Mellon

A Business in Transition

A REPRINT FROM MAY 2006

PLANSPONSOR ROUNDTABLE

Transition Management Services

Plan sponsors are doing more transitions, and more complex transitions. At the same time, transition managers are evolving, often with different business models. However, one trend is clear: Well-executed transitions matter more than ever before, and the true cost of a transition gone wrong can be devastating. PLANSPONSOR recently spoke with two executives in a unique position to see how the business is changing: Mark Keleher, president of Mellon Transition Management, based in San Francisco; and Lawrence Bancroft, president of Bivium Capital Partners, a San Francisco based manager of managers.

***PS:* For a plan sponsor, choosing a transition manager used to be simple– these days it is quite the opposite. What has complicated these choices?**

Keleher: There are a number of issues that a plan sponsor has to reckon with when choosing a transition manager. To begin with, there have been a startling number of new entrants in the transition management field. At the same time, transition management teams are leaving one player and joining another, and this combination of new players and changing players has put the whole business in a state of flux. In addition, there is a lack of clarity about what some transition managers will and will not do as fiduciaries, and we find that more plan sponsors are looking for providers that are prepared to take on the level and responsibilities of a fiduciary.

Bancroft: Agreed, I think plan sponsors increasingly are seeing the importance of getting a transition right and no longer are making decisions on transition managers based solely on existing relationship at the custodial and/or brokerage level. Furthermore, the increased number of players – with seemingly large marketing budgets has forced plans to formalize the process by the use of RFPs and consultants.

***PS:* Has all the new competition changed the business? For instance, is it now more price-driven?**

Keleher: The new players are out there banging on doors but not, thus far, with much success. It is hard to drive this by price alone, because most plan sponsors understand how nebulous price can be when deciding a transition. A transition that may incur zero commissions still can be inordinately expensive, as many plan sponsors have discovered. The key in assessing a bid is to understand each bidder's business model; only then can you ascertain its true cost.

Bancroft: In an effort to differentiate their services, transition managers are being a bit more thoughtful about how they approach the business and are focusing on their respective strengths. For example, some tout their research and performance measurement capabilities, while others discuss their trading prowess. The bottom line is that, while pricing is important, it should have less of an impact on your decision once you have determined clearly what is important to achieve in the transition.

***PS:* How about transitions themselves– is their nature changing?**

Keleher: They clearly are getting more complex, which means that transition managers must be able to handle

"… by and large it seems that Mellon is getting transitions right."

"'First-rate team, very solid execution,' says a client."

multiasset class, multimanager, often multicountry transitions. So, to your previous question, these days it is far from simple to make sure you have the right transition manager. At the same time, its more important than ever before. More and more transitions are being done. More attention is being paid to asset allocation and plan sponsors understandably have less patience with underperforming managers. As market returns fall and many plans remain underfunded, every last basis point becomes much more important.

"'Smooth, efficient, and hassle-free transition', notes a Fortune 500 client."

Bancroft: To add to the point about complexity, plan sponsors often are terminating managers before they know exactly how they're going to replace them. So, sometimes, transition managers are being asked to create an interim solution, whether it's using ETFs or futures, to keep the plan aligned with its investment policy.

***PS:* Are transition managers, even if only by default, finding themselves in the investment management business?**
Keleher: Yes and no. I think it's important to understand that we are not alpha generators and we don't hold ourselves out to be. That said, as Lawrence mentions, we often are looked to in situations where the plan sponsor has not yet resolved what will be done with the assets of the terminated manager or managers, and that requires an extensive understanding of derivatives and other instruments that can be used to do this. It raises the bar in terms of the intellectual capital you need to have to excel in the transition business today.

***PS:* As the transition business elevates itself, do the bricks-and-mortar aspects of the business – administration and custody– become any less important?**
Bancroft: Not in my opinion. We've recently done two transitions, both relatively complicated because of the illiquid nature of the securities being traded, and the issue that ended up concerning us the most was administration, communicating between the back offices of the outgoing and incoming managers. At Bivium Capital, we hire small, relatively undiscovered managers that often have thinly staffed back office and trading capabilities. So, communication in these transitions is really very important– they are like relay races, and the point is for you to get the baton passed from manager to manager with as little slippage as possible. We've seen some real errors take place, including one transition provider delivering a portfolio to an incoming manager that was entirely another manager's portfolio.

