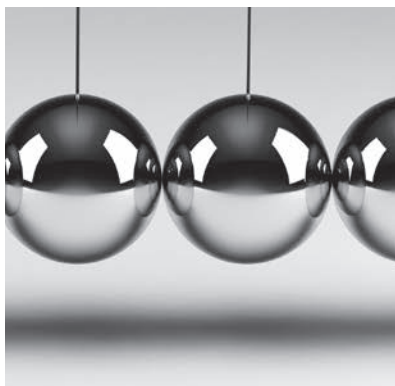




Transition Management



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What institutions need to know about transition management

An interview with Michael Gardner, Head of Transition Management, J.P. Morgan.

Q. What are the key considerations for investors currently about to undergo a transition and looking to appoint a transition manager?

A. Often investors don't realize how complex the transition process is, and it's easy to underestimate the number of operational elements involved. A lot of institutions focus solely on the trade, but the main challenge for clients is the administrative burden. Transition management is time consuming and resource intensive requiring planning coordination across many participants including internal client reporting, consultant interface, custodial services, both legacy and target manager communications and accounting and performance teams.

In deciding who to appoint as a transition manager, a number of factors need to be considered, requiring expertise in a variety of disciplines:

- **Trading capability:** excellent trading capability is vital, as is the ability to demonstrate broad market reach while minimizing cost, information leakage and ultimately risk. Ask the transition manager how they develop their dealing strategy and manage risk and what sources they execute through, internal infrastructure or outsourced to other execution firms.
- **Project management expertise:** a transition is more complex than placing an order with a dealer and requires a comprehensive project plan, as well as contingencies for unforeseen market events or disruptions. Find out how long the manager has worked in the area of transitions. Try to assess their ability to be flexible and react quickly to the unexpected.
- **Robust risk management systems and procedures:** given the number of risks inherent in a transition, it is important that the transition manager is committed to successfully managing risk in all its guises, both from a trading and a risk assessment, strategy development perspective.
- **Clear analysis and reporting:** it is essential that your transition manager provides accurate and comprehensive pre-and post-trade reporting, and relating post-trade results with the pre-trade estimates. Ask what types of reports they provide and request examples.
- **Transparency:** transparency means full disclosure on the details of each transaction and the fee structures. It is important that all charges incurred are clearly stated and easily understood.

Q. How should an institution decide on the most beneficial transition management arrangement? Should it opt for an exclusive TM provider, a panel of managers or an open tender for each individual transition exercise?

A. There are benefits to both a partnership provider (exclusive arrangement) and a panel of providers. With an exclusive provider there is minimal information leakage about a transition event prior to its occurrence, which may ultimately save cost and allow clients to develop a deep understanding of their provider's operations. With a panel of providers competitive forces ensure that pre-trade estimates are as sharp as possible. One consideration with selecting a panel is the notion of regular due diligence of the panel to ensure the reasons each provider was selected still holds true.

Q. How can the T-Charter principles for best practice in the transition management industry help investors ensure a smooth transition?

A. The objectives of the T-Charter are, among others, to instil client confidence in the integrity of transition managers and to ensure good market practice. Your transition manager should support these principles. Integrity will ensure that procedures and systems are in place to protect confidentiality and market sensitive information, both internally and externally, and to ensure the business is structured to minimize or eliminate potential conflicts of interest.

Q. What sort of techniques can transition management firms use to help investors manage the risks posed by a transition?

A. Risk minimization is one of the key objectives of a transition manager, as there are many risks inherent in the transition process not readily identifiable to investors:

- **Broad market risk:** market exposures (both security and currency components) must be carefully

evaluated and managed throughout the course of the transition. Management typically consists of trade optimization, regional timing execution and hedging strategies to quickly mitigate unwanted exposures.

