Transition Management Background and Fundamentals

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Purpose of this Presentation

- To discuss the development of transition management over the last 15+ years
- To introduce a proven process
- To illustrate how professional transition management services add value
- To discuss transition management's key points

Defining Transition Management

- Transition management is the process of managing the movements of portfolio assets due to changes in:
  - investment manager(s);
  - asset allocation;
  - investment style; or
  - fund flows.

Examples:

- Replacing a global equity manager for performance reasons
- Rebalancing a portfolio due to proposed changes based off an asset/liability study
- One sided liquidations or portfolio builds

The Origins of Transition Management

Inefficiencies in managing changes to portfolios led to the development of transition management

Portfolio Performance

- Legacy managers often liquidated portfolios to cash
- New managers re-invested cash with no great urgency (performance holiday)
  - Result: a black hole of performance.
    - 1996 William Mercer study: cost was 2.7%when unmanaged
    - Later studies: anywhere between 2% to 5%
    - Can negate years of potential alpha

Project Management

- Asset owners left to move assets and juggle multiple stakeholders and thus bare all operational risk

Early Days of Transition Management

Project Management

- Improved co-ordination and single-party accountability, reduced operational risks and centralized communications.

Cost Reduction

- Appropriate execution strategies reduced the market impact and market spread costs.
- Commission rates charged by a transition manager are typically lower than a standard commission structure.

Current State

Building upon what we have learned in the early years, today's Transition Manager provides:

- **Reporting**
  - Pre- and post-transition analysis. Detailed cost estimates that identify costs and risks.
- **Risk Management**
  - Reduced portfolio tracking error with trade optimization tools.
- **Algorithmic trading**
  - Advanced trading tools reduce imbalances in the portfolio (sector and market capitalization)
- **Hedging Strategies**
  - The use of futures, OTC forwards and ETFs to reduce tracking error.
- **Fiduciary Acceptance**
  - TM accepts full fiduciary responsibility and overall liability.

Managing a Transition is a Complex Process

- Who will manage this project?
- Who has the trading expertise?
- Who has the experience?
- Who has the technology?
- Will my project be kept confidential?
- Will it be transparent?
- Will performance be measured?
- Who is liable?

Transition Management Process

Legacy Portfolio

Manager A

Manager B

Manager C

Manager …

Transition Process

Phase 1 Pre-transition	Phase 2 Transition Implementation	Phase 3 Post- transition
Project management	Operational control	Risk management
Trading strategies	Trade execution	Custody and client reporting

Hedging strategy

Target Portfolio

Manager D

Manager E

Manager F

Manager …

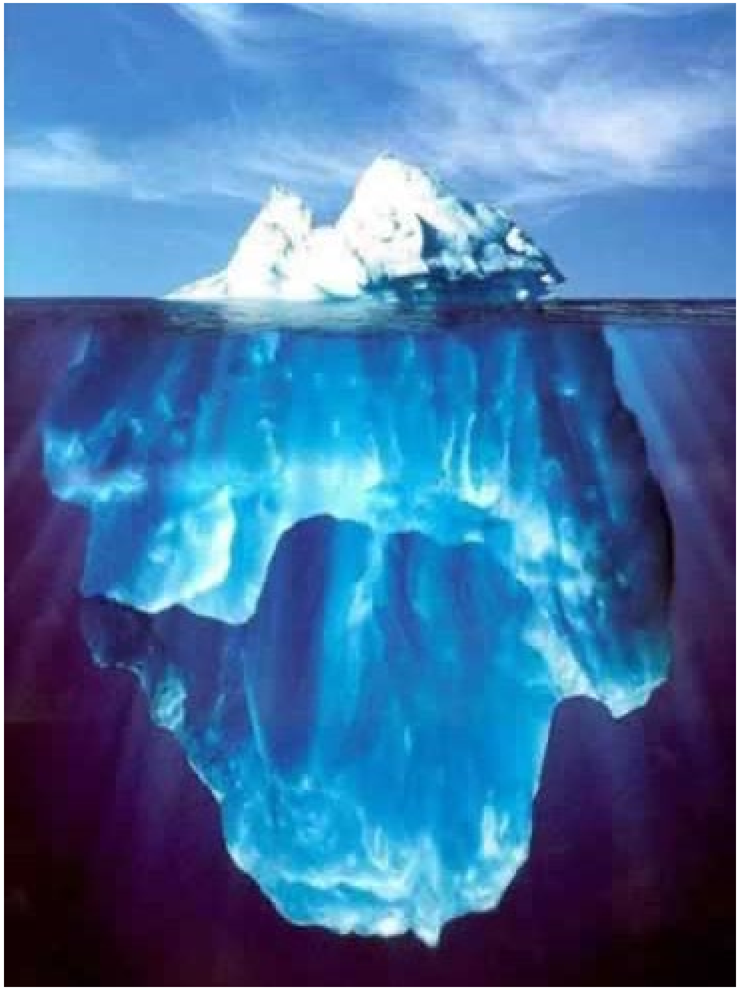
Phase 1: Pre-transition Preparing a game plan

