Talking Transitions *with* Penserra

SERIES 2 | ARTICLE X

Leaving a Manager? Let a Transition Manager Bridge the Gap

[*Note: This is a previous write-up updated to reflect current market conditions*.]

A considerable amount of time, money and effort is usually spent during the selection process of a new investment manager, yet not nearly enough resources are committed to when it is time to terminate one. In fact, it is not uncommon for terminations to take place at a moment's notice with little done in the way of an established plan to transition the investment into a suitable alternative.

Flight to Passive

Of all investment themes in play right now, the most publicized is the ongoing move from active to passive management. While the trend is nothing new, there does seem to be a shift in how quickly asset owners are to remove a manager either on "watch" or who is simply mediocre and yet continues to charge higher fees. The decision for an abrupt firing becomes easier when the under-performing manager also shows signs of rapid asset losses, makes sudden investment team/leadership changes or announces plans to shutter its business.

But once a manager has been fired, what then? What happens to the terminated investment portfolio? Who assumes managing underlying assets until the plan sponsor decides on its deployment?

As part of their fiduciary responsibility to plan assets, it is up to plan sponsors to have a prudent process in place that carefully identifies and evaluates all options prior to a termination. This should include partnering with specialists like transition managers who can offer various short- to mid-term exit strategy solutions with notable cost reduction and risk management benefits. These solutions can be applied whether the end goal is to raise cash or reallocate the investment to another manager.

▶ Getting out in cash

Often considered as the "easy" way out, clients will simply direct a terminated manager to liquidate the current investment in to cash and either leave the proceeds in the account or have it delivered to them. While this strategy can be a modestly time-saving and relatively hassle-free way of moving on, it can also be costly as the underlying investment exposure may be sub-optimally managed towards the end of the relationship.

Terminated Managers may:

Unload the portfolio quickly

Creating undue adverse impact (that is, the prices of securities falling precipitously) in the market and inevitably reduce the net proceeds raised. While the manager is still considered to "act" as a fiduciary, interests may not be aligned with little incentive to 'maximize' cost savings for the plan.

Not have the information

To line up the liquidation of the terminated investment (security sells) to match up with intended target investment (security buys). This leaves clients vulnerable to out-of-market exposure, or exposure risk, as an investment shifts from one manager to another. From a performance standpoint, risk can be significant if markets trade higher during the period.

Depending on the extent of the outflows relative to the overall strategy size, the approach a terminated manager takes to quickly unload assets in the marketplace may end up being the same regardless of the number or size of loss mandates. By having the manager employ a combined sell program, with no regards to impartiality or consideration of the relative risk profiles, the overall cost of trading could be borne equally across all involved plan assets as they compete for liquidity and best available price with the same assets. For this very reason, cashing out at the same time as those plans with a larger percentage ownership of the strategy may not be advantageous for all plan sponsors.

A transition manager is often fully capable of executing the liquidation themselves—acting as a 'temporary' investment manager for a client.

By consulting with a transition manager, the areas of risk and costs surrounding the liquidation can be identified and a cost-effective solution devised to fit the clients' specific needs. Utilizing their cost models and risk datasets, a transition manager can create a quantitative framework to show the trade-off between slow, lower-cost, higher-risk strategies and fast, higher-cost, lower-risk strategies. From there, an informed tactical recommendation can be made regarding how, when, and where to trade with capital preservation in mind.

▶ Interim Management

For clients needing someone to temporarily manage terminated portfolios until a new 'like' manager is found, a transition manager can offer an exposure based solution incorporating some or all of the current terminated portfolio holdings.

The thought behind this solution is to minimize the cost of moving into an eventual target while also managing risk relative to a benchmark. To create an interim solution, the legacy portfolio is evaluated versus a given benchmark. The current tracking error is measured as well as the cost to fully transition from the current legacy portfolio into the benchmark. These two data points become the end points to form a range of possible solutions. One extreme is a zero-cost solution where the client bears the full risk of tracking error with the existing portfolio to the benchmark. The other end of the spectrum is a low-risk solution of holding the benchmark but bearing all the trading costs associated with transitioning into that benchmark. With those end points, a transition manager can create multiple solutions along that continuum allowing the client to choose the most appropriate combination of cost to trade and risk to the benchmark.

In discussions with clients, the appropriate target portfolio solution is determined based on preferences in the trade-off between costs of trading and risk versus the benchmark (the same systematic approach as discussed in the previous section). The transition manager is able to create and hold that target portfolio for a negotiated period of time. Depending upon the duration of the mandate, reports are provided on a monthly basis evaluating the ongoing active risk relative to the benchmark allowing for a periodic rebalance of holdings to a target risk level. This solution allows clients the time to make a more informed decision on whom to hire while also preserving the cost savings of potential in-kinds in the event the physical assets are going to a target manager within the same asset class.

▶ Conclusion

The advantages of using a transition manager are the same as when they are hired for manager rebalances and/or asset allocation shifts for a plan—to efficiently 'bridge the gap' with an expert and remove any undue risk. The ability to assess and manage various investment and trading risks, reduce any related transaction costs, execute the necessary trades and report on performance during a period of uncertainty can be an appealing proposition to a plan sponsor seeking to put in place a termination protocol. All this by teaming up with a provider who has the best interest of the plan assets.

Note: Certain sections have either been paraphrased or taken as excerpts from previously written Penserra articles.

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

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