Russell Investments

Practice Note

Russell Research

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T Standard implementation shortfall: Does it force trading faster than optimal?

Issue: An established measurement for the all-in costs, explicit and implicit, of a transition event is the T Standard.[1] The performance metric at the heart of the T Standard is a form of implementation shortfall that uses the portfolio value at the prior night's close as a reference point. Some observers are concerned that the T Standard creates an incentive to trade a transition quickly, since the risk of large market movements increases with time elapsed. But indeed does the T Standard truly reward a "fast" trading strategy?

The pace of trading encouraged by the T Standard is dictated by market volatility, potential views of fund flows, and liquidity conditions - which is what the investor should want.

Response: Implementation shortfall compares the transition's actual outcome to the ideal of an instantaneous, cost-free transition. There are two sources of shortfall or cost risk: one is the effect of non-instantaneous execution, and the second is the cost of trading. If there were no costs of trading, implementation shortfall would indeed encourage fast trading. Delay introduces the risk of shortfall – or opportunity cost – as the actual portfolio's performance inevitably diverges from that of the desired target portfolio. Transition managers must balance the two risks: fast trading is better than slow trading only to the extent that the additional cost of fast trading does not exceed the cost of delay.

Opportunity cost tends to be the dominant consideration in volatile markets or in highly liquid market conditions, while it becomes less significant in tranquil markets or illiquid conditions. Hence, the pace of trading will reflect market conditions. In this way the T Standard optimizes for the minimization of the total cost of the transition.

[1] The T Standard, Russell Investments. Available at: http://www.russell.com/us/institutional-investors/fiduciary-solutions/implementation-services/t-standard-transition-management.page?

Background

The earliest days of transition management were costly for investors. When pension plans or institutional investors changed their manager lineups or their asset allocations, assets would typically be transferred to the new managers for disposition. The new fund managers often asked for and were given performance holidays. Consequently, as they sold securities not belonging to their investment portfolio and opportunistically acquired target securities, they often did so in ways that were not cost-effective for their clients. Investors had no consistent and transparent reporting standards to which they could hold managers accountable during transition events.

To address this issue for its own fund complexes and for third-party transition events, Russell pioneered the T Standard, now an industry-accepted performance metric for measuring transition events. The T Standard captures the full time-weighted investment performance of the transition from the investor's perspective. It tracks changes in portfolio value from the pre-implementation period through to the transition's completion and the handoff of the target portfolio to the new manager(s) – with no performance holiday.

Earlier reports of cost measurement often gauged success in terms of trade-by-trade metrics against execution benchmarks such as Volume Weighted Average Price (VWAP), previous close, and Trade Weighted Average Price. These examples of trade metrics could hide the true costs of the transition on the portfolio's value. The T Standard offers eight simple rules for performance measurement, including that the arithmetical difference between the return on the actual portfolio and the return on the target portfolio is calculated from the date on which the terminated manager no longer has discretion to the time when the incoming manager does. The pension plans and consultants readily embraced the idea.

The T Standard uses as its implementation shortfall benchmark the portfolio's asset prices as of the night's close on the day before trading can begin. Therefore, it presents a reference value that cannot be met: even if one traded the portfolio entirely at next day's open and there were no liquidity constraints, the inter-day costs of overnight volatility would still appear in a T Standard report. *With* liquidity constraints – which are typically binding, in the case of institutional funds – trading the portfolio entirely on the open would have significant market impact.

