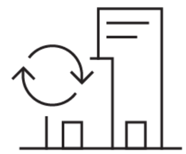
INTERIM MANAGEMENT:

MANAGING RISK

Change in life is inevitable and the management of investment portfolios is no different. Like all change, switching the management of your portfolio can carry considerable cost and risk, but that doesn’t mean that these can’t be managed in a controlled and transparent way.

There are common reasons for changing an investment manager:



1. Portfolio manager lift-outs
2. Investment manager closure of the business or winding down a specific strategy
3. Scandals or improper conduct and underperformance

When these changes occur, there is typically a desire to make a change quickly, but investors can be faced with options that are not ideal and can leave assets in limbo while a new manager is vetted and selected. Often this manager search and selection process can take months to complete. **Yet, while these changes in the long-term are unavoidable, through the use interim management, the investment fallout is certainly manageable.**

Challenges that you face

Unnecessary costs	Unrewarded risks	Administrative workload

Improved efficiency over portfolio changes

Interim management is the process whereby Russell Investments acts as a short-term asset manager to implement decisions that otherwise can take many months to finalise.

The Challenges	The Impact	The Solution – Interim Management
• Strategic Asset Allocation changes • Incorporating ESG filters/tilts • Manager change – poor performance • Manager change – manager lift out • Fund / portfolio mergers	• Delay to implement physical changes • Delay due to manager selection, due diligence, contracting • Cost of active fees **DELAY =** **1.** Unrewarded risk **2.** Increased costs **3.** Loss of control	• Strategic changes made with little delay • Risk and cost reduced while finalising decisions • Accountability and reporting retained • Passive fees during interim

Source: Russell Investments, for illustrative purposes only.

Why wait?

Once the decision has been made to terminate an existing manager or mandate, institutional investors are faced with holding an unwanted investment strategy until a new manager is selected and under contract. We believe there is an optimal way to handle this situation, but let's first review some of the more common, but less than ideal solutions to this challenge.

1. Leave the mandate with the existing manager (where able)
2. Terminate the mandate and require care and maintenance
3. Restructure to a passive mandate

Each of these options have several disadvantages, which tend to outweigh any potential advantages:

1. Leave the mandate with the existing manager (where able)

ADVANTAGES	DISADVANTAGES
• Least amount of work/administrative ease.	• Concerns over governance of your organisation's assets. If you're holding on to a manager in which confidence has been lost, are you really doing your fiduciary duty? • Continuing to pay for active management fees when the active manager's insights are no longer desired. • A less capable portfolio manager could potentially take charge of your portfolio. This often arises in instances where the old manager has been lifted out. You may be left with a manager you've potentially never researched.

2. Terminate the mandate and require care and maintenance

ADVANTAGES	DISADVANTAGES
• Administrative ease. • Compared to the do-nothing approach, perhaps governance is at least improved under this approach, as no new active decisions are being made by the manager in which confidence has been lost.	• Still sitting on active bets taken by the manager that will become stale over time. • No real active oversight over the portfolio, let alone accountability for it. • Continuing to pay active management fees.

3. Restructure to a passive mandate

ADVANTAGES	DISADVANTAGES
• Administrative ease.	• It's very costly to transition from active to passive, then back from passive to active, as you end up paying transaction costs for selling and buying assets on both ends. • You were already paying active management fees to meet a particular alpha target or investment exposure. Moving away from an actively managed portfolio may increase the chances you won't meet your investment objectives. • In a fund structure this will likely also require a material change to the prospects.

The costs of these simplistic approaches are significant

The one consistent advantage seen in all three is the ease-of-use factor – that is, the lack of an administrative burden.

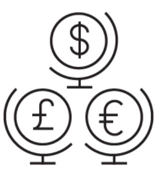
What if there was a solution that could satisfy the need for easing the administrative burden, while also still saving cost? We believe the solution to this exists in a fourth option – interim management.