- **Stock specific risk:** frequently, a small subset of securities will produce significant risk within a transition event – i.e. illiquid and/or high value assets. These securities need to be identified and carefully analyzed, and an appropriate trading strategy designed to minimize the risk to portfolio performance.
- **Operational risk:** operational risk can lead to costly delays or errors. Clear, frequent contact and a robust project plan help to avoid misunderstandings or miscommunications.
- **Counterparty risk:** it is particularly important to ensure that trustees are dealing with a secure and reputable global counterparty. This has now become a key part of the due diligence process, with transparency taking a high priority.

Q. What hidden costs can there be within a transition? How can an investor identify these and reduce them?

A. Investors can lose a significant amount of asset value when undergoing transition due to a lack of coordination or missed opportunities. A transition manager's inability to properly manage risk and/or convey the full attribution of performance can at times be construed as hidden costs.

Truly "hidden costs" are typically a function of misunderstandings around what resources a provider has at their disposal in-house and what aspects must be outsourced to another market participant, who in turn levies a fee for their services.

Outsourcing a particular element of a transition is not necessarily a bad thing, but investors should fully understand a transition manager's processes and capabilities, and importantly, how each potential external provider's charges are structured.

How the transition management process works

Each transition is unique in its characteristics. However, whether there are operational constraints, time constraints, legal and compliance elements or challenges presented by the securities involved, the process for each event typically follows the same path.

Investors face a continual challenge to meet portfolio performance targets. Whether it is the impact of market forces or a change in funding requirements, a restructure of assets is bound to be required at some point. So, once the investment decisions have been made, how are they implemented in the most efficient way? Enter transition management, a well established service that can help preserve asset value and manage the risks inherent in the implementation process.

Setting objectives

The first step of the transition management process is to have a clear idea of goals and objectives. There are a number of factors to consider. What are the priorities and attitude towards risk? What is the time frame for implementation? Are there any trading constraints or funding issues? These objectives determine the direction and set the framework for the entire project.

Planning

Careful planning and attention to detail will help ensure a smooth transition. The earlier this process starts the better. During this stage, the transition manager coordinates with the client, portfolio managers and custodians to discuss and confirm the transition objectives, verify documentation is complete, ensure custody accounts are open for markets to be traded, and reconcile legacy positions to custodian records.

Legal documentation that typically needs to be in place at the start of an event includes:

- A Transition Management Agreement which sets out the terms of engagement
- Investment Manager Agreements with new fund managers
- Due diligence – Know Your Client (KYC) documents such as company reports and accounts
- An up-to-date list of Authorized Signatories
- Letters of Authority to custodians and fund managers to accept instructions from the transition manager
- Non-disclosure Agreements that may be required between the fund manager and transition manager to ensure that information is kept confidential

As negotiating agreements and getting documents signed by the required people can take time, many investors arrange to have the majority of legal documentation in place well before a transition is imminent. That way, they can move quickly when ready.

Once appointed, the transition manager communicates with all involved parties and produces a detailed project plan to ensure that everyone knows what they need to do and by when. Careful planning of individual responsibilities and processes will minimize operational risk and potential delays. Events such as market holidays, economic announcements and corporate actions are all taken into account before designating a date to commence trading. Contingency arrangements are put in place in case email or other critical systems should fail. Clear and frequent communication is key.

“Careful planning of individual responsibilities and processes will minimise operational risk”

Pre-transition analysis

After speaking to all the parties involved and collecting relevant information on the legacy and target investments, the transition manager will assess which assets can be transferred directly into the new structure and which will have to be bought and sold. A pre-transition analysis will report the results and include written commentary and a quantitative cost estimate.

This report describes the planned activity, major themes within the transition and their related risks. It also identifies the expected cost components and proposes a trade strategy to mitigate those costs. If there are potential issues in meeting the transition objectives, these are clearly identified. If appropriate, alternative strategies may be suggested for a part of the implementation; these would be described and marked for further discussion.

