

Transition Management: *Complexities of Emerging Markets*

by Nell Axelrod

Transitions are more complex and time consuming in emerging markets but can easily be handled by an experienced manager.

Emerging markets development

Emerging market investments have experienced significant growth in recent years, as evidenced by the graph below which provides an illustration of mutual fund flows since 2004. In step with this growth in flows, transition management has seen an increase in restructures involving this segment, both from investors moving into these markets as well as investors implementing fund manager changes within their emerging market allocation.

Investing and implementing manager changes in these markets introduces a layer of complexity beyond the normal transition management challenges. In this article we provide an overview of the transition process in emerging markets, drawing on our experience of managing these events.

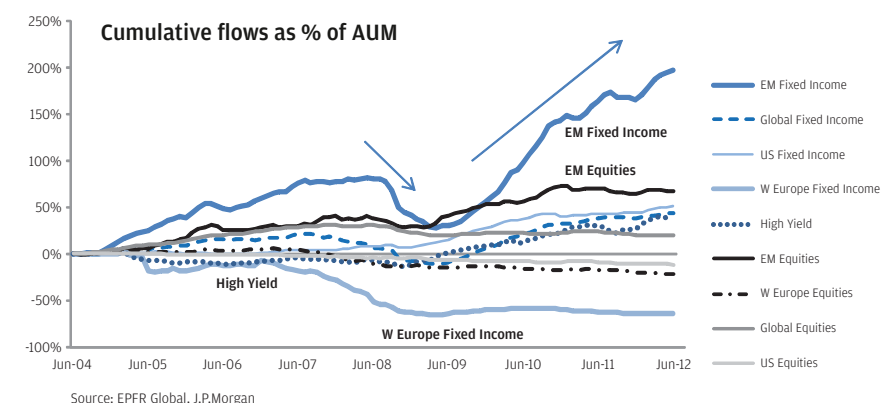
Investment structures matter

Pooled versus segregated: Investors either hold underlying securities in a segregated account with their custodian or they invest in a pooled vehicle, which offers access to a manager's expertise but with securities held in the name of the fund. Transitioning assets with pooled vehicles adds another leg to the restructure – and requires taking an 'in-specie' slice of assets from the legacy fund to a transition account for restructuring and/or delivering a slice to the target fund. Because assets are registered in the name of the fund instead of the underlying client, this introduces what's referred to as change of beneficial ownership, or CBO. While most developed markets allow securities to transfer free of payment between accounts, many emerging markets do not.

As a result, depending upon the fund, securities for some markets would need to be liquidated or purchased directly by the outgoing or incoming fund managers themselves in the market, reducing an element of the cost savings one would normally achieve by transferring like assets in-kind. As a generalisation, our experience typically sees this non-transferable market amount to be in the 20% - 30% range.

Plan ahead

In order to implement a restructure, a transition manager needs a custodian-based account to stage the event and settle trades. Whereas in developed markets, the custody account



opening process is straight forward and fast, some emerging markets require additional documentation. Account opening times vary by government; those markets taking the longest time include India (up to twelve weeks), Venezuela (ten - twelve weeks) and Taiwan (four weeks). The good news is that Cumulative flows as % of AUM where an investor already holds segregated assets in their own name, opening a transition account for most markets is simple and efficient. Should a 'documentation market' be included on the target side in a transition, the client and fund managers have a number of options:

- Postpone the restructure until all markets are open
- Implement the transition in a phased approach, employing futures or ETFs for the documentation market exposure until the account is ready
- Purchase depository receipts or a developed market listed line of the specific stock

Naturally discussions of any substitutions would involve the target fund manager and should be addressed in the planning stage of the event.

In addition to custody account documentation, some markets require that investor identification be submitted at the time of execution. The application process for investor IDs also takes time, and will need to be done in advance of the transition.

As a result of the additional bureaucracy that comes with the inclusion of emerging markets assets, transition managers are seldom used when clients invested in pooled funds only change the managers, but not the structure of their investments.

Ready, set, trade

Once all the boxes have been ticked – i.e. determined the restructure involves segregated securities, the custody accounts are open and investor IDs established – the transition manager assesses the execution requirements and designs a risk minimising trading strategy.

In the first instance, it's critical that the transition manager understand the specific market nuances when designing the trading strategy. Rather than provide an exhaustive list, we illustrate the types of situations one encounters through the following equity market examples:

1. An existing portfolio may hold a depository receipt (ADR or GDR) whereas the target manager may request the local security.

This could be an in-kind opportunity and a good transition manager would recognise that both securities are pointing to the same company and would then evaluate the costs of converting an ADR to local shares versus trading both sides.

2. Along the same lines, a target manager may request a specific foreign line Thai security, however Thai foreign lines can be thinly traded. In fact, a transition manager should consider liquidity of other associated

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instruments. Where a 'foreign investor limit' has not been reached, the manager could purchase the more liquid local line and convert it to the foreign line required by the fund manager. Non-voting shares (NVDRs) of the same line may also be an acceptable substitute for the target asset manager and may trade more in line with local shares, thus reducing the cost of transactions.