DIFFERENT PERSPECTIVES, ONE PERFORMANCE MEASURE

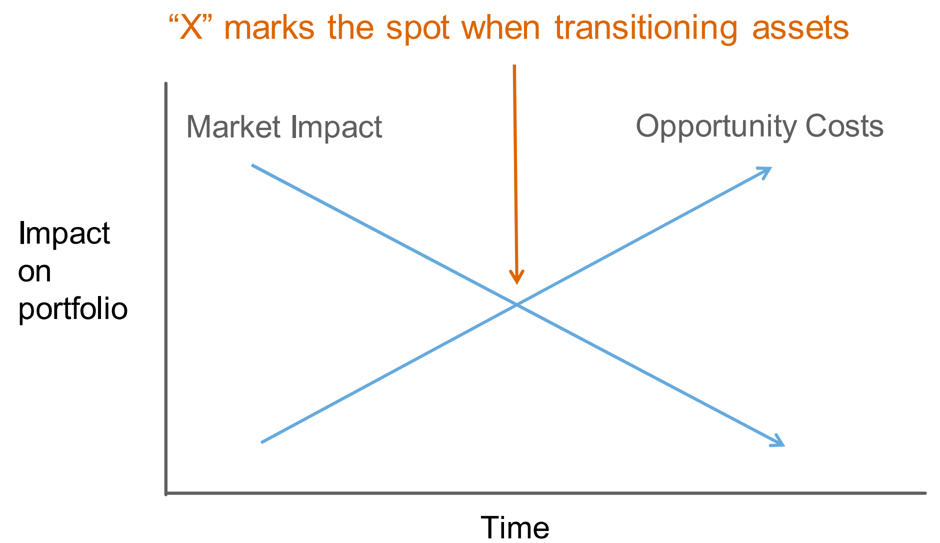
So from a transition manager's (TM's) perspective, the T Standard is a challenging benchmark against which to be measured. However, the T Standard emphasizes the perspective of the investor. The T Standard answers the asset owner's question, "How much is this restructuring costing me in asset value?" It is a method that shines a light on costs that are otherwise hidden, such as the true costs of pre-hedging, or of how much slippage may occur from trading.

So, given that a TM's final portfolio value is to be compared to the implementation shortfall benchmark close on the night prior to trading, one might think this creates an incentive to trade as quickly as possible. Yet there is a countervailing incentive, in light of the potential for higher market impact from trading too fast. Indeed, it is conceivable that if overnight volatility moves against the portfolio's values, there may even be an incentive to delay trades. Either way, the TM's overriding objective is to minimize the impact of the transition on portfolio values. The pace at which the portfolio is traded is a function of how much stock- and sector-specific risk is contained in the legacy and target portfolios, as limited by the amount of liquidity required to trade.

TRANSITION PERFORMANCE IS A DIFFERENT ANIMAL THAN PORTFOLIO PERFORMANCE

It is often the case that, unless the legacy and target portfolio managers (PMs) inform otherwise, the transition manager (TM) may make an assumption of "informationless" trades. What this assumption means is that the TM holds no belief in whether the security is trending up or down. Or the TM may have a desk view on fund flows or directional views on individual securities that they may incorporate into the overall transition strategy.

These are different perspectives than that of the target and legacy portfolio managers, who are likely to have views on the longer term fundamentals of the securities to be traded. Unless the target manager expresses strong preferences for the way the trades are to be done, the TM will focus instead on minimizing costs and risks to the portfolio while the baton is passed. A high-calibre TM will deploy an array of techniques designed for cost and risk management which typical alpha-seeking portfolio managers may not. Whether using risk models, market insights gained from awareness of flows, or anticipation of volatility spikes, the TM is continually watching for liquidity while the opportunity cost clock is ticking. A TM operates primarily upon liquidity views and risk profiles within as brief a period as possible (all else considered) to expedite the time from which the target active manager may assume control. Once the transition has been effected, then it is time for the target fund PM to make informed trades in pursuit of excess returns.



Trading in a way that minimizes impact on a portfolio requires a trade-off between market impact, which occurs from trading too fast, and opportunity costs, which occur from trading too slowly. The T Standard makes it easier for the investor to see a transition's all-in costs.

Upon completion of the event, the TM should provide the client with attribution reporting, such as the T Standard report, by which the client can judge the TM's competence and effectiveness. If the event was too quickly traded, market impact costs may dominate. If too leisurely a pace was taken in managing the event, opportunity costs may dominate. When performance is compared against the T Standard, the TM – and the investor – will desire an optimized trade-off between the two.

OTHER WAYS TO TRADE; OTHER BIASES INTRODUCED

The approach described above limits the transition manager's perspective to short-term views regarding volatility and liquidity, describing the trades as otherwise informationless. It is the approach Russell takes toward transition management. However, other approaches to transition trading are in use in the industry. They can be characterized either as proprietary position views or significant flow views.

Proprietary position views are formed when the transition desk may know of