The numerical analysis is a detailed report that provides summary estimated costs on the securities to be traded which includes commissions, taxes,

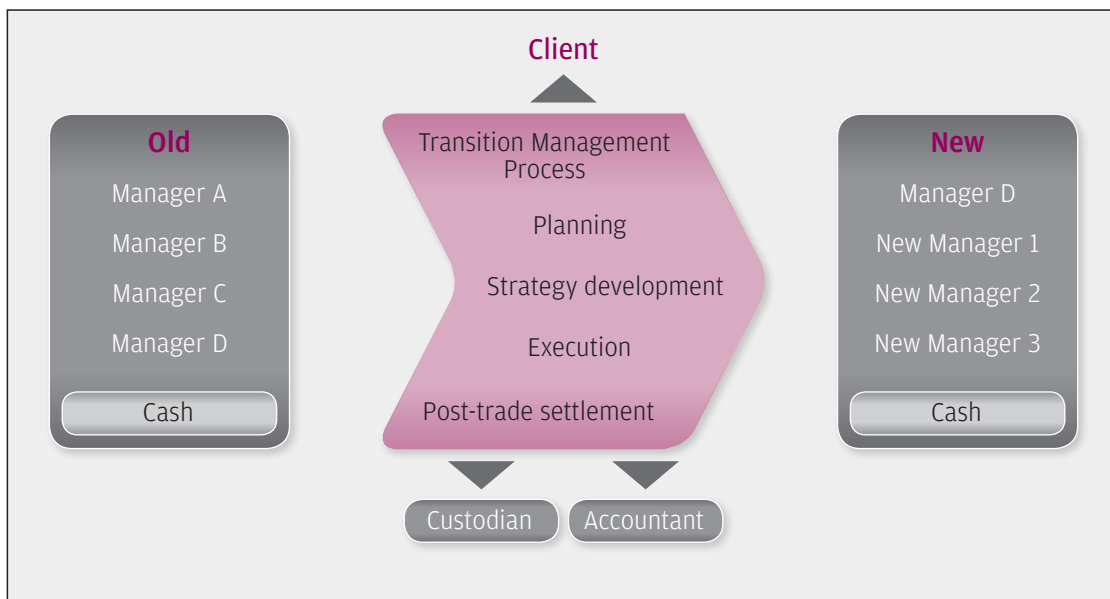


bid-offer spread, foreign exchange spread, market impact and opportunity cost. Additionally, it can describe the liquidity and volatility profile of the trade as well as provide the market exchange, country and capitalization breakdown. The securities trade list will be disclosed, along with the share amounts to be traded, current price and other relevant cost characteristics. Often, this analysis is run more than once, with the last report generated just prior to trade date.

Cost evaluation factors

This cost estimation considers variables such as order volume as a percentage of average daily volume (ADV) for specific stocks, anticipated time horizon to complete the trade and contribution to risk. Risk is often measured by tracking error, which is the difference in the price behavior of

Transition Management process flow



Source: J.P. Morgan

the buys versus the sells or the target portfolio versus the legacy portfolio. In general, securities that contribute the greatest amount of risk will be traded more quickly in order to reduce overall risk, while the balance may be traded less quickly.

“Clear and frequent communication is key”

To be as accurate as possible, the analysis will use individual security specific price data as well as correlation data between securities, sectors, countries and other data to produce the optimum trade strategy for the particular transition; the one that minimizes the combined sum of the market impact and opportunity costs.

Review with client

The optimum trade strategy is reviewed to ensure that all risk considerations are taken into account, such as moves between regions and asset classes. If there are significant shifts within the restructure, derivative instruments such as futures may be used to minimize the market exposure risk. These instruments are often liquid and inexpensive to trade; they allow the transition manager to achieve the target exposures more quickly than trading the underlying securities. Once a hedge is in place, the underlying securities can be purchased or sold at a controlled pace that will reduce the impact to price. The hedge position is unwound in line with trading.



Along with the pre-transition analysis, timelines and other aspects of the transition are discussed with the client. Reporting preferences and any benchmarking requirements are agreed.

Execution

The planning and preparation of the transition event usually takes the greatest percentage of time. Once complete, the actual implementation can follow quite swiftly. Assets are usually transferred into a transition account held by the custodian. This separates them from other client or manager assets while providing the basis for a clean audit trail of transactions. Asset transfers are monitored and reconciled before trading is executed in accordance with the agreed trade strategy.

