

IN PRAISE OF TRANSITION

*Controlling risks can lead to cost control
during portfolio transitions.*



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ALTHOUGH PHILOSOPHIES ON TRANSITION MANAGEMENT HAVE CHANGED, THE ULTIMATE GOAL IS TO REDUCE THE COST TO THE CLIENT

Transition management has become an industry buzzword as the high cost of switching managers draws increased attention. Experience demonstrates that costs lie not only in such factors as bid/offer spreads and commissions, but also with the market impact associated in trading institutional-sized positions, opportunity costs caused by random market fluctuations and the more mundane operational problems and settlement penalties. Typical estimates of the total costs of transitioning between managers range from 100 to 200 basis points—certainly a staggering amount in an environment when expected returns are around 8% per annum.

Beyond the large cost of transitioning portfolios, the process remains problematic. Communication between the client, investment managers, and custodians is necessary to ensure all assets that can be transferred in specie or in kind actually are. Moreover, purchases and sales should be coordinated to ensure the portfolio is neither under- nor over-invested, and that no corporate actions are missed that result in an over-bought or over-sold position.

Clearly, switching investment managers is an expensive, complex proposition. This is where professional transition managers enter. Although philosophies on transition management have changed, the ultimate goal is to reduce the cost to the client.

The first step is to identify each player's operational role: the transition manager coordinates, the client authorizes and instructs; the custodian opens accounts, certifies assets, and helps settle the trades; and the investment manager identifies the shape and risk characteristics of the

new portfolio. The issue of accountability is a real one—a missed wire deadline, incorrect settlement instructions, or incorrect portfolio lists can all spell disaster.

Once a transition manager identifies the operational issues, they must undertake a rigorous liquidity study of the legacy and target portfolios. The transition manager must also consider the specific factors causing the residual risk between the legacy and target portfolios (residual risk, in this instance, is a measure of the potential opportunity cost of holding the old portfolio rather than the target portfolio).

A trading strategy is developed after considering the trade-off between liquidity and the risk of holding (or not holding) a security in terms of potential opportunity cost.

Often the strategy will use futures or forwards to hedge a macro-asset allocation decision, then focus on the optimal trade sequence in which to trade securities or sectors. This trade sequencing is critical, as it enables the transition manager to mitigate the residual risk between the legacy and target portfolios using liquid securities, thereby reducing the urgency that illiquid securities with potential market impact problems must be traded, reducing the total cost of trading.

A good transition manager will do all of this simultaneously—all while searching for liquidity, accepting and rejecting trades based on an appraisal of market impact versus risk contribution on a total portfolio basis to keep the operational issues and processes under tight control.

Transitioning assets will always have costs. It is also critical to understand the potential risks of a transition—risks that, if uncontrolled, could wipe out a diligent investment manager's year-to-date alpha. Once these points are understood, and a plan is developed to control transition risks and minimize trading costs, it is easy to see how risk control can lead to cost control. ■