FIXED INCOME TRANSITIONS: A SPECIALIST APPROACH

Russell Investments

INDEPENDENT TRANSITION MANAGEMENT ADDS TRANSPARENCY AND ACCOUNTABILITY

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Hiring a dedicated manager for the transition of equity portfolios is now considered best practice for both asset managers and asset owners alike. Yet still today fixed income transitions are often left unmanaged. Despite the opaque nature of fixed income markets, many of the trade- and risk-management practices in equity transitions have proved effective in fixed income transitions as well. Regardless of the asset class involved, asset owners should always seek to manage an investment transition in a manner that is consistent with the principles of prudence and due diligence.

Why hire a fixed income transition manager?

It would belabour a largely accepted point to say that transition management can add value to the investment process. Since the early 1990s, transition managers have saved institutional investors tens of billions of dollars in portfolio value[1], and transition management is now routinely used for the equity portion of a portfolio.

Historically, though, asset owners have put less emphasis on the management of fixed income transitions. The risks and costs associated with an unmanaged equity transition are considered unacceptable by most asset owners. however, when making shifts that involve fixed income portfolios, sponsors often revert to practices they abandoned years ago for equity transitions – even though the costs are often more significant. In fact, when alpha expectations for various asset classes are compared relative to average estimated transition costs, fixed income transitions erode a higher percentage of alpha than equity transitions (see **Exhibit 1**).

If a fixed income transition is managed incorrectly or not at all, the erosion of alpha can be significantly worse than the result shown in **Exhibit 1**. Thus, transition management is critically important in the fixed income marketplace.

Exhibit 1: Alpha expectations compared to average transition costs

MANDATE	BENCHMARK	TRACKING ERROR	TARGET ANNUAL GROSS EXCESS PERFORMANCE†	5-YEAR AVERAGE IMPLEMENTATIO N SHORTFALL‡	TRANSITION COSTS AS % OF TARGET ALPHA
Global equities	Russell Global Developed Equity Index	350 bps	200 bps	46 bps	23%
Global fixed income	Barclays Global Aggregate Bond Index	175 bps	100 bps	28 bps	28%

The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies, and/or current market conditions and are not an exact indicator. What you will get will vary depending on how the market performs and how long you keep the investment/product.

Source: Source: Russell Investments. For illustrative purposes only. It is not representative of a projection of the stock market, or of any specific investment.
† Estimated based on alpha expectations of Russell Investments Mutual Fund range.
‡ Average estimated TM costs from Russell Investments Transition Management performance database, three years to 31 December 2023.

Are fixed income transitions unique?

So why is it that asset owners still often default to using their existing asset managers when restructuring fixed income portfolios? Are fixed income transitions less complex to manage – is the process simpler than for equities? Do the same principles that apply to transition management not also apply to this unique and opaque asset class? Or do asset owners feel that transition managers lack the required skills?

We believe that fixed income transitions are often more complex, and that the main principles of transition management apply even more strongly to fixed income transitions. However, from an asset owner's perspective, the answers often derive from the fact that measuring the costs of fixed income trading can be more difficult. This lack of natural transparency can lead an investor to undervalue the usefulness of transition management in this asset class. Skilled transition managers can play a key role here in increasing transparency, (where too often) little exists, and helping clients understand the true costs of a transition. Finally, a skilled transition manager will be accountable for performance (no performance holiday), will manage market exposure and minimise transaction costs, which are the main aims for any transition regardless of the asset class.

There are both similarities and differences between fixed income and equity transitions. Asset owners can better steward investor assets through an understanding of how transition management applies to both.

Accountability for performance is a fundamental part of transition management, and asset owners must be wary of giving managers "performance holidays" (periods when managers are not accountable for performance) and remain sceptical of any claim that target managers are best suited for trading legacy and target assets.

Specialist approach

Although the mechanics of trading in equity and fixed income markets may differ, the goals are consistent. The transition manager must access the best sources of liquidity and act only as an agent for their client to ensure the best price. The need to source liquidity must be balanced with the need to maintain discretion and anonymity while managing the overall risk of the portfolio. And, for both bonds and equities, delay can incur opportunity costs and exposure to market risk. For either asset class, we believe the costs of unmanaged portfolio risk and market exposure are likely the greatest drivers of overall restructuring costs.

Some other key differences in implementation exist for a fixed income transition. Equity markets have exchange-centric trading, tailor-made options for managing risk, and an ocean of trade data and analytics. Compared to data availability for equities, the fixed income markets are the dark side of the moon. Whereas equity risk is driven by the particulars of company risk and market segment, the two primary market risks for bonds are interest rate risk and spread risk. There are also unique pricing and operational challenges for fixed income transitions which makes an experienced team a critical requirement of hiring a transition manager.

