

# Transition Management:

Helping Clients Navigate Volatile Markets

**J**ohn Minderides, Global Head of JPMorgan Transition Management, discusses market volatility and increasing portfolio turnover, and how these trends have impacted the transition management industry.

## **HOW DOES MARKET VOLATILITY IMPACT TRANSITION COSTS AND THE SERVICES TRANSITION MANAGERS PROVIDE?**

Transitions are potentially harder with increased market volatility, because the impact of opportunity costs on the final outcome is higher than in less volatile markets. This doesn't mean you're managing the transitions differently—you're still employing an optimization approach to control and minimize risk—it just means that the transition, even though it is well-managed, will potentially incur a higher cost. For example, in a low-volatility environment, a badly managed transition might cost 20 basis points, when a well-managed transition could cost only 10 basis points. In a high-volatility environment, these figures

might be 100 and 50 basis points, respectively. While the relative performance is the same, the client stands to lose much more in the second case. By making transitions more difficult and more costly, volatility amplifies the differences between providers.

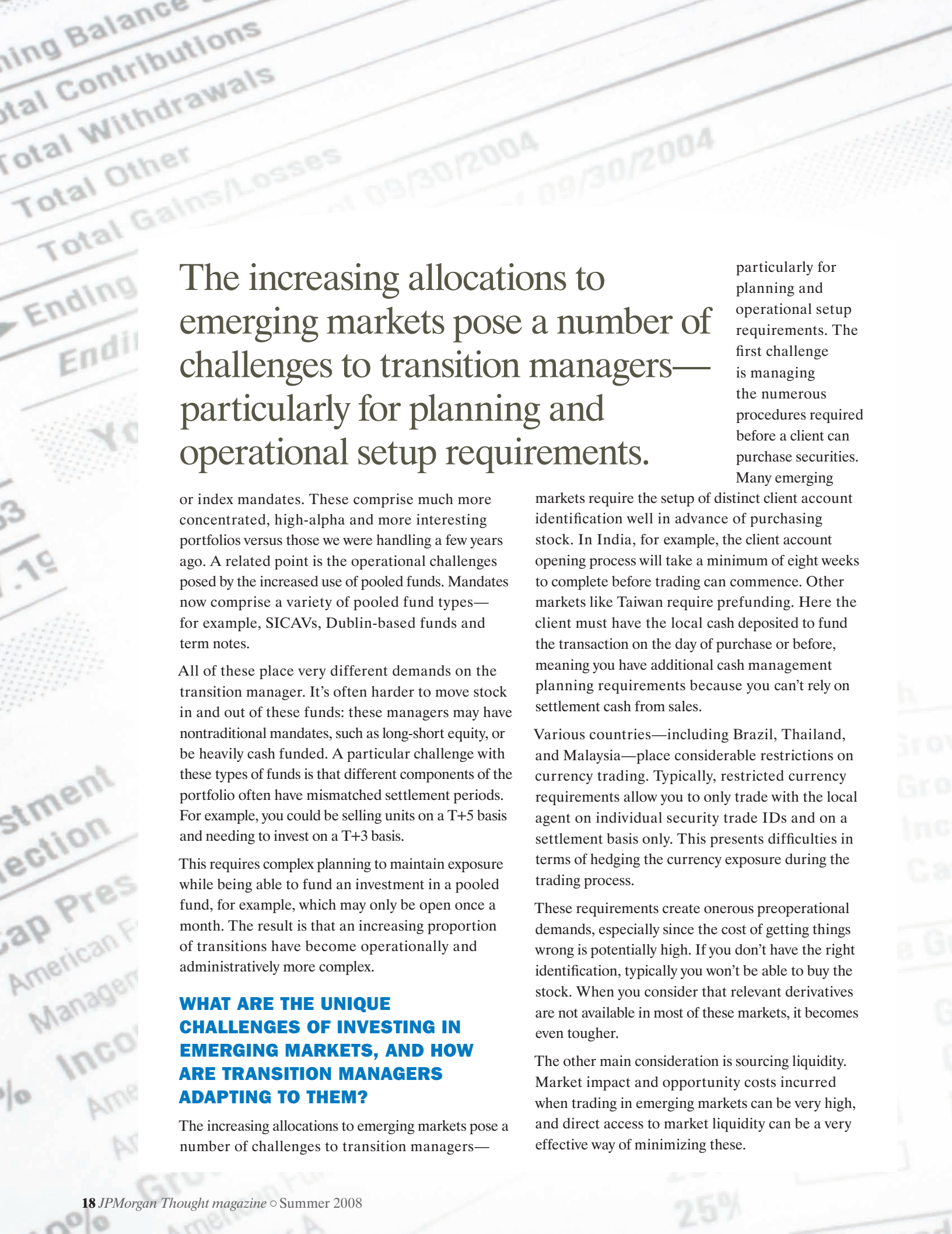
## **WHAT IMPACT HAS MOVEMENT IN ASSET CLASSES HAD ON TRANSITION MANAGERS?**

We've noticed a couple of trends. The first concerns the equity/fixed income balance. After the 2006 rush to increase bond exposure, 2007 saw a slowdown in the increase in allocation to bonds. In 2008, bond allocation is still growing, but at a slower rate.