***PS:* As a manager, when does the performance clock start ticking?**
Bancroft: The manager, of course, would prefer performance measurement to start only when the entire portfolio is in place but, of course, the plan sponsor has to be concerned with performance regardless of the state of the transition. As a manager of managers, we fully expect the plan sponsor to rely on us to ensure that performance doesn't lag in that time – and it could be as long as a month in some asset classes before the incoming managers consider themselves properly invested in the right stocks. That's why we are so fully involved in these transitions. If our annualized excess return on assets is 350 basis points above the Russell 2000, and we lose 50 to 60 basis points against the index in the first 15 days, then you've just dug a hole from which you have to extricate yourself. The point is it is important to know that the "hole" is a likely outcome and plan sponsors have to take responsibility for the performance during the transition period based on the decisions they make.

***PS:* How do you avoid that hole?**
Bancroft: First, having a clear vision of the goal of the transition is critical. For example, in one case, the goal might be to get into the names as quickly as possible. In another, the goal might be to get into the names in an optimal matter, i.e., over time. As Mark pointed out, really understanding the transition manager you are contemplating working with is critical in properly assessing whether that transition manager will be able to execute your goals effectively. In addition, we are involved in the flow of communication between the managers being funded and the transition manager. It is also important to have an informed perspective as to the best timing of a transition. Often, managers you are funding would prefer to be given cash and slowly work into positions and, in some asset classes, that's the right answer, but this may not be in the plan sponsor's best interest. So, whenever an incoming manager tells you that you don't need a transition manager, look out. It's also worth noting that a plan sponsor really needs to ensure that, when the performance of a manager is measured, it is not including the drag of legacy investments that more properly were the problems of a previous manager.

***PS:* Do equity and fixed-income transitions present the same issues when it comes to legacy portfolios?**
Keleher: I think you can legitimately separate the two. While it is very much in a plan sponsor's interest to look to deliver specific securities to an incoming equity manager, that is not the case with fixed income. We believe that incoming bond managers need latitude to construct their own portfolios, so we tend to try to give them liquid securities that reflect the overall characteristics of the plan's fixed-income exposure.

***PS:* You've mentioned changing plan sponsor attitudes to the role of the fiduciary: Is that a function of the growing complexity of transitions?**
Keleher: Plan sponsors are increasingly aware that, with all these moving parts, there are a lot of hidden ways to make money, which some providers by the very nature of their business will look to take advantage of. When you act as fiduciary, you're precluded from doing many of those things. As a fiduciary, you're held to a very high standard, and many of the ways that broker/dealers make money out of transitions are eliminated.

***PS:* Haven't some broker/dealers declared themselves comfortable with taking on this fiduciary role?**
Keleher: It has been recognized that, in order to compete and win some transitions, you have to be able to act as a fiduciary, and some broker/dealers have set up special-purpose subsidiaries to do that – but sponsors have to be totally comfortable with the firewalls set up to do this.

***PS:* The history of transition trading doesn't lack its share of horror stories about investment banks making fortunes out of specific transitions, but hasn't the competitive nature of the business today ensured that won't happen?**
Keleher: Unfortunately, those kinds of things still occur: We have a fairly recent example in the UK in a blind bid, where a plan sponsor went out with the risk parameters of a trade and one of the investment banks reverse-engineered the trade and came up with a similar portfolio and started trading that portfolio in advance. Some of the less liquid names in the portfolio moved by between 10% and 5% before the close. In this particular instance, the trading activity was noticed by the regulators, and the investment bank had to make restitution to the client.