Comparing equity to fixed income transitions

SIMILARITIES	DIFFERENCES
• Performance focus • Risk-management process • Multi-venue execution model • Project management • T Standard reporting	• In-kind process and substitution • Key factors – interest rate & spread risk • Principal vs. agency market • Pricing valuation/ methodology differences • Operational burden • Crossing complexities

Over the past 20-plus years, Russell Investments and other institutional asset managers have developed specialist fixed income transition services, and asset managers are increasingly seeing the benefits that using a transition manager can bring to them. Execution capabilities have significantly improved, with transition managers having specialist traders who can add real value in sourcing liquidity.

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Do transition managers add value in fixed income events?

The evidence would strongly suggest that they do, both from an operational perspective, but even more importantly also from an overall cost perspective. Although asset managers and transition managers both trade fixed income bonds, the strategy and market interaction could not be more different. Asset managers are focused on alpha, research and trade ideas as they've been hired to outperform a benchmark. Transition managers are focused on exposure, risk, and execution as they have been hired to mitigate a shift. Below we outline a few major differences in the trading process between an asset manager and a transition manager, while both specialise in what they've been hired to do.

- Traditional asset manager's desk structures are segregated to a finite sliver of the market. Example, one trader will trade 1-3yr financials, while another trader will trade 3-7yr. This typically creates specialists, which is great for asset management, but limits the oversight of a TM program as a whole and can cause overdrafts, performance drag, and exposure issues if each trader does not communicate their part.

  ✓ *Russell Investments is active in all markets with intraday visibility to program level data and prioritise exposure risks over cheap trades.*

- Traditional asset managers leverage secondary trading for improved primary positioning, research and further allocations from bulge bracket dealers. Primary issuance plays a huge part in supply and building Alpha, but this limits execution to a smaller audience of dealers and is not generally better execution for TM order flow.

  ✓ *Russell Investments' traders are focused solely on best execution at the total portfolio level for their clients with an agency trading desk that is not influenced by primary issuance and research from trading counterparties.*

- In our experience, traditional asset managers typically trade with far fewer dealers. Each asset manager can have hundreds of accounts they are responsible for in their daily trading process. The operational burden to setup each of these accounts with hundreds of dealers is massive. Add in the alpha benefits listed above for primary issuance, and in our experience most asset managers will trade 90-95% of their order flow with only 10-15 dealers.

  ✓ *Russell Investments' traders interact with over 400 dealing books globally and diversify their trading flow with only ~72% of its order flow going to the top 10 dealers.*

- Asset managers with asymmetrical information can be viewed by the street as predatory leaving the street cautious on taking a position.

  ✓ *Russell Investments' trading desk has no principal book and only executes as a pure agent and is thus seen by the street as a liquidity provider and not predatory. Hence, we believe dealers are less cautious in their interaction with us.*

> *A transition manager has a clear mandate: minimise the performance impact of the transition.*

A prudent approach to moving assets

Hiring a skilled transition manager evidences the asset owner's level of care and due diligence this is consistent with their fiduciary responsibilities during changes to their portfolio structure. A transition manager has a clear mandate: minimise the performance impact of the transition.

To improve transparency and accountability, the transition manager will estimate the performance impact of a transition prior to the event; measure the actual implementation shortfall of the assets after the event; and be accountable for the performance of the assets during the transition period. Given the fundamental principles of fiduciary management, it follows that asset owners would want to transition assets with a clear mandate and understanding of the costs involved. Indeed, many asset owners believe they will fulfil their "prudent expert" responsibilities during a transition by providing transparent performance measurement. In the end, transparency into the performance impact of any restructuring is essential to the assignment of accountability. As Peter Drucker is attributed to have once said, "What gets measured, gets managed."

LOOK BOTH WAYS BEFORE CROSSING FIXED INCOME

With the potentially high costs of trading some fixed income securities, it is not surprising that crossing would be an attractive proposition. This can, however, be something of a cautionary tale in fixed income markets, where centralised pricing exchanges and crossing networks do not exist. The impact of this is that there is no single observable price or consolidated quote. Transparency into liquidity and price is therefore not readily available, so the challenge is in determining the price at which you cross. A transition manager who can independently source potential crossing counterparties at arm's length – and who can add transparency and competitiveness to the price-setting process by, for example, creating an auction environment for each trade – can have a material impact in reducing overall costs during a restructuring.

[1] Karceski, Livingston, and O'Neal (2001) estimate that an average equity fund incurs annually an average explicit brokerage commission of 38 basis points and as much as 58 basis points (bps) in implicit trading costs. Compared to transition costs that may, on the higher end, cost 60 basis points, and to the above fund costs being associated with only a 60% annual turnover, our figures significantly understate the value of the Transition Management proposition. To further avoid the appearance of exaggeration, we use here a conservative savings assumption of 20 bps per transition, with another conservative assumption of $2 trillion transitioned per year based upon a 2004 Global Investor estimate of $2.1 trillion in global assets transitioned. This leaves an annual figure of $4 billion saved annually through better transition management.

QUESTIONS?

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