Talking Transitions *with* Penserra

SERIES 2 | ARTICLE XII

A Guide to Examining Pre- and Post-Trade Analysis

While plan sponsors expect differences from one transition provider to another, the assumptions for pre- and post-transition trades should be consistent across proposals.

For this reason, it would be prudent for plan sponsors to clarify business models, assumptions, and terminology to ensure comparisons are made on an "apples to apples" basis.

The purpose of this guide is to provide topics for discussion and offer key considerations for transition manager evaluation, especially during the time of submitting a bid. Many of the questions raised here are based on practical experience by experts in the field.

▶ Pre-Trade Analysis

Portfolio Risk Models — What is the active risk estimate between the legacy and target portfolios?

Most factor models should be relatively close in their estimate of the annual estimated differences in return between two portfolios (legacy and target). Any significant difference between proposals likely highlights a manipulation of portfolios. There can be differences in how the annual risk numbers are 'de-annualized' to measure risk during the trading horizon, but it is a good practice to make sure proposals start from a similar risk analysis.

Portfolio Risk Models — Does the risk analysis consider both short term and long term models?

Risk models were originally developed for portfolio managers with long time horizons. Defaults for many factor models are to use at least one year's worth of data to estimate risk. An argument can be made that the best estimate of volatility for tomorrow (transition trade date) is a function of what happened over the last 10 days as opposed to the last 250 days. It is important to understand recent volatility trends and have a thoughtful approach to what risk model (and how much historical data) you use to estimate active risk. Annual risk estimates are then 'de-annualized' to estimate the risk over a specific transition event horizon.

Trading Assumptions — Explain the crossing estimate and how it is determined.

Shares crossed are an important component of any estimate of trading costs. The primary reason is that spread and impact model estimates are generally only applied to shares traded in the open market. If you assume a 40% cross rate, all else being equal, spread and impact estimates will be 50% higher than from a similar proposal that assumes 60% crossing. Crossing can be a tool to manipulate cost estimates.

Trading Assumptions — What is included in the estimates of crossing opportunities (internal, external and fund level)?

There are significant differences between internal, external and fund level crossings –it is important to understand what type of crossing is anticipated and the implications for cost and risk estimates.

For this reason, it would be prudent for plan sponsors to clarify business models, assumptions, and terminology such that comparisons are made on an "apples to apples" basis.

- Internal Cross -Department of Labor (DOL) governed crosses can be significantly different than other forms of internal crossing. Some types of internal crossing can result in less favorable outcomes for the client including increased opportunity cost. How internal crosses are classified and reported should be clearly explained including details on how crossing prices are set, by whom and why specific crossing tools will benefit the transition and not pose a conflict of interest.

- External Cross -These are technically market trades. Flow is executed through specific crossing venues and executed at the midpoint or better price. Accurate estimates of expected crossing volumes directly impact the quality of trading cost estimates.

- Fund Cross - A less common form of crossing. When fund level crosses are executed, the same benchmark reporting challenges are present as compared to a security level internal cross.

It is important to understand the how, why, and where of crossing and the sensitivity of cost estimates to those crossing estimates. The follow-up is to determine if actual crossing was well reflected in pre-trade estimates.

Trading Styles — How was the trading 'aggressiveness' addressed in creating the estimate of spread and impact costs?

Most transaction cost models allow an adjustment to the 'level of aggressiveness' when estimating implicit spread and impact trading costs. Less aggressive scenarios lead to lower trading cost estimates –the least aggressive scenario estimates can often be more than 50% lower than most aggressive scenario estimates when all other variables are held constant. It is important to note that the least aggressive trading strategy may win more business but may not be the most realistic estimate of actual trading cost.

Trading Styles — What liquidity guidelines are used to estimate the trade horizon?

Related to levels of aggressiveness in trading, trade horizon is a function of how aggressively you approach trading. There should be consistency in a transition strategy between spread and impact estimates and trade horizon –it is extremely difficult to achieve both low end trading cost estimates and shorter trading periods.

Trading Styles — Does the trade strategy include market on close (MOC) elements?