***PS:* Plan sponsors in the main look to consultants to understand vendors– where are consultants on the learning curve when it comes to transitions?**
Keleher: The leading consultants have quickly come up the curve on transitions, and you're starting to see both better databases and more informed due diligence. There are plan sponsors with real experience in this arena, of course, but if you don't have the expertise to evaluate transition managers yourself, you should make sure you hire a consultant who does have that expertise. There's just too much complexity to try to muddle through these choices – and, these days, the list of providers has grown to about 40.

Bancroft: I think many consultants took some time to focus on this, because it was away from what they knew best, which was asset management. Also, we have sometimes seen plan sponsors hiring transition managers just because they happened to be there at the time. In other words, they made a sales call at the right time, as opposed to being the right manager for that particular transition, or they just default the transition to the custodial bank. However, as these transitions have become more important, so too have plan sponsors and their consultants increased their focus, and these decisions are made more intelligently today than they were in the past.

***PS:* Increasingly, we see investment banks looking to get into the transition space. Why?**
Keleher: A couple of reasons. First, something close to $2 trillion a year is transitioned in the US market, and that's a huge amount of flow to be excluded from. There are lots of ways to make money off that order flow, and that opportunity comes at a time when the decline in traditional commissions has hit all these firms hard. All these firms have substantial proprietary trading efforts, and I think at least some of the push into the transition space comes from that.

***PS:* Both of you have talked about how much more complex transitions are today, not least because plan sponsors simply can't afford for any period of time to take on risk characteristics that are not anticipated. Does this mean that transition managers need much more in place in terms of analytics than in the past?**
Keleher: The business is much more intellectually challenging today and much more operationally challenging, so it is ironical that so many more firms are now claiming to be able to do it. It used to be that crossing was seen as all-important; now, it is widely recognized that crossing is just one of many components. There are investment and operational risks that need to be recognized, mapped out, implemented, examined, and then re-examined after the fact. There might be more firms trying to win this business, but I think that it can be argued that there are actually fewer in a position to execute well, and fewer still that can demonstrate no potential conflicts of interest. This is a very complex area of finance that spans the entire width of the investment process.

"Another public fund client is more expansive: 'Overall, from start to finish, Mellon did an excellent job. They identified alternative strategies and the pros and cons of each approach. They executed in line with expectations, and they worked closely with our custodian… post-trade analysis was excellent."

"Clients give Mellon high scores in this survey, particularly high in the five categories in which the firm wins its Best in Class awards."

Mellon Transition Management Services (MTMS)

"Best In Class" awards

PRE-TRADE

Availability/advice on hedging options
- Credit Suisse
- **MELLON**
- Russell
- State Street

Quality of pre-trade reporting
- Credit Suisse
- Lehman Brothers
- **MELLON**
- Russell

POST-TRADE

Quality of reporting
- CAPIS
- **MELLON**
- Russell
- State Street

ORGANIZATION & SUPPORT

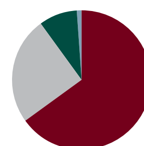
Number/experience of personnel
- Credit Suisse
- **MELLON**
- Merrill Lynch
- Russell

Interaction with manager(s) & custodian(s)
- Bank of New York
- CAPIS
- **MELLON**
- Merrill Lynch
- Northern Trust

Number of transition trades	**301–400**
Value of transition trades	**$50B–$100B**
What % of the trades were equity related, based on value?	**87%**
What % of the transition trades were crossed internally, based on value?	**7%**

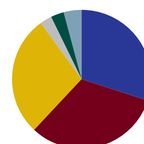
Based on value, what % of the securities in transition trades were:

N American	**65%**
European	**25%**
Asian	**9%**
Other	**1%**



Please estimate your transition management client types:

Corporate plans	**30%**
Public/Gov't plans	**32%**
Endowments/Fdtn	**28%**
Mut Fds/Inv Mgrs	**3%**
Insurance Co	**3%**
Other	**4%**



A fiduciary for transition management clients under the 40 Act? ☑ Yes ☐ No

Respondent profile
- 34 responses, representing 66 transition, worth $15.174B
- 59% of Mellon's respondents are corporate and public plan sponsors. Another 15% are endowments and foundations.

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www.mellon.com/transitionmanagementservices/index.html

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