

Managing the Transition to an Outsourced Investment Platform



Following a decade of what seemed to be perpetual crisis, the pension market is in the midst of agonizing soul searching. There is a renewed urgency for re-examining risk management and adopting innovative investment solutions. Central to this initiative has been the evolution of the “outsourced investment platform” or “Fiduciary Management” as the approach is commonly called in Europe. As plan sponsors carefully weigh the benefits such a decision could have for plan participants, they must also consider the importance of the initial transition to the platform, and the cost and risk to plan assets that it may involve.

Trustees who have already come to the conclusion that the ongoing management of investments and related risk monitoring is a task best outsourced, can also extend this reasoning to the management of the initial transition to this type of investment model.

The dedicated transition manager (TM) specializes in offering these capabilities, and by using a TM, the plan sponsor realizes a myriad of benefits: operational coordination, risk minimization, cost control, clear delegation of roles, and performance accountability.

Operational coordination

A TM’s specific competency is the consolidation of skills:

- The back-office proficiency of a custodian
- The risk analysis of a consultant
- The trading expertise of a broker
- The investment acumen of an asset manager

These skills must be applied in a repeatable process to bring many moving parts in synchronous tandem towards a singular goal.

The many moving parts in a large scale transition would be a drain upon the resources of the client investment staff, the outsourcing manager’s staff, and the custodial servicing staff. It is a time consuming process to ensure cash flows and liquidations are coordinated. It requires experience in the trading and settlement of the major asset classes and types of securities within each of the individual countries.

A TM assumes a variety of tasks to facilitate a smooth transfer:

Before...	...During...	...After...	
Investment Committee	Transition Manager: <i>Central communication Performance measurement Trade strategy recommendations</i>	Investment Committee	
Investment Staff			
Custodian			
Consultant		<i>Account coordination Settlement and error resolution</i>	Fiduciary Manager
Administrator			
Actuary			
Managers: Passive Equity 1 Passive Equity 2 Active Equity 1 Active Equity 2 Int'l Equity 1 Int'l Equity 2 Int'l Equity 3 Passive Fixed 1 Active Fixed 1 Active Fixed 2	<i>Identifying in-kind transfers Maximizing crossing efficiencies Direct market trading OTC broker trades Exposure management through overlays Coordination of fund redemptions, openings, and contributions Solutions around illiquidity</i>	Investments: Fund-of-fund 1 Fund-of-fund 2 Fund-of-fund 3	

- Transitions require a unique capability for fundamental trading expertise coupled by a rigorous, project management framework.
- Transitions require the necessary knowledge and resources to manage the complex movements of hundred, if not thousands, of securities in diverse portfolios across several asset classes between multiples of investment managers and custodians.
- Transitions must be accomplished in a relatively short amount of time.

While a custodian may indeed have some of the necessary characteristics, they would not likely have the complete integration of process checklists, analytical tools, and experienced trading strategies, coupled to a team structure specifically designed to handle the communication of trade, operational and strategic details with all of the other participants. Yet this is critical to ensure that goals are met while errors are detected and escalated properly. The supervision over operational risk is a capability borne by experience, not to be entrusted to any party where it is not a core function.

Risk minimization

Besides the exposure to operational risks (which tend to be more qualitative in nature), the investment-related risks are a web of interrelated correlations requiring a well thought out strategy, in addition to the aforementioned capability for practical, tactical trade execution. This investment risk encompasses two phases, the pre-trade strategy, and the course-of-trading strategy.

With only modest hyperbole, the determination of the optimal path from legacy to target portfolio can be compared to rocket science, where several paths of least resistance are identified, their trajectories calculated and compared, so as to arrive at a proposed optimal path, where advantages are clear and pitfalls known in advance. To launch a rocket, the

modeling of gravity, resistance, fuel, and weather requires massive computational power with robust access to real-time data. Similarly in a transition, multiple models of spread levels and market impact calculations must be used against historical and forward looking data with due considerations for the existing market environment, with sensitivities closely aligned to the potential trade execution methods, in a manner that can be employed equally for each individual security.

Maximization of in-kind opportunities is the first step, as these incur no market impact or opportunity costs. Yet operational considerations can have significant effect even at this stage, particularly in international securities where ownership transfers rules and custodial fees vary widely. Crossing opportunities must be carefully analyzed against the metrics of market impact (price increases due to large orders) and opportunity risk (adverse price movement costs of delaying transactions) as unintended costs can accumulate.

There are significant risks associated with un-invested cash during a transition. Missing the market's best days can significantly erode an investor's total returns. As such, market timing is not part of a sensible transition strategy — the crux of the strategy is to implement a seamless switch to the new allocations.

Time is of the essence in a transition — implementing a new desired asset allocation should be accomplished quickly and efficiently (i.e. less costly). A TM specializes in designing and implementing strategies that support that goal. In such a large scale exercise, there would necessarily be some exposure differences between the old and new portfolios, mismatches between the legacy asset allocation and the outsourced manager's target fund solution. In these situations, overlay strategies can play a significant role, where a wide range of instruments can maintain intended market exposures.

