

# IN TRANSITION

Topics in Transition Management



Mellon Transition Management Services

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## DEFINED CONTRIBUTION SOLUTION?

*Managing DC Transitions*

Looking back through two years worth of *In Transition*, one theme recurs through each issue: no matter what each transition may hold in common, every restructuring is different. Transitions are commonly described as discrete events which regularly involve different asset classes or different managers. At the very least, they take place at different points in time with different market conditions. Each transition is unique, and consequently each presents its own set of challenges.

With complexity, however, comes opportunity. Transition management was once considered solely the province of defined benefit plans. Like many things in the current investment world, an approach grounded in increased flexibility is supplanting pre-conceived ways of doing things. As more and more plan sponsors launch defined contribution (DC) platforms, many of those institutional investors are applying lessons learned in the traditional defined benefit (DB) space to the brave new DC world. In some cases, that may include hiring a transition manager to assist in the implementation of investment changes.

In last quarter's *In Transition*, we described the additional due diligence required for global transitions:

*"For single market restructurings, transition management may be considered one part portfolio management and one part project management. When the transition involves multiple markets, time zones, languages, and settlement conventions, however, it may be more accurate to describe transition management as one part portfolio management and **three** parts project management."*<sup>1</sup>

This is equally true of DC transitions which may have additional layers of operational complexity and often pressing deadlines for completion. To paraphrase Tolstoy, all transitions are a challenge, but each DC transition is a challenge in its own way. In the context of heightened DC activity in general, we examine some of the reasons why DC transitions can pose particularly knotty problems.

## STEADY MIGRATION TO DEFINED CONTRIBUTION PLATFORMS



In what has become a widely documented phenomenon, the traditional DB plan that generations of employees have relied upon to sustain them in

their golden years appears to be headed the way of the dodo. It is well behind the scope of this article to comment on whether this is a good, bad, or indifferent trend. (Fortunately, volumes have been written on this topic.) Instead, we start by merely suggesting that if this shift continues, it seems plausible to conclude that transition managers can expect to receive more and more assignments within DC plans. A recent study by TowerGroup is one of many that forecast the continuing proliferation of DC plans and the demise of their DB cousins.

<sup>1</sup> *In Transition* Volume 8: "Foreign Relations: Operational Challenges of Global Transitions"; 2006; available at <http://www.mellon.com/transitionmanagement/services/newsletters/intransitionWinter06.pdf>

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## US Workers with Pension Coverage by Pension Type (1983, 1992, 2004, 2011P)

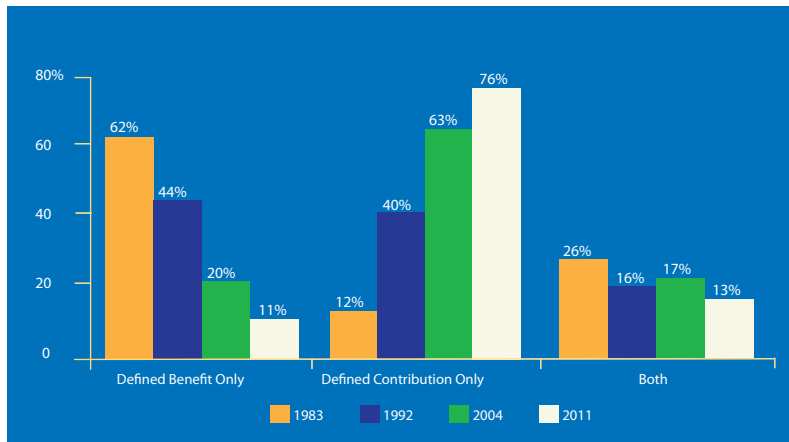


Exhibit #5005M-E5  
Source: Center for Retirement Research at Boston College, Tower Group estimates

It is no news flash that substantial dollars have been moving toward defined contribution platforms. To support this remarkable growth, surveys suggest that many DC plans are considering making significant changes related to the investment offerings within their line-up. Whether due to the advent of lifecycle funds, increases in employer matches, or mandatory contributions, changes in DC plans seem likely to continue unabated.<sup>2</sup>

### MANAGING THE COST AND RISK OF CHANGES

One of the criticisms of defined contribution plans has been that they push the burden of investment management onto the shoulders of participants who are ill-equipped to handle the myriad decisions required to fund retirement. Indeed, research suggests that defined contribution plans underperform their defined benefit counterparts.<sup>3</sup> This underperformance is due, in part, to the additional costs and risks that DC plans incur when restructuring. A recent example highlights the risks DC plans sometimes bear.

