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Trustee MasterClass

Transition Management

In this edition of Trustee MasterClass we examine the importance of transition management in reducing the costs of portfolio change and managing risk.

What is transition management?

Put briefly, a transition is the restructuring of a portfolio from one strategy or allocation to another.

Examples of transition activity include:

- Change in investment manager
- Change in asset allocation
- Change in investment strategy (e.g. active to passive)
- Portfolio liquidation or investment from cash
- Change in portfolio structure (e.g. moving to a common investment fund structure)

The role of a transition manager

The transition manager takes on the burden of the reorganisation and seeks to minimise the costs and risks to the scheme. Of equal importance, the transition manager will take responsibility for planning, strategy, execution, reconciliation and accounting to ensure that the process runs smoothly. The concept is straightforward but the execution is complex and requires expertise and careful, detailed planning. Two key areas of focus for the transition manager in carrying out their role centre on the costs of portfolio change and risk management.

The Costs of Portfolio Change

Every time assets are transacted or moved between portfolios, costs can arise. Sources of transition cost will include both those that are explicit and those that are implicit, such as:

- Broker commissions
- Taxes and exchange fees
- Custodian fees
- Spreads (the difference between the bid and offer price)
- Market impact (the effect of your trade on the market price)

Cost type	Definition	Minimisation through
Direct costs	Broker commissions, stamp duty and similar direct charges.	Efficient custody structure & assessment of alternative transition strategies to reduce transactions.
Bid/offer spread	Difference between the selling price and the purchase price for investments.	Best execution, crossing (dealing at lower cost outside the market with other investors) & careful dealing of the transactions.
Market impact	The extent to which buying or selling large volumes moves the price against the buyer or seller, i.e. upward when buying and downward when selling.	Confidentiality, crossing & sophisticated dealing techniques.
Opportunity cost	The relative movement in prices which occurs whilst a restructure is being implemented.	Use of hedging instruments and/or careful scheduling of transactions to control market exposure.

Risk Management

The process of portfolio change can also generate significant additional risks that must be managed, these can be broadly categorised as:

- Exposure risk – differential performance arising from being exposed to the incorrect asset class or unwanted cash exposure.
- Execution risk – associated with transacting in the market, for example, through information leakage or counterparty risk.
- Operational risk – resulting from settlement and portfolio set-up at each manager/custodian due to portfolio change and volume of movements.
- Process risk – arising from lack of a clearly defined project management process and accountability.

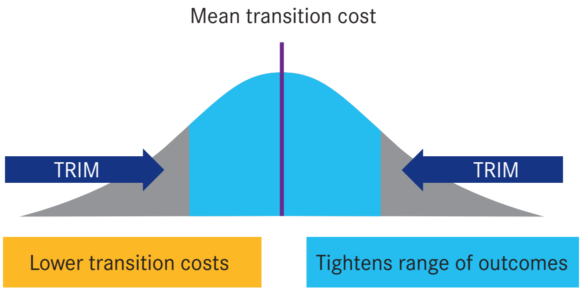
By using the services of a transition manager, asset owners can effectively outsource the control of these risks and associated costs to a single party able to provide a comprehensive value-added service and peace of mind.

This not only gives clients the benefit of significant experience in the trading of multiple asset classes, but also access to specialist expertise in risk management, project management and operational change. An experienced transition manager will also provide the accountability of detailed pre- and post-trade analytics and responsibility for cost control without the need for any 'performance holidays'.

Efficient management of the transition process can reduce both the expected mean transaction cost of the reorganisation and through risk management, the potential range of performance outcomes.

Measuring the success of a transition

The overall success of a transition should be assessed in two ways.



First it is necessary to consider financial performance. The generally accepted measure for this purpose is implementation shortfall, often referred to as the T-Standard, which compares the value of the portfolio at completion with the value that would have been achieved had the transition been implemented instantaneously and at no cost at the outset. Whilst an instantaneous reorganisation is not a practical alternative, the measure is nevertheless important as it captures all explicit and implicit costs incurred in the restructure.

Secondly, it should be remembered that transition management is more than just a trading exercise. The effectiveness of the operational process, the degree of client support and the satisfaction of all the stakeholders are equally important as the performance outcome.

Through this a skilled transition manager adds value by reducing many of the concerns associated with asset restructuring.

Conclusion

A transition manager works to help solve and mitigate the risks, costs and disruptions in doing so the manager builds and maintains a close dialogue with their client.

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