This phase focuses on establishing communication and preparing for the trade implementation:

- Meet client to understand and establish the project goals
- Finalize legal agreements. Typical TM contract is executed as a master agreement to handle future transitions with addendum to include specific transition details.
- Centralize communication by establishing contacts and managing information flow with investment managers and custodian
- Present pre-transition analysis to client and propose a timeline
- Develop appropriate trading strategy with custodian and manager

Pre-transition: Costs incurred during a transition

- Like an iceberg, there are transition costs which are visible and invisible.
- There are direct costs such as brokerage, taxes and custody fees.
- There are also indirect costs such as market impact, bid-ask spreads and opportunity cost.
- Together, these make up the total cost of the project.



Transition Management: Crossing Terminology

- **Crossing: It is important to note how your TM provider engages in crossing**
  - In-kind transfers
    - Eliminates the need to purchase and securities that both the legacy and target portfolios have in common. The securities in question are transferred at the custodial level from the legacy manager to the incoming manager and incur no additional costs (commissions, taxes, bid-ask spread and market impact.
  - Internal crossing
    - Crosses against a provider's principal desk or against a provider's proprietary or affiliated funds (such as index funds).
  - External crossing
    - Market crosses between two different clients who are unaffiliated with the provider executing the cross.
    - Dark pools

Pre-transition: Considerations for a Global Transition

- Investing in emerging markets (India, Taiwan) is complex and time-consuming
- Tax implications on transfers (UK, Greece)
- Need to keep abreast of new rules and regulations (For example, in 2012 a new 20-basis-point tax on French Equity purchases (FTT) was levied; and a two-per-cent tax on new foreign purchases of Brazilian Real was eliminated.)

Phase 2: Transition implementation
Avoiding unnecessary costs and reducing risks

- Trade optimization / trading algorithms:
  - Trading tools help minimize spread costs
  - Risk management techniques reduce market impact
  - Optimize trading schedule using order management system ("OMS")

- Trading in a global market using sophisticated trading tools and source liquidity via internal manager network and liquidity pools (lit and dark)

- Communicate directly with custodians to maximize settlement effectiveness (SWIFT)

- Settle trades efficiently using knowledge of international settlement rules and regulations

Phase 3: Post-transition
Summarizing total costs and their components

- Provide a comprehensive cost analysis of the transition using Implementation Shortfall Method and/or other client benchmark
  - Implementation shortfall is the difference in performance between the theoretical target portfolio and the actual transition portfolio at the end of the transition period.

- Compare the final results to pre-transition cost estimate

- Debrief with client to review the analysis and answer questions

Tips to be more effective

- Start the planning early
  - Contracts/agreements
  - Custody set-up
- Use your transition manager as a partner
  - Trusted trading advisor
  - Open communication channels
- Never assume
  - Understand the business models (agency vs. principal trading)
  - Hidden fees
  - Aggressive pricing

Transition Management: Benefits to the Client

Established process, specialized skills: Experienced and skilled transition managers will quantify and manage the costs related to portfolio changes.

Single-party accountability: By centralizing project management, operational risk is reduced and the transition plan is communicated to all stakeholders (e.g. client, custodian, legacy managers, target managers).

Offset Liability: The transition manager takes the liability of the transition process away from the fund's staff.

Maintain market exposure: Transition Managers will develop a transition plan that seeks to maintain market exposure (avoiding leverage or cash drag) while controlling transactions costs.

Pre-transition analysis: Transition Managers will provide reporting to help identify potential costs, and trading strategies that seek optimal/low volatility trading window (earnings, eco events, volatility index).

Post-transition analysis: Transition Managers will quantify the total cost of a transition with post-transition reports that transparently compare results to the pre-transition estimate and attribute the various transition costs.