

Transition Management: Eight guidelines for choosing a trusted provider

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Choosing a trusted transition management provider is a decision with significant financial consequences. There is no simple formula to steer this decision, but we have provided eight simple guidelines to help institutional investors improve governance of the process.

Overview: Understand the game.

Institutional investors' use of specialist transition managers has grown in recent years for two main reasons: increased attention on risk exposures when restructuring portfolios, and the need to focus on investment performance during volatile markets.

Distinguishing among providers and choosing the most appropriate transition manager remains a challenge because historical track records are not always standardised and therefore difficult to meaningfully compare. Unfortunately this allows some providers to game the results without the client's knowledge - to hide implicit costs or cherry pick composite benchmarks to the client's disadvantage.

BROKERAGE COMMISSIONS MAY NOT BE THE GREATEST COST.

One popular evaluation criterion is lowest explicit commissions. While some investors view brokerage commissions as the only cost they can control, there are potentially greater costs for the unwary. Transaction cost analysis provider Plexus Plan Sponsor Group found that explicit commissions and fees represent one of the smallest costs of a transition event. Expert testimony presented in the United States to the U.S. House Committee on Financial Services confirms this – stating that total costs of a transition are frequently ten times the commission cost.¹

Further, those who focus solely on low commission levels tend to ignore execution quality, risk management, project management and client service capabilities of the transition provider – characteristics that often determine a quality outcome.

Aside from commissions, choosing the right provider remains a subjective decision by staff and fiduciaries. The representatives of investor interest must decide which provider's value proposition is the most convincing. As surveys and press coverage has shown, selection is in no small part a question of trust.

¹ Wayne Wagner testifying before the House Committee on Financial Services, 3/12/2003
www.house.gov/financialservices/media/pdf/031203ww.pdf

EIGHT GUIDELINES FOR CHOOSING A TRUSTED TRANSITION PROVIDER.

- 1. Think and plan ahead.** Perform your due diligence up front and choose a provider before the need arises. Contract well in advance of your needs. Last minute selection and bidding decisions do not permit careful scrutiny and may even result in price-sensitive information leakage to the market.
- 2. Thoroughly understand the provider's capabilities, including their strengths and weaknesses.** Apply the same principles to a transition manager that drive investment manager selection decisions, such as: team structure and experience, philosophy, process, and performance history.
- 3. Require the same oversight required of your on-going investment managers.** Engage a provider who is obligated to act in your best interest and that acting in 'your best interest' is clearly stated in your transition contract. Educate yourself about the level of disclosure in the provider's business model, the activities of any affiliates and its sources of explicit and implicit revenue based off your event. Beware of provisions in your contract that may lessen the fiduciary responsibility of affiliates involved in the transition or that direct the provider to use affiliates or allow for principal trading.
- 4. Understand how your providers can generate revenue.** Can the provider trade securities for their own account or act as principal? Can any affiliates who may be involved in the transition act in this way? These revenues come out of assets, and may be subsidising the commission rates being quoted. There is no free lunch. If a transition provider appears to be offering a very low commission rate, there is a good chance that additional revenue is being drained from your assets in an undisclosed way.
- 5. Require disclosure about where trading happens.** Some transition managers do not operate like investment managers who typically deal through an independent network of external brokers and liquidity sources. Instead they internalise trade flow as much as possible, often to their benefit rather than the client's. In fact, low commissions are often associated with high levels of internalisation (please see side note), which can detract from performance.
- 6. Understand how trades will be priced.** This is especially important if a provider is going to act as principal or represent the other side of the trade by using an internal liquidity pool. For a cross with an index fund, the price must be the closing price of the day by regulation. But for other internal trades, no such rules are mandated and there are often strong incentives to provide a better price to one side of the trade. The impact of uncompetitive pricing on crossed trades can swamp performance.
- 7. Use discretion.** In blunt terms, be secretive. Until you have hired a partner you trust, limit the information you share with potential providers – and the outside world, if possible. The more information that gets into the market, the greater the danger of activity ahead of your transition.

Internalisation The focus on internalising trade flow is the major differentiator among providers. Transition providers have powerful incentives to internalise trade flow, such as cost savings (crossing internally rather than executing on market), commission generation and trading profits by interacting with proprietary and/or principal flows. While costs savings are certainly a positive marketing benefit, earnings reported by the major banks for commission generation and trading profits are huge and not likely to the advantage of you, the investor. Unfortunately, these profits do not materialise from thin air; they are drained from your assets. The lack of transparency and disclosure keep investors from easily protecting themselves. Without total transparency, 'proof' will always be fleeting. But this makes the dangers no less real. From unregulated internal crossing to principal trading, marketed 'cost savings' may lure in the transition client. But these revenue-generating mechanisms can drain client assets without the client's knowledge. An egregious example is the use of affiliated, off-shore broker-dealer entities. While the transition provider will market the low commissions and eliminated spread and impact costs through 'crossing' with the affiliate, the revenue potential for the provider is extreme and ultimately reduces the assets in the client's portfolio. Consider a client looking to purchase an equity that trades in the open market at \$30. The affiliate might buy the security at \$30, and immediately cross it with the transition client at \$30.25. While the reduction of several basis points of commission and spread costs feels good, the true cost diminishes the client's portfolio by an unnecessary \$0.25 per share, or 83 basis points! This revenue motive directly reduces the portfolio value, often without any knowledge by the client. Caveat emptor!

Information leakage can move prices to your disadvantage, driving up the cost of the transition. Better yet, partner with organisations that you know cannot use your information to their gain – those without any capability of principal trading for their own profit.

- 8. Demand use of the T Standard.** Excluding some activity or choosing when to begin the performance calculation are two common ways that implementation shortfall calculations are manipulated to your disadvantage. Updated in 2008², the T Standard ensures objective, complete performance reporting and will fix the start and end dates for measurement, which limits the provider from gaming measurement. Properly employed, the T Standard will capture the effects on portfolio performance from all transition activity. This consistency of reporting is critical for clients to be able to effectively compare providers and their estimates.

Be demanding.

Of late, TM has proven to be a bit of a minefield, with unseen hazards hidden below the surface. Protection from these hazards requires a clear set of demands on your part: Demand fiduciary oversight, transparent revenue reporting, understanding on the timing, location and pricing of trades, and use of the T Standard.

The transition management marketplace continues to evolve with consolidation of the banks and major financial institutions. Several long-time providers have pared back their transition teams as non-core businesses. Unfortunately, transition management still falls behind the rest of the investment industry in disclosure standards, reporting infrastructure and in-depth understanding of all aspects of the transaction marketplace on the part of plan sponsors and consultants.

The good news is that standards are taking root and the T Standard represents a significant step forward for the industry. By following the guidelines suggested above, institutional investors can better position themselves to improve transparency, manage risk and generate better performance outcomes for their stakeholders.

RELATED READING:

Murphy, Aran. (December 2008). "Introduction: Updating the T Standard". *Russell Research*.

Murphy, Aran. (December 2008). "T Standard Version 2.0". *Russell Research*.

² For further detail on the latest, industry-reviewed version of the T Standard (v. 2.0), and collateral materials, please visit www.russell.com/tstandard.

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