#### The Washington Post

By Stephen Barr Thursday, April 19, 2007; Page D04

*It was a lucky day at the Thrift Savings Plan.*

*On March 5, the overseas markets were falling, and worried federal employees filed orders to sell shares they held in the international stock index fund, known as the I Fund, at the TSP.*

*In the biggest transaction ever for the I Fund, the employees liquidated stock valued at \$865 million. The Asian and European markets were closed when the TSP sent the sell orders to the fund manager in San Francisco at 2 p.m. Eastern time, the standard practice. But overnight, the U.S. stock market looked brighter, and the overseas markets opened strongly.*

*The I Fund shares sold on March 6 were up a percentage point, not down as expected, and reaped \$8 million in trading credits. By the time the books were settled, the \$8 million earned that day erased almost all of the fund's year-to-date trading costs. "We got very fortunate," said Tracey A. Ray, the TSP's chief investment officer. Normally when selling stocks, the TSP absorbs commissions, price differences and other transaction costs. All holders of I Fund accounts pay for the trading costs, even if they did not sell or buy. To give a sense of the stakes involved in such transactions, Ray noted that the I Fund had trading costs of \$13 million in 2006. The \$8 million credit last month "could have easily gone the other way" and could have been "money out the window," she said.*

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Given persistent investment, regulatory, and compliance pressures, many defined contribution sponsors recognize that they must consider incorporating the same cost management and risk management solutions used by many conventional retirement plans. For this reason, more and more DC plans are considering transition management as a risk-controlled approach to implementing portfolio changes.

### THE DEVIL IN THE DETAILS

Transition management has not always been considered a natural fit (or even possible) for defined contribution plans. For one thing, mutual funds have historically been the investment vehicle of choice for the DC platform. The daily net asset values (NAVs) and limited in-kind possibilities associated with these types of funds have typically been deemed unsuitable for transition management. Even more significantly — as indicated in the TSP example — trading costs are self-contained within mutual funds. When one participant enters or exits the fund, the rest of the participants bear the trading costs. In this regard, sponsors are almost disincented to manage trading costs — a circumstance that is anathema to transition management.

<sup>2</sup> For examples of recent studies, see <https://www.towergroup.com/research/home/index.htm> or [www.buckconsultants.com](http://www.buckconsultants.com).

<sup>3</sup> For example, see "Investment Returns: Defined Benefit vs. 401(k) Plans"; Munnell, Soto, Libby, & Prinzivalli; Center for Retirement Research at Boston College; September 2006.

But sponsors should not lose heart. Despite the conventional wisdom, in-kinds may be possible into and out of mutual funds. For large redemptions or contributions, delivering securities across mutual funds may be the preferred approach. Even in instances where it is optimal to “cash-out” of one mutual fund and wire cash to another, a transition manager may be able to mitigate the risk of cash drag that such a transaction creates.<sup>4</sup>

Beyond the cost challenges there may also be significant operational hurdles to clear in defined contribution transitions. In part, additional challenges stem from an extra stakeholder to DC restructurings — the record keeper. In addition to the plan sponsor, consultant, investment managers, and custodian — all involved in the typical DB transition — transition managers must also plan for accommodating another vital player to the DC transition. While careful project planning is required, the logistical challenges of defined contribution transitions can be addressed by a transition manager who assumes the role of quarterback to the event.



## BLACKOUT PERIODS — DON'T GET CAUGHT IN THE DARK!

In addition to the logistical challenges that DC transitions pose, there may also be significant regulatory risks. Post-Enron, many DC sponsors fear the so-called

“blackout” period that a transition may cause where plan beneficiaries are unable to direct or diversify investments. During this period — because the asset line-up is in flux — there are typically limited distributions, withdrawals, transfers, or other changes permitted by beneficiaries. Blackouts that aren’t handled smoothly carry with them a potential for litigation. At the very least, a bungled blackout may pose significant headline risk, and for this reason alone structuring blackouts around DC transitions certainly warrants careful planning. Additionally, in the era of Sarbanes-Oxley, sponsors must be mindful of special notification requirements to participants.<sup>5</sup>

## DB & DC SIMILARITIES

All additional planning aside, when it comes time to restructure the DC asset portfolios, the role of the transition manager looks very much the same as during a DB transition. At the end of the day, a stock is a stock regardless of where it’s held.