The second trend is the move toward more sophisticated mandates and away from the balanced



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or index mandates. These comprise much more concentrated, high-alpha and more interesting portfolios versus those we were handling a few years ago. A related point is the operational challenges posed by the increased use of pooled funds. Mandates now comprise a variety of pooled fund types—for example, SICAVs, Dublin-based funds and term notes.

All of these place very different demands on the transition manager. It's often harder to move stock in and out of these funds: these managers may have nontraditional mandates, such as long-short equity, or be heavily cash funded. A particular challenge with these types of funds is that different components of the portfolio often have mismatched settlement periods. For example, you could be selling units on a T+5 basis and needing to invest on a T+3 basis.

This requires complex planning to maintain exposure while being able to fund an investment in a pooled fund, for example, which may only be open once a month. The result is that an increasing proportion of transitions have become operationally and administratively more complex.

### **WHAT ARE THE UNIQUE CHALLENGES OF INVESTING IN EMERGING MARKETS, AND HOW ARE TRANSITION MANAGERS ADAPTING TO THEM?**

The increasing allocations to emerging markets pose a number of challenges to transition managers—

particularly for planning and operational setup requirements. The first challenge is managing the numerous procedures required before a client can purchase securities. Many emerging

markets require the setup of distinct client account identification well in advance of purchasing stock. In India, for example, the client account opening process will take a minimum of eight weeks to complete before trading can commence. Other markets like Taiwan require prefunding. Here the client must have the local cash deposited to fund the transaction on the day of purchase or before, meaning you have additional cash management planning requirements because you can't rely on settlement cash from sales.

Various countries—including Brazil, Thailand, and Malaysia—place considerable restrictions on currency trading. Typically, restricted currency requirements allow you to only trade with the local agent on individual security trade IDs and on a settlement basis only. This presents difficulties in terms of hedging the currency exposure during the trading process.

These requirements create onerous preoperational demands, especially since the cost of getting things wrong is potentially high. If you don't have the right identification, typically you won't be able to buy the stock. When you consider that relevant derivatives are not available in most of these markets, it becomes even tougher.

The other main consideration is sourcing liquidity. Market impact and opportunity costs incurred when trading in emerging markets can be very high, and direct access to market liquidity can be a very effective way of minimizing these.

## HOW DOES USING AN OUTSIDE TRANSITION MANAGER HELP THE ASSET MANAGER RAISE THE LEVEL OF SERVICE PROVIDED TO A PENSION FUND CLIENT?

For asset managers, the selection of a transition manager has become increasingly instrumental in proving excellence in service delivery to clients. In selling their fund management services, asset managers increasingly need to show they are employing best-of-breed providers across the board to deliver associated services, with transition management included in this list. Pension fund clients, for example, increasingly will ask the asset manager how they will take on their assets and how they will save them transaction costs. If the asset manager is able to say “We’re using a best-in-class transition manager, and the service is tied in seamlessly with our own systems and operations to deliver the transition,” then that box is checked.

Asset managers are used to doing some of the activities required in a transition. However, it is not generally a core competency, and they are often not resourced for the peaks in activity or the specialist skills that are required. Consequently, partnering with a transition manager can be a very effective way of leveraging their services. Pension funds, generally having very little in-house resources, look to the transition manager to provide all aspects for the transition, including planning and preparation, custody and manager liaison, execution, risk management, pre- and post-trade analysis and reviews, and reconciliation. In this role, the client is looking to the transition manager to take on a level of fiduciary responsibility, whereas in providing transition services to an asset manager they continue to have those responsibilities to the pension fund.

## WHAT ROLE, IDEALLY, SHOULD CROSSING PLAY IN A TRANSITION MANAGER’S STRATEGY?

For years, crossing has been a barometer of transition

quality: the assumption was that the more you can cross, the better the transition. This is certainly an oversimplification. While it forms a useful source of liquidity for executing securities, it needs to be used in a quantitative way as part of the overall designed trading strategy. Crossing at the wrong price or waiting too long for the opportunity to cross can significantly increase the delay costs in trading, and also the exposure risks of the overall portfolio of securities to be executed. These delay costs and risks can far outweigh any savings made in spread or commissions.

In particular, a lot of crossing done at the close can hinder, rather than benefit, the client. In the first case, the manager may have waited all day to cross, incurring unnecessary market volatility. In the second, the cross is not at a midpoint price, but rather at a last price in a closing auction. Due to the different drivers of the users seeking closing market prices, the end-of-day auction process can be a very volatile time to trade, and may result in very unfavourable prices for the transition client.

A transition demonstrating a crossing level of, say, 30% cannot in any way be said to be a more efficient transition than one that only achieved crossing of 5%. A full analysis of the execution of the whole transition, together with appropriate benchmark analysis and implementation shortfall calculations, is required to demonstrate the effectiveness of the transition exercise and any crossing that was involved. ○