As shown in these two examples, accurately assessing an emerging market event requires a significant amount of thought and consideration in simply evaluating the asset lists.

In addition to the various security choices and assessment of liquidity and timing, the transition manager evaluates any potential cost and risk reduction by including futures or ETFs. In general, when executing transitions, it's preferable to use the securities within the restructure to hedge exposure. For example, the transition manager would maintain correct market exposure by timing liquid purchases to accommodate illiquid sells. If futures are used, the transition manager should consider whether, for those relevant markets, locally listed (e.g. Taiwan's TAIEX) or foreign (e.g. SIMEX's MSCI Taiwan) contracts provide the better hedge.

Another timing issue common with equity emerging markets events is staggered cash settlement cycles. For instance, when selling and buying in India, transacting simultaneous sells and purchases in order to manage out of market risk will place the client in a cash overdraft situation. While it is a "T+2" settlement market, cash for purchases is required on T+1 and the receipt of cash proceeds from sales does not occur until T+3. The transition manager must devise cash management strategies as well as investment exposure strategies when dealing in these types of markets.

In addition to timing, settlement methodology also needs to be understood, as not all markets settle on a pure delivery versus payment basis.

As with all transitions, the transition manager should review the proposed trading strategy with the client. Local connections, execution capabilities and insight can smooth the trading process and minimise information leakage.

Trading emerging markets fixed income, by contrast, is fairly straightforward. Emerging

market debt stock is increasing, sovereign debt for many countries trades electronically and emerging market corporate securities can be quite liquid. Within transitions, we see around 60% of investments made in hard currencies and 40% in local currency, which helps to minimise challenges associated with local currencies and domestic settlement.¹

A comment on style: active versus passive

In J.P. Morgan-managed transitions we have seen a trend toward highly concentrated actively managed portfolios. In fact, this trend is fairly independent of region and alongside the typical developed versus emerging split we have seen a number of "global active" appointments where the portfolio has less than 200 names and includes both developed and emerging exposure.

Larger, more concentrated positions can take longer to trade. Trading in line with volume, we estimate we can trade 10% of a security's average daily volume (ADV) with minimal impact and are comfortable trading up to 20% ADV in a security on a given day. Large, concentrated portfolios are typically less liquid and require multi-day trading and block liquidity sourcing, which has the knock-on effect of constantly re-evaluating current risk relative to the target exposures. The transition sells and buys need to be carefully coordinated to minimise these exposures that can occur with mismatched liquidity profiles.

Passive portfolios can be simpler in a transition for a couple of reasons:

1. A greater number of securities typically required in indexed portfolios result in smaller, more liquid positions and
2. For some markets futures or ETFs with a low tracking error to the benchmark can be used to augment a trading strategy.

Cash is (still) king

Emerging markets introduce a number of challenges when it comes to cash management and currency transactions.

- **Mismatched settlement.** As noted briefly above, most of the developed world settles on a T+3 basis and with the same cycle for buys versus sales; this is less standard within emerging markets. In a number of markets, purchases settle prior to sales, making it difficult to trade on a cash balanced basis without supplying cash for pre-funding.
- **FX trade implementation.** Many emerging market currencies are not freely traded, requiring custodians to execute via local agents. Whereas FX trading is normally an integral part of 1 For a comprehensive

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review of emerging market debt, please see J.P. Morgan's recently published research article, "EM Rerates as an Asset Class: EM Fixed Income Passes a Second Stress Test, 5th Edition, August 10, 2012, the transition process, managing currency risk alongside the underlying securities, in emerging markets the transition manager often focuses more on the operational risk rather than the market risk.

- **Additional considerations.** There are a number of country-specific rules and regulations that must be adhered to. In the same way that establishing a custody account can carry an increased bureaucratic burden, some countries require specific documentation on cash transfers. Another common feature is that some countries require pre-funding of purchases. Furthermore, taxes can be introduced and changed, as was the case with Brazil's Financial Transaction Tax introduced in recent years.

Cash flow management is a core part of any transition; transition managers need to incorporate the market-specific requirements when designing the optimal trading strategy.

Forewarned is forearmed

Inclusion of emerging markets within an asset allocation strategy has become the norm. Accessing these markets through funds, ETPs and futures is straightforward and easy. Once the decision is taken to have a larger investment, and via segregated securities instead of funds, advance planning and careful coordination with the help of a transition manager can minimise the risk and cost of initial implementations and future manager changes.

¹ For a comprehensive review of emerging market debt, please see J.P. Morgan's recently published research article, "EM Rerates as an Asset Class: EM Fixed Income Passes a Second Stress Test, 5th Edition, August 10, 2012.

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To find out more about our transition management solutions, visit: jpmorgan.com/transitionmanagement or contact your J.P. Morgan representative.