Progress is monitored throughout the day and any unexpected events are promptly communicated to the client. If market conditions change materially, the transition manager may suggest altering the strategy.

Processing and reporting

Throughout the implementation process, trade settlements, corporate actions, income and cash movements are all monitored. Reconciliations are performed daily and once settlement is complete, assets are transferred from the transition account to the new asset managers on the pre-agreed day.

“Progress is monitored throughout the day”

As with the pre-transition report, a quantitative and qualitative post-transition report is compiled and sent to the client for review. This report identifies the actual costs that were incurred. A meeting is subsequently held where the transition manager presents the performance of the transition, explains any deviation in cost from the estimate and answers questions.

One of the most common questions asked is how long does a transition take? The answer of course depends on the complexity of the event and the types of assets involved. However, assuming legal negotiations go smoothly and the securities to be traded are reasonably liquid, a one month time period should be sufficient to complete the entire project.

The evolution of risk strategies for transition management

The transition management business is a very dynamic industry; seeing changes in form, function and process at a rapid rate for the last decade. Our industry has shaped itself over a remarkably compressed time period, which means that looking back at “the way it was” doesn’t require one to go too far into history to notice very significant changes, writes Michael Gardner, Head of Transition Management, J.P. Morgan.

Early beginnings

The genesis of our business came with the recognition that there were savings to be had by more efficiently project managing changes to investment portfolios. At this time, (pre-2000) trading was largely a by-product of the project management activity. The first priority was to coordinate movements to reduce exposure; the second, to attack tangible elements of cost: i.e. market spreads and impact. With that, trading tended to focus on these two factors alone. Crossing (in many forms) was popular as it was easy to point to half bid/offer spread cost savings and the lack of market impact with such transactions. The industry mantra became, “cross, cross, cross and then clean up on the open market”; the more one crossed, the more one “saved”.

A new era – bringing risk to book

True to market forces, the industry witnessed a rapid influx of new transition providers which forced all participants to refine and improve their offering. Now, the industry began to ask, “How much are we risking relative to what we are saving”? This was a fundamental change. Providers were now not only quantifying expectations of cost, but also the degree of certainty around those expectations (i.e. opportunity cost dispersions). To compete, providers had to devise ways to

reduce cost, while at the same time minimize the dispersion (increase the certainty of the estimates being put forth).

However, it is one thing to state that a particular strategy is more or less risky, but quite another to quantify that risk.

“pre-2000 trading was largely a by-product of the project management activity”

So how much is at risk with a crossing strategy? One way J.P. Morgan looks at this is to take a single market and monitor the daily average tracking error of one industry sector relative to another. The outcome from one sample report



(August 2010) was 62 basis points. This is significant when one considers this approach is typically taken precisely in order to avoid much lower levels of commission, spread and impact.

Risk management comes of age

A new theme arose – Risk Management. This focus was important as it helped to evolve the product from process management to one that also concentrated on trade strategy development and execution management. The variants of ‘Risk Management’ ran the gamut – i.e. from maintaining a cash balanced trading strategy to introducing trade optimization into the picture.

Through trade optimization, for example, J.P. Morgan began to measure tracking error between the aggregate legacy and target portfolios, and more importantly, drill into the marginal contribution of tracking error at a name by name level. This facilitated more sophisticated strategies – i.e., identifying which names were the highest marginal contributors of risk and which names we would prefer to hold in the portfolio rather than simply selling with market liquidity (low marginal contributors of risk).

These developments also coincided with the proliferation of algorithmic trading. This, along with technology enhancements in many of the larger investment banks, pooling trade flow volumes from various businesses (internalization of order flow) and electronically harnessing market fragmentation so that transactions could be executed across many venues (smart order routing), meant transition managers could now deliver significant advances in trade strategy development and execution.