Whether dealing with a DB or DC restructuring, the transition manager acts very much like a short-term fund manager. Likewise, whether working with a DB or DC plan, the transition manager identifies assets within the legacy portfolios to be retained by the target portfolios. The transition manager then completes the event as residual securities are sold and remaining securities in the target portfolios purchased. Depending on the liquidity of the legacy and/or target portfolios, trading can occur over multiple days. By examining the liquidity of the investment portfolios, the transition manager can help the plan sponsor evaluate the need for and length of any blackout period.

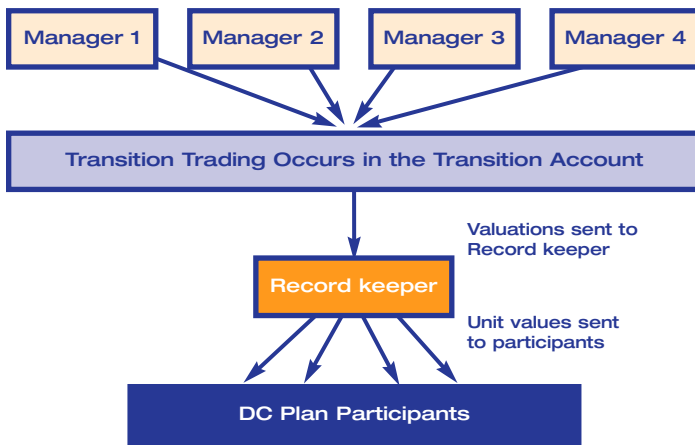
Once the transition starts, the transition manager is responsible for monitoring cash flows into and out of the transition account. Futures contracts and/or exchange traded funds may be bought or sold depending on the exposures created by such cash flows. The transition account effectively serves as the investment option for the plan participants during the transition.

### INTERACTION WITH THE RECORD KEEPER IN A TRANSITION

- The record keeper provides the transition manager with a timeline of unit and/or portfolio valuation daily deadlines as well as trade and transfer notification deadlines.
- The record keeper notifies participants of changes to plan, where appropriate.
- The record keeper notifies the transition manager of net cash investment/redemption activity daily.
- The transition manager ensures all trade details are distributed to custodian and record keeper by stated and agreed deadlines so that they may publish fund unit valuations.

<sup>5</sup> Section 306(b) of the Sarbanes-Oxley Act of 2002 (the “Act”), enacted on July 30, 2002, amends Section 101 of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), generally to require plan administrators to give 30 days advance notice to affected plan participants and beneficiaries of any blackout period with respect to an individual account plan. Blackout periods are often imposed by plan administrators to implement changes in investment alternatives or record keepers, or in connection with corporate mergers, acquisitions or spin-offs that affect the coverage of groups of participants under the plan.

<sup>4</sup> To learn how, please refer to *In Transition Volume VI: “Demystifying Derivatives”*; <http://www.mellon.com/transitionmanagementservices/newsletters/intransition/Summer06.pdf>



Source: MTMS 2004

## CONCLUSION

A transition event for a defined contribution plan involves careful coordination between the plan sponsor, consultant, legacy managers, record keeper, custodian and target managers. While the portfolio management activities during the event need to be managed carefully to preserve performance, the operational and project management issues associated with the coordination of the event become a primary focus. Taken together, a successful transition involves delivering results that are in expectation with projected costs and opportunity risks, balanced with a soundly executed plan that meets deadlines for delivering necessary information to the plan's participants.

MTMS offers global transition management services designed to assist clients rebalance asset allocations, enter new investment strategies, or liquidate existing portfolios. Mellon has provided transition services to clients since 1983. Headquartered in San Francisco and with a global presence, MTMS offers a proven process designed to mitigate operational risks, lower transaction costs and reduce the administrative burden for client sponsors.

Please feel free to contact us should you have any questions or desire additional information.

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