The optimal solution: Interim asset management

Interim management, is an investment management solution provided by some transition managers, like Russell Investments, as they have specialist teams who are not only ideally placed to “transition” the assets being restructured in a manner that minimises costs and risk, but are also held accountable for the performance of the portfolio during the interim period between the departure of the old manager and the onboarding of the new manager. During this timeframe, the assets are held in an account managed by the interim manager. Meanwhile, the interim manager is responsible for minimising the performance impact of the portfolio restructure and maintaining the desired investment exposure. This includes employing strategies, such as derivatives, that minimise unnecessary trading costs for the asset owner, in addition to mitigating unrewarded risks. This eliminates so-called performance holidays, ensuring there are no gaps in overall performance.

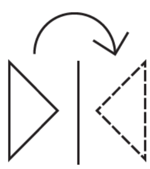
Just as important, the workload is transferred from the asset owner to the interim manager, preventing vital resources in the organisation from becoming overly burdened by non-core administrative tasks. As a result, the asset owner often receives active management with reduced risk without paying the active management fees.

Advantages of interim management



Costs

Optimised beta exposure and a reduction in trading and transaction costs by consolidating multiple transitions.



In-kind transfers

Maximise in-kind transfers with each transition.

Flexibility

Increased flexibility, nimbleness, and the ability to efficiently leave the legacy manager.

Utilise securities

Ability to utilise existing securities to fund new manager once chosen.

Examples of how we have helped

Case Study 1: Building an optimised representation of the MSCI ACWI[1]

A client of ours, wanting to get out of a global mandate, initially tasked us with building a full representation of the MSCI All Country World Index.

Our team was able to analyse the client’s portfolio and build an optimised portfolio of individual securities and a few ETFs, tracking the index within 35 basis points (bps) of annualised tracking error. We were able to retain a significant amount of the legacy portfolio by only purchasing approximately 1,200 names in the index – leading to dramatic savings in trading costs and custody fees.

After the initial optimisation, the client used this as an implementation account for the next six years. The account fluctuated between $200 million and $5 billion in value, depending upon what the client was doing, with the client transitioning in and out of the implementation account eight to ten times per year.

Case Study 2: Transition from AJO[2]

In October of 2020, AJO Partners announced that it would be closing its doors at the end of 2020, meaning that clients would need to move their assets to another investment manager.

Ultimately, we were hired by seven clients to take over their AJO portfolios, trim the tracking error risk from around 4% of the benchmark to somewhere around 1.5% to 2% of the benchmark, and then manage the assets on an interim basis until the clients could find a long-term solution with another investment manager.

The clients chose to go with a 1.75% tracking error to the benchmark (with an estimated cost of 12.5 bps, +/-14.2 bps), which saved them an estimated 34 bps in transaction costs versus going all the way to the index. We were able to achieve these results with only a 15% turnover in the portfolio, while still maintaining their desired investment exposure.

Case Study 3: Pension plan with EM Debt manager[3]

In mid-2020, a public pension plan approached us as they wanted to terminate an emerging-market debt manager as the whole underlying EMD portfolio management team had been taken on by another asset manager. They did not wish to leave the assets with the remaining portfolio managers and believed it could take six months to hire a new manager.

We helped evaluate a few options and provided various risk and cost scenarios. This analysis also factored in various turnover scenarios, ranging from 5% turnover to 20% turnover – and the risks and cost impacts associated with each scenario. In the end, we were able to reduce the tracking error by approximately 40% by turning over just 5% of the portfolio, while preserving the desired investment exposure. The tracking error was maintained within the targeted limits and a successful transition was implemented upon the completion of the interim mandate.

[1] Past performance does not predict future returns. Source: Russell Investments. Interim start date September 2017, completed December 2020.
[2] Past performance does not predict future returns. Source: Russell Investments. Interim start date July 2020, completed June 2021.
[3] Past performance does not predict future returns. Source: Russell Investments. Interim start date September 2022, completed January 2023.

Your portfolio always deserves specialist oversight and management – especially during times of change. We have the experience and deep capability set to help you manage your exposures and navigate the challenging road ahead. Let us know how we can help.

GET IN TOUCH:

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