customisation that is necessary in formulating that new target portfolio in fixed income can be quite challenging. A portion of Jamie's point was that investment managers are much more willing to work with transition managers today. That does not mean that every strategy is done better by a transition manager than by a target fixed income manager. If you look at some of these strategies, some of the hybrids and swaps that are in a fixed income portfolio today, it really does need to be done by the target manager. In that situation, the transition manager may be serving the client's interests best by giving a laddered portfolio of treasuries or gilts to maintain duration, because something like 83% of the risk in the average fixed income transition is durational.

IT'S A COMPETITIVE WORLD OUT THERE

FRANCESCA: Increasingly some beneficial owners have brought trading capability in house. Is that a trend here and how are you countering that? I am happy to go on the record here and say that I find that particular trend something of a worry.

CAROL: I find it almost incomprehensible that somebody would not employ a transition manager for a transition of any size or complexity. There is simply too much at risk not to hire a professional to assist in this critical piece of the process.

BILL: They may not be taking on every aspect of transition management, irrespective of what they might be claiming. There is probably some partnership, or vendor relationship somewhere that they are accessing to do parts of it: maybe they are outsourcing the administration, or the performance measurement or their broker networks to trade and the algorithms their broker provides on their desks. When we hear that somebody is doing transition management themselves, we always have to drill down and ask; "What is it that they are actually doing as part of that?" They might actually be using transition management in a way that we might not recognise, in that we might offer entire traffic control and fiduciary and they might simply be using a fiduciary to trade or to manage money temporarily in an overlay strategy. You really have to drill down before you

get too afraid of what they might be employing that helps them get to where they might want to go.

PAUL: I know of at least one large corporate in-house investment management firm, with tens of billions of assets, contemplating a transition, but electing not to do it in-house. Is it that they lack trading capability? Absolutely not. They have great trading expertise. The question is "Do they have the project management skills and the right procedural controls around the process?" That is not something that you want to invent on an ad-hoc basis. Unless you do transitions on a day-to-day basis and are committed to eliminating the sixth decimal of risk, you probably don't want to go up that learning curve.

BALANCING RISK AND CREATIVITY

JAMIE: Two things. There has been a greater acceptance on the part of the end user and the consultant to look at transitions as a risk management exercise and not simply a cost minimisation exercise. Rather, cost minimisation is derived from risk management. Nonetheless, there is still some room for us to be able to advance that idea and for people to think about transition costs in risk adjusted terms. In comparing cost proposals, how much risk must the client assume to achieve that cost outcome? Maybe there is a way that I can lower explicit trading costs (by trading over a longer horizon or crossing more), but the only way that I can do that is for the client to bear more risk. There is also room for transition managers to better articulate this concept to the end user. Second, Bill touched on this earlier, is that the client will increasingly look at transition management in the same way they approach their distressed debt manager; or their custodian, or whomever. You won't hire a transition manager because they are the last person to come through your door and they are a name you remember, or that they happen to be a custodian or because they happen to be your index manager. There is a level of due diligence that needs to be completed and we are seeing a greater recognition of that by the client.

MATTHEW: I agree wholeheartedly, as far as an improved understanding and perhaps an awareness of absolutely taking on one objective very well at the expense of other things that you may want in a transition. Then clearly formalising the selection process along the lines of how you select an investment manager. At Watson Wyatt we encourage a strong focus on business people and process, and we apply the same rigour and reference points and formalise the process and have it be comparable with any other selection process.

BILL: You don't buy Jamie's, Kal's or my transition model, put it on your desk and press a button. People don't buy that anymore. We are getting greater opportunity to discuss what it is that we do, and on the other side of the table, asset owners are driving and understanding the discussion, the framework and the metrics and all of us getting a much greater understanding of what it is that our clients are trying to achieve. Once we fully understand that we can enhance our service to help them get where they really want to go. It is collaboration, discussing what is available; discussing fixed income; discussing defined contribution plans; cash that is going into alternatives. We are all continually advancing the process and so it is no longer "Fire me your bid and I will take a look." We are all getting opportunities, fair opportunities to present fully what we do and explain what it is we can provide, and not what our model is and that theme will continue. I don't know if you can call it a future trend, I am not so bold.

CAROL: In terms of future expectations, it is almost sounding as if it is a commoditisation of the business model. That may be an extreme view, but things are becoming more the same. You have the T-Charter that will drive it in towards greater standardisation and you have competition that will drive it further in that direction, etc. While I recognise that each firm has its own unique capabilities to bring to table, it will probably, from a plan sponsor's point of view, bring about a more transparent and hopefully more cost efficient process, with even better risk controls. But in terms of any future transitions, I would suspect that we would do nothing different than we did in the process that we concluded at the end of June.

KAL: The cry is now: "Give me a solution," or preferably, "Give me a set of solutions for the problem I have." Now those solutions are comprehensive as we noted earlier and so it becomes how you manage market risk, operational risk and how you are going to handle the trades. That particular aspect will continue to allow us to differentiate ourselves from one another. It will be about creativity: who can put three or four solutions to a particular transition on the table. If I have five trading strategies, each one will come with a certain combination of market impact and opportunity cost and depending on how much risk you are prepared to bear, you tell me what you want me to do. That will be the way forward.

CAROL: I said that more to be provocative than anything else. However, it could go that way. If transition managers are pitching directly to me—and I made the mistake early on in having one transition manager do that—it is very difficult for plan sponsors, unless you have done a lot of transitions, to ascertain what they are really good at and how they distinguish themselves from other transition managers. Are they good project managers? You cannot know that, without direct experience. Therefore, it is useful to hire a consultant to help you as they can give you more intelligence on those soft factors and more clearly distinguish how particular firms stack up.

PAUL: Looking at transition managers does require focus and specialised expertise to be able to do it well. When I heard Kal talking about the trends he sees, I expect that there will be (hopefully) a more universal adoption of best practice. Improved governance is where there is an opportunity for investors. The US is regulated by policy, as opposed to regulation. Last February the President's working group suggested that we don't need to regulate hedge funds: that was the headline everyone saw. However, buried in the announcement was the advice that institutional investors do need to scrutinise and monitor all service providers. The due diligence and governance that is now taking place around transition management is a great thing for investors.