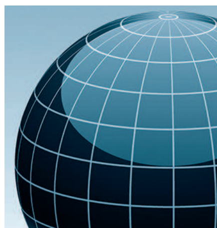
UNDERSTANDING DEVELOPMENTS IN TRANSITION MANAGEMENT

Dispelling the New Top Five Myths



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Transition managers aim to preserve fund value by minimizing trading costs and managing market volatility while seamlessly implementing events. Yet the realities of the industry can be more complex. In 2006, Northern Trust published an article describing the *Top Five Myths of Transition Management* prevalent at the time:

1. The lower the commission rate, the better the trade.
2. The higher the internal crossing rate, the lower the implementation shortfall result.
3. There is a 50/50 chance that opportunity cost will be either positive or negative.
4. Broker-dealers have a technological edge over other transition manager models.
5. A fiduciary is not worth the premium.

While the above myths are now largely understood, new myths have appeared. In this changing landscape, it remains important for clients to separate fact from myth when selecting a transition manager.

Myth #1. All "fiduciary" transition managers provide the same level of protection.

The biggest change since the *2006 Myths* were published is the increase in client demand for a transition manager to act as a fiduciary. A "fiduciary" transition manager acts in the best interests of the client and provides transparency of the revenue earned on a transition assignment. However, the transition manager's use of affiliated or third party brokers may impact the scope of its fiduciary status over aspects of the transition process.

Some "fiduciary" transition managers outsource 100% of their trades to third-party broker-dealers. Although the transition manager remains a fiduciary, the executing broker does not have direct fiduciary obligations to the client. The transition manager's contractual obligations may limit its fiduciary role with respect to the third party broker-dealers trades. A potential conflict of interest could occur if the broker-dealer is serving two clients at the same time – the transition management client and a client on the other side of the trade-in connection with a cross trade.

A slight variation of the above model is a situation where a transition manager, acting in a fiduciary capacity, directs trades to its capital markets desk, which operates as a broker-dealer. If the transition manager and the broker dealer do not have adequate policies and procedures to prevent the misuse of client information, the broker-dealer's trading desk may send out indications of interest to hedge funds and other smart money traders in order to profit from the other side of the trade. Although the transition manager remains a fiduciary, the trading desk has no fiduciary obligation to the transition management client. While it has a duty of best execution in executing the client's trades, it can also act in a manner that is not fully in the transition management client's best interests.

It is important for clients to understand how, where, and with whom, the transition manager trades in order to guard against information leakage and to ensure their interests are aligned with those of the client.

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Myth #2. Transacting with securities for commingled fund trades is more cost effective than transacting in cash.

Clients can withdraw from or contribute to commingled funds in cash or with securities (in-kind). Transacting in cash has historically been considered more expensive since the client generally incurs 100% of the liquidation costs, has no opportunity to use securities to help build the target portfolio, and potentially leaves the client out of the market unless temporary exposure is purchased. However, transacting in-kind can also result in additional costs, especially for global funds due to asset transfer costs and taxes owed if the transaction is considered a change in beneficial ownership (CBO). CBO taxes can be as high as 50 basis points of the market value transacted, depending upon the country. Also, legal costs might be incurred when seeking counsel on how best to avoid or minimize these taxes or when applying for exemption in eligible markets. In addition, substantial penalties of up to 150 basis points could result if the transaction taxes are declared incorrectly and/or without the proper documentation.

To determine the most optimal solution, the transition manager should contact the fund company during the planning stage of a transition event to determine the viability of an in-kind transaction. If an in-kind transaction is permitted, the transition manager then needs to perform a cost-benefit analysis to determine whether the costs incurred to transact in-kind are less than transacting in cash. Without this important step, clients could end up paying hundreds of thousands of dollars in additional costs with no potential offsetting savings in reduced trading costs.

Myth #3. Some transition managers have better access to fixed income liquidity than others.

The fixed income market is opaque. There is no central exchange to view prices in real time so prices are determined through an over-the-counter negotiation process. However, over the past several years, there have been significant investments made in developing fixed income trading platforms that allow institutional investors to meet and obtain optimal pricing. Investment managers and transition managers pay a fee to use these platforms and access liquidity.