Again, this brings us back to the concept of core competency. Whereas the typical focus of the active asset manager is generating alpha over a longer horizon, the TM's expertise is highly focused on managing the short term beta risks associated with the metamorphosis to a new investment portfolio.

Cost control

One common myth to dispel is that there is an additional cost to hiring a TM. In fact, the TM's sole task is to preserve asset values against unnecessary costs while minimizing the overall risk of the exercise. The TM's fee tends to be less than one quarter of the total cost borne by the assets in transition, and an even lesser fraction when compared to the costs borne in an unmanaged transition.

The largest cost components of restructuring, spread costs from the market impact of institutional transactions and the performance difference between the portfolios, are the cost components that are significantly reduced by utilizing a TM, as the application of algorithmic trading strategies and multi-venue execution methods locates the most advantageous pricing opportunities and minimizes the performance differences between the portfolios. While commissions are typically the primary source of revenue for any provider conducting trading, the large volume of related trading and focus on this particular service by TMs creates economies of scale.

Commissions can thus potentially be significantly less than those normally charged through conventional brokerage, and highly transparent when compared against the costs incurred during the unmanaged transition.

Another myth to dispel is that crossing rates are the foremost determinant of lower costs in a transition; in fact, crosses create potential opportunity costs that can quickly accumulate if unmanaged in an overall portfolio context. This is yet another aspect of how the TM's creation of a sensible execution strategy can reduce the costs resultant from in-transition performance differences in the old and new portfolios.

Clear delegation of roles

Another aspect benefitting the Plan Sponsor when using a dedicated TM is with regard to the contentious topic of delegation. In the move to a fiduciary management platform, delegation of authority is a difficult series of decisions, where committees must make choices around, how much to give up, and how much to retain control over. This has led to several different levels of offerings by the Fiduciary Managers to match the interest and abilities of their clients.

The TM however takes a role of central responsibility during the course of the entire transition, acting as the single delegate of authority to manage the course of the event.

Performance accountability

Finally, for the cost-conscious Plan Sponsor, no greater reason exists to hire a specialist TM than the accountability for performance.

Were a Custodian or investment manager to conduct the transition, they may seek to minimize costs, but their primary concern will be limited to their own area of responsibility, either by the careful accounting and movement of assets in the case of custodians, or in regards to the performance of their own portfolios in the case of asset managers. The passing along of costs is of little concern to the legacy manager and an unfortunate matter of consequence for the target managers.

The TM places this accountability for the entire performance of the interim portfolio at the forefront, managing explicit costs and minimizing implicit costs. They provide the Plan Sponsor detailed reporting and attribution to answer the questions of, "What did it cost," and more importantly, "Why did it cost that."

Summary: The Role of the TM

When discussing the move to a fiduciary model, the interested parties are generally comprised of Fiduciary Managers, Consultants, Pension Board Members, Trustees, Asset Managers, local authorities and other institutional investors. One other party that closely fits the mindset of the fiduciary management decision is the dedicated Transition Manager.

TABLE

Delegation of Authority	Without a TM				With a Dedicated TM
	Pension Staff	Outsourced Manager	Custodian	Broker/Trader	
Developing the funding and settlement timeline			✓	✓	✓
Risk-based analysis of Target and Legacy Asset Lists		✓			✓
Coordination around the authorization and documentation between all parties	✓				✓
Hedge/overlay management to manage exposure mismatch and avoid cash drag				✓	✓
Conducting and executing trades				✓	✓
Reconciliation and Settlement			✓		✓
Cost & Performance accountability		✓			✓
Oversight over the Entire Transition Process	✓	✓			✓

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Just as the Fiduciary Manager is retained to provide an outsourced function for the ongoing management of plan assets, the TM is retained to outsource the function of the most efficient movement of plan assets. Such a service is simply not the core competence of the Fiduciary Manager or any of the other above-mentioned parties.

TMs manage overlays, minimize out of market risks, and closely align the targeted performance to the actual performance, in a time-sensitive manner. Their task is that of an independent, best execution manager, which alleviates the time-related burden of strategic planning, operational follow-through and thoughtful execution that would otherwise be ultimately borne by the investment committee and staff (which again, is not their core competency). The critical role they perform is the integration of determining the optimal exit strategy from each vehicle in a manner which allows for the precise movement and settlement of assets, while working in tandem with portfolio management staff to address the investment exposures during the period when those mechanical processes are in action.

A well thought out trade strategy with clear communication between all parties is the key to any transition, and magnified in a transition of the size and complexity typical of a move to a Fiduciary Manager platform.

In a period of great change, the Transition Manager becomes the central office of responsibility — coordinated and dedicated to putting the interest of the plan and its beneficiaries first.

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