Many providers also introduced hedging into the mix, through index futures or Exchange Traded Funds (ETFs). While adding yet more tools, these products sometimes add as much confusion as they do risk management. It is particularly important to measure the “fit” of the hedge relative to the exposure. For example,

if implementing a hedging strategy will reduce the tracking error estimate from 9% to 2%, the hedging strategy would be worthwhile. However, if hedging only reduces the tracking error estimate from 9% to 7%, then taking into account the short duration of the hedge and increased transaction costs, this may not generate sufficient savings to warrant its use.

Staying ahead of the curve

Technology continues to create opportunities for enhancement. We can easily filter names in any transition event according to those that “live well” within an algorithm, and focus high touch trading on other names that are the largest contributors of risk, the largest drivers of performance and which do not trade well in an automated fashion. We can reach multiple execution venues simultaneously, trading names (or even substitutable names) more cheaply and with greater speed (and lower opportunity risk) than ever before. Incremental improvements to computing memory and speed have allowed us to take an iterative approach to trade optimization by measuring risk intra-day, creating an optimized trade basket and executing, and then re-measuring. We can measure the success of the approach and repeat the exercise, or we can note the lack of success, and adapt to new market conditions.

“Significant advances in trade strategy development and execution”

Looking ahead, questions focus now on how to manage risk in “real-time”, or whether advances in trading mean that operational risk exceeds execution risk. The transition manager has no choice but to move with the markets.

Fixed income transitions – analysis of a growing market

As one of the largest global fixed income houses, fixed income restructures have always represented a significant proportion of J.P. Morgan's overall transition management business. Here, we discuss how fixed income and equity transitions compare and the key points investors should consider.

Administrative setup

In many ways administrative preparation for a fixed income event is simpler than for an equity event. Many emerging market bonds trade in USD, for example, reducing some degree of currency management. Settlements are also streamlined, with most bonds settling via DTC, Fed or Euroclear.

suitable/substitutable securities. For fixed income events, in-kinds are not simply based on common security identifiers.

Other security universe-relevant considerations include quality of the issuer, credit rating, the bond age, issue size, order size relative to issue size and the issuer/sector liquidity.

Security universe and substitutability

The fixed income universe is composed of different segments, typically divided into government bonds, quasi government bonds, mortgage/asset-backed securities and corporate bonds. The corporate segment when compared with equities is quite large, with multiple securities per issuer, resulting in additional challenges and opportunities for portfolio creation and implementation.

Should a fund manager request a bond with limited availability, then suitable substitutes with similar characteristics e.g. duration, sector, rating, can generally be identified. Conversely, opportunities exist to maximize in-kind transferability to target managers by examining the characteristics of the target portfolio construction and relaying common characteristics of the legacy portfolio to find



Assessing trading risk

Fixed income restructures face many of the same risk factors as equity events, as well as issues unique to this opaque market. The following risk factors are inherent in both equity and fixed income transitions, the mitigation of which should be a core focus when designing each trading strategy:

Risk factors common to both equities and fixed income

- Regional allocation shifts
- Country and currency allocation shifts
- Operational coordination
- Economic releases and earnings announcements

Fixed income-specific risk factors

In addition to the common factors above, there are considerations unique to fixed income events:

- Duration exposure shifts in the transition
- Credit shifts in the transition
- Sub-asset class shifts

It is important to manage trade timing so that the client is fully invested. For example, to maintain exposure in a transition out of government bonds into credit securities, the trader would stage the sells to match the speed at which target securities are located. This also mitigates duration risk.

- **Pricing differences:** security prices will only be known when the trader goes to the market to execute and will be different from the historic prices fund accountants and custodians use. This gap between the accounting or custody value of the legacy portfolio and the value of the portfolio based on achievable execution prices can represent a cost to the fund when it realizes

updated valuations through the transition process, and should be highlighted in the preliminary cost estimate stage, prior to execution.

