

# Interim Portfolio Management

Risk behind you, time on your side

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“I need to terminate one of my investment managers – but I don’t have a replacement lined up and it may take months to get one. What do I do?” This is a dilemma for many institutional investors.

## Between a rock and a hard place

There are times when the need arises to move assets from an existing investment manager to a new one before the new manager is chosen. Potential causes range from a manager collapse, scandal, and under-performance to an investor’s judgment that a given exposure or strategy is no longer suitable. The imperative to make a move can leave assets in limbo while a new manager is selected. Often this manager search process can take six months or longer.



Weeks.....turn into.....months

## What to do during the interim?

Institutional investors currently use several approaches to deal with assets during this interim period, including ‘do nothing’, ‘care and maintenance’, or ‘go passive’ – all of which have certain advantages and disadvantages.

But, another solution does exist. Interim Portfolio Management (IPM) combines some of the best aspects of existing solutions and few, if any, disadvantages.

This paper briefly examines existing solutions, then describes IPM – what it is, why it is an improvement on existing solutions, and finally why it can be an effective tool for institutional investors facing a difficult dilemma.

## Existing solutions

### DO NOTHING

A surprisingly common solution is to keep the legacy manager in place until a new one is ready to be funded.

#### Advantages

- Administrative ease

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### **Disadvantages**

- Concerns over governance when holding on to a manager in which confidence has been lost.
- Paying active management fees for a manager whose active management insights are no longer desired.

### **CARE AND MAINTENANCE**

The legacy manager is told to stop trading and will only manage corporate actions, proxies, and other administrative matters until the mandate is officially terminated.

### **Advantages**

- Administrative ease
- Compared to 'do nothing' it could be argued that governance is improved as no new active decisions are made by the manager in which confidence has been lost.

### **Disadvantages**

- Concerns because bets taken by the manager remain in place in this portfolio, even if the manager removes the bets from other portfolios he or she manages.
- No real active oversight over the portfolio or accountability for it.
- In many cases investors continue to pay full active management fees.

### **GO PASSIVE**

Existing assets are parked with a passive alternative. Once a new manager is ready assets are moved from the passive solution.

The client can choose between a few passive options; index funds, exchange traded funds (ETFs), and index futures.

### **Advantages**

- Existing active bets are removed, while the investor continues to receive the desired market exposure.
- Management fees are typically significantly lower than the 'do nothing' solution and likely lower than the 'care and maintenance' solution.

### **Disadvantages**

- More work than 'do nothing' and 'care and maintenance' from a client perspective.
- May not be cost effective. The trading costs incurred when investing and disinvesting can be significant.
- May not allow for client-specific considerations.

### **Interim portfolio management: All the advantages, few, if any, disadvantages**

What is IPM and how could it be implemented? Let's look at an example:

- An institutional investor has decided to terminate an active large cap U.S. equity manager and give the assets to another active manager once due diligence on several possible new managers is completed.
- Current annual tracking error of legacy manager to the Russell 1000® Index is 6%.

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- The investor agrees to use IPM and a 1% tracking error to the index during the interim period.

As soon as the legacy manager is terminated (which can occur right after the termination decision is made) Russell would undertake a quantitative analysis to determine what existing positions need to be sold, and what positions need to be purchased in order to reduce the tracking error to the target of 1%. Many times the bulk of the active risk in a portfolio can be removed by making relatively few trades, provided they are the right trades.

In practice this means selling off any large active bets the existing manager had in place and using those proceeds to diversify the portfolio. While a tracking error of 1% is low, the required turnover to achieve it is often surprisingly low.

Once the interim portfolio is in place Russell monitors and maintains it according to the guidelines agreed with the investor until the time comes to move assets to the new manager.

### **Advantages**

- Sound governance. Existing active risks are reduced, while the institutional investor continues to receive the desired market exposure.
- Typically lower management fees vs. 'do nothing' and 'care and maintenance'.
- Can be adapted to specific client needs. Cost effective. The trading costs of investing and disinvesting the IPM portfolio are likely to be lower than the corresponding trading costs for the 'go passive' solutions.
- Ability to explicitly quantify cost savings vs. the 'do nothing', 'care and maintenance', and 'go passive' solutions.
- Evergreen solution. Once in place IPM can be used for all IPM needs (not just a single appointment).
- Peace of mind. If a management walkout occurs at a manager or there is another drastic occurrence (law suit, scandal, etc.) IPM can be immediately utilized to minimize exposure to the manager.

### **A fiduciary's burden**

If a given investment allocation is no longer suitable, the imperative is to move out of that allocation as soon as is possible. If the target manager structure is not yet determined the question is what to do with the legacy assets until such structure is ready for investment.

Interim portfolio management is a powerful tool for institutional investors to use in these situations. It has the benefits of other solutions but few, if any, disadvantages. It is a solution that is sound from a fiduciary perspective, cost effective, extremely flexible, and should offer peace of mind in what can be a difficult situation.

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**For more information:**

Call Russell at **800-426-8506** or  
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