

# Transition Management: Choosing a trusted provider

AUGUST 2009

BY STEVE  
KIRSCHNER

Head of Transition  
Management, Americas

There is no simple formula for choosing a trusted transition management provider, but there are several guidelines to help institutional investors improve governance of the process.

## Some background

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 standardized 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.

## HOW DO SOME INSTITUTIONAL INVESTORS CHOOSE SPECIALIST TRANSITION MANAGERS?

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. Plexus' expert testimony presented 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.<sup>1</sup>

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.

## THERE'S A BETTER WAY TO CHOOSE A TRUSTED TRANSITION PROVIDER

- **Think and plan ahead.** Do 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.

<sup>1</sup> Wayne Wagner testifying before the House Committee on Financial Services, 3/12/2003  
[www.house.gov/financialservices/media/pdf/031203ww.pdf](http://www.house.gov/financialservices/media/pdf/031203ww.pdf)

- **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.
- **Require the provider to be a 1940 Act Investment Adviser/Fiduciary.** Engage a provider who is obligated to act in your best interest, rather than to perform based on suitability. 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.
- **Question providers on how they evaluate and select brokers and other market execution outlets.** Understand the criteria they use to ensure best execution. Some transition managers do not operate like investment managers, dealing through an independent network of external brokers and liquidity sources. Instead they internalize trade flow as much as possible, often to their benefit rather than the client’s. [See information on Internalization] Further, low commissions are often associated with high levels of internalization, which may detract from performance. If the commission rate seems too good to be true, buyer beware!
- **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 (using an internal liquidity pool). For a cross with an index fund, the price must be the closing price of the day by regulation. For other internal trades, however, 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.
- **Understand your provider’s revenue model.** A good place to start is monitoring where a firm generates the bulk of its profits – such as proprietary trading at investment banks or foreign exchange at custodial banks. Be realistic: the challenges and risks of large investment management and trading exercises are not taken on at “a dollar over factory invoice.” 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.

**Internalization** The focus on internalizing trade flow is a major differentiator among different providers. Transition providers have powerful incentives to internalize 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 the investor.

Unfortunately, these profits do not materialize from thin air; they are drained from 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 can be extreme and may ultimately reduce 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!

- 
- **Use discretion; be secretive.** Until you have hired a provider you trust, limit the information you share with potential providers – and the outside world if possible. Avoid tipping off the trade press. The more information that gets into the market, the greater the danger of activity ahead of your transition. Information leakage can move prices to your disadvantage, driving up the cost of the transition. Better yet, providers with organizations that you know can not use your information to their undisclosed revenue gain – those without any form of principal operation.
  - **Demand use of the T Standard** implementation shortfall for performance measurement. Recently updated<sup>2</sup>, the T Standard ensures objective, complete performance reporting, will fix the start and end dates for measurement and limits the provider from gaming measurement. Properly employed, especially when evaluating competing bidders, the T Standard will capture the effects on portfolio performance from all transition activity. When providers are told up front that the T Standard will be used to measure the outcome, they may provide a more comprehensive cost estimate than if they know they have flexibility in how they report performance after the event.

### Conclusion

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. *Introduction: Updating the T Standard*. December 2008

Murphy, Aran. *T Standard Version 2.0*. December 2008

<sup>2</sup> 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](http://www.russell.com/tstandard).

---

**For more information:**

Call Russell at **800-426-8506** or  
visit **[www.russell.com/institutional](http://www.russell.com/institutional)**

**Disclosures**

---

Russell Investment Group, a Washington USA corporation, operates through subsidiaries worldwide, including Russell Investments, and is a subsidiary of The Northwestern Mutual Life Insurance Company.

The Russell logo is a trademark and service mark of Russell Investments.

Copyright © Russell Investments 2009. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments. It is delivered on an "as is" basis without warranty.

Transition management services are offered through Russell Implementation Services Inc., member FINRA/SIPC.

First used: September 2008; revised August 2009

USI-4709