- **Bond Liquidity:** bond liquidity is a function of the original issuance size, parties willing to buy and sell securities and the availability of suitable substitutes for the target portfolio. When the legacy portfolio contains an illiquid “tail”, a transition manager should be able to offer solutions to facilitate the client requirements. For example, over the past couple of years it was quite common for clients to experience difficulty selling asset and mortgage backed securities from their legacy portfolios. At J.P. Morgan, we help clients manage illiquid tails as follows:
 1. **Ongoing transition:** for small illiquid tails, J.P. Morgan can hold the securities in the transition account and periodically review market price levels with the client, selling based on the client instructions.
 2. **Cooperation with Asset Management:** for larger portfolios J.P. Morgan Asset Management can take over the ongoing management of an illiquid portfolio and sell the securities when market conditions improve.
- **Currency hedging to base currency:** fixed income portfolios commonly hedge the local currency exposure using forwards. The transition manager needs to work with target and legacy managers to ensure that when required, the appropriate swap transactions is executed and coordinated.

Execution methodology

Whereas the equity markets typically manifest in centralized execution venues frequently tied together through “smart order routing”, fixed

income markets are fragmented with institutions negotiating prices bilaterally for each transaction. Agreed prices may be posted publicly and available via tools such as Bloomberg, however institutions are not obliged to post trades. Furthermore, prices are not posted at all for some security classes, such as mortgage-backed or asset-backed securities.

Orders can be implemented on a principal or agency basis, although not all transition managers are equally skilled at both:

- **Principal:** in a principal solution, a transition manager's affiliated brokerage firm commits capital to take a client's order on their proprietary trading book. Principal trades are traditionally used when a client seeks to sell securities or purchase very large positions of liquid names, this is due to the difficulties associated with shorting fixed income securities, mainly around availability of bonds to borrow.
- **Agency:** in an agency solution, the transition manager executes with a counterparty on the client's behalf and an explicit commission is charged based on value of assets traded. Typically, multiple quotes are obtained and the best price selected. Multiple quotes help demonstrate best execution and provide confidence around the bids and offers received.

Proactively obtaining quotes carries risk of information leakage – the detrimental impact on price increasing as at the number of parties familiar with the intended trade increase. As such, for agency execution it is imperative that the transition manager has a strong universe of brokers, understands their respective strengths and targets only those counterparties most likely to transact.

Conclusion

Transition managers work to preserve asset value and introduce operational efficiencies for all restructures. As transition management becomes progressively recognized as industry best practice, transition principals have been appointed to manage a broader range of asset classes.

Fixed income transition events introduce challenges specific to that asset class that require different skills from equity transitions. Critical in selecting a transition manager is assessing each manager's capabilities in addressing these challenges and experience in successfully implementing cost-effective restructures. At J.P. Morgan, we have applied our expertise and infrastructure towards the development of fixed income-specific solutions to make this a core competency of our global transition management business.

This article was first published in Global Investor magazine, September 2010.



Transition Management

Seamless change. Extraordinary results.

Changing asset allocation is not a decision pension funds take lightly.

Neither do we. By combining the execution capabilities of a leading investment bank with the operational skills of a global custodian, our dedicated transition management experts help reduce both cost and risk for our pension fund clients.

As markets evolve, we can help you manage the complexity of structural change seamlessly and efficiently, reshaping your investment portfolio to achieve the results you need.

Servicing: Transition Management
aiCIO's Industry Innovation Awards, 2012

Transition Manager of the Year
Global Pensions, Annual Awards, 2011

Transition Management Provider of the Year
ICFA, European Awards, 2010, 2011
ICFA, Americas Service Provider Awards, 2011

Best Transition Management Firm of the Year
European Pensions Awards, 2011

Transition Manager of the Year
Global Investor, Middle-East Awards, 2010, 2011

Best in Transition Management
Best Transition Management Mandate
The Asset, Triple A Awards (Asia), 2012

Transition Manager of the Year
Asia Asset Management, Best of the Best Regional Awards, 2011

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Asia - **Patrick Fanning**, patrick.s.fanning@jpmorgan.com or +61-2-9003-7810

Europe, Middle East & Africa - **Robert Calder**, robert.a.calder@jpmorgan.com or +44-20-7742-0257

The Americas - **Christie Cobb**, christie.cobb@jpmorgan.com or +1-212-552-8126

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