MOC orders can make sense as part of an exposure management strategy but can also be used to lower estimates of both trading cost and risk. Some make the assumption that any shares that trade MOC incur neither spread and impact nor active risk when that is not necessarily the case. This is particularly relevant if a provider submits a bid that is framed as T Standard compliant.

Trading Styles — How are abnormal, but expected occurrences such as corporate actions, earnings announcements, macro events, etc. addressed into the strategy?

Attention to detail on specific names that may experience out of pattern volatility is important to managing outlier risk. Many events can lead to abnormal volatility and so, as part of managing a transition, it is important to understand how transition providers will address these matters, and the results that can occur.

Performance — Does the analysis adhere to T Standard reporting?

The T Standard is a code of best practices for transition managers. As the transition management industry developed, it was determined that more transparency was needed. As a result, the T Standard was developed to clearly define performance measurement standards and to manage conflicts of interest. It should be noted that there are instances where deviation from T Standard guidelines can compliance is important to the customer, there should be discussions about strategy and the rationale for non-compliant activity. Disclosure regarding the impact of non-T Standard practices on shortfall reporting should be part of that review.

Note: Inherent in conducting a pre-trade analysis is the incentive to create a bid that will optimize on both low cost and low risk. This creates a challenge when an analysis is not based on actual but instead on simulated portfolios. By definition when optimizing, portfolios will be simulated to fit least cost criteria by each prospective manager. This allows greater flexibility to create simulated trades that will show lower costs. In reality, the actual portfolios are often significantly different and as a result, pre-trade estimates may vary dramatically not only between providers but also when compared to costs for actual portfolios eventually traded.

Post-Trade Analysis

Performance — Was the transition strategy discussed in terms of components that are not T Standard compliant?

The T Standard is industry accepted convention in terms of the best methodology for measuring transition performance with an unfettered benchmark. Issues like trading MOC at the benchmark close, including trading currency on T-1, are outside the boundaries of what is considered a T Standard compliant strategy. While there are good reasons for considering T-1 trading strategies, such as focusing on exposure (risk) management, a potential conflict with the strict performance reporting guidelines of T Standard may arise. Non-T Standard strategies can also make trades appear cheaper with lower risk. Again, there is value to understanding the trade-offs between risk management and performance reporting when non-T Standard compliant strategies are used.

Performance Transparency — Is the transition manager willing to submit actual post-transition information to a third-party Transition Cost Analysis (TCA) provider?

As good governance for all transitions events, plan sponsors should consider having a TCA provider assess the results of the transition manager. For a reasonable fee (normally covered by the transition manager), plan sponsors can receive an independent review of how effective the transition manager was in managing the trade.

Cost Transparency — Does the post-trade clearly compare actual results with pre-trade estimates both in terms of shortfall versus trading estimates and shortfall relative to the estimated one standard deviation risk range?

One of the measures of effective transition management is the ability to consistently deliver on the performance detailed in the pre-trade. In an environment where cheaper often wins a transition mandate, transition managers should be held accountable to deliver as promised over time. Any deviations from what was estimated in the pre-trade vs. post-trade (what actually happened) should be attributed and explained in detail.

Revenue Transparency — Will the transition manager attest in writing to sources of transition generated revenue for both themselves and affiliates?

There is a history in the financial industry of counterparties finding creative ways to make a profit. Those sources of profit can be difficult for one outside the process to discern –some of those sources include un-disclosed mark-up or mark-downs on trades, payment on the other side of cross trades, principal currency trades by affiliate entities, and rebates from trading venues for order flow. One way to clarify expectations is to require a legally binding attestation as to all sources of revenue by transition providers.

Project Management — How was the overall transition managed?

While this guide is focused on the quantitative aspects of a transition, plan sponsors should not neglect their overall experience with their transition events. This would include the coordination and communication provided by the transition manager throughout the process, as well as how accurate the transition plan/timeline proved to be. In the end, the various moving parts should be clearly identified and managed by the transition manager to ensure the transition is executed in line with client expectations.

Turn to Penserra to deliver the investment, trading, and operational expertise you require for a seamless transition.

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