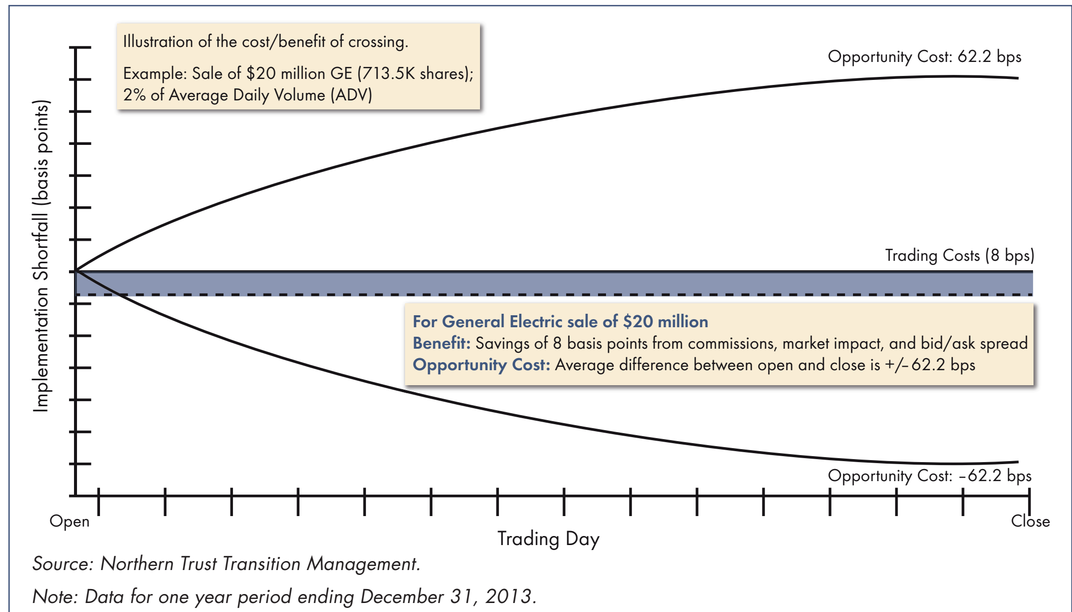
Today, saying that a transition manager has access to unique fixed income liquidity is equivalent to saying that an equity trader has an advantage because he or she can trade on the New York Stock Exchange. While it is important for clients to understand a transition manager's source of fixed income liquidity, it is also important to separate fact from myth when evaluating the uniqueness of their liquidity sources.

Myth #4. The higher the crossing rate with other transition clients, the lower the trading costs.

Since the *2006 Myths* were published, clients have recognized the risks inherent in internal crossing. The Department of Labor (DOL) permits internal crossing only if the trades are executed at the market close, which provides an objective and clearly observable price. Although the client avoids bid/ask spread and market impact costs by using internal crossing, they can incur up to a full day of risk – termed "opportunity cost" – that prices might move against them, see chart on next page.

Since opportunity cost generally exceeds the savings realized from internal crossing, some transition managers began advocating crossing with other transition management client flow. The perceived benefit is that trading would be executed earlier in the day to reduce opportunity cost and that clients would continue to incur zero trading costs. However, there is no objective benchmark to measure best execution. While one client could receive an advantageous price, the client

OPPORTUNITY COSTS OF SINGLE STOCK SALE



Source: Northern Trust Transition Management.

Note: Data for one year period ending December 31, 2013.

on the other side of the trade could claim a disadvantageous price. The same safeguards that are in place to provide an objective, end-of-day internal crossing price are not in place for trades that are crossed intraday between transition management clients.

While it is important for clients to select providers that seek to minimize trading costs, the transition manager must avoid using liquidity sources whose execution price could be called into question. In addition, a successful transition does not start with selecting liquidity sources and then developing trade strategy. Rather, a successful transition starts with understanding the risk exposures and liquidity constraints in the portfolios and then choosing the appropriate liquidity sources that will minimize the overall costs to implement the event.

Myth #5. Volume Weighted Average Price (VWAP) is an acceptable performance measurement.

Volume Weighted Average Price (VWAP) represents the average execution price weighted by trade size throughout a trading day. The main advantage of VWAP is its simplicity – an execution price that beats VWAP indicates that the security was traded at better than the average weighted daily price whereas a price worse than VWAP indicates the opposite. The shortcoming of using VWAP as a performance benchmark in transition management includes:

- **VWAP doesn't measure opportunity cost.** Executing versus VWAP is a passive trading strategy which forces the trader to participate in-line with market volumes in order to match the average price of the day. However, if a stock is moving against the trader, the pace of execution will remain unchanged. For example, assume that a stock was sold over one day at an average execution price of $14.25 versus a VWAP price of $14.24. At the outset, trade execution looks very good against the VWAP at one cent per share better. However, if it was revealed that the stock opened at $18.00 and closed at $13.00 per share, the quality of execution would be called into question as the delay in trading clearly adversely impacted the real performance of the trade.

- **VWAP doesn't measure market impact cost.** Trades that represent a large percentage of daily volume have a greater influence on the VWAP. For example, if a trader is the only seller of a stock on a particular day, the execution price would equal the VWAP price, incorrectly implying no impact costs. Traders can also influence VWAP by increasing the pace of their trading to a point where their execution looks better than the impact they caused. Such techniques can more easily be done with large orders or low liquidity stocks.
- **VWAP is ill-equipped to measure the success of a two-sided trade.** The potential opportunity cost due to tracking error between the legacy and target portfolios is generally the largest cost of a transition event. A trader using VWAP strategy is limited in his or her ability to manage this risk and reduce potential lost opportunity resulting from adverse price movements. Proactive trading, as opposed to passive VWAP trading, is needed to manage risk and preserve fund value.

The chosen method of performance in the transition management industry is the use of "implementation shortfall" to measure the performance of a trade. Implementation shortfall measures the difference in return between the transition account and target portfolio, assuming a costless transfer. Implementation shortfall remains the industry standard because it captures all costs that are incurred in transition between the legacy and target portfolios, including commissions, market impact, bid/ask spread, currency spread and opportunity cost.

SUMMARY

For many clients, transition management has become an integral part of their investment management process and a fundamental governance policy. As such, it is important for clients to separate fact from myth when selecting a transition manager.

TO LEARN MORE

If you would like to learn more about Northern Trust's transition management services, please contact us at 312-557-5173, or by e-mail at nttm@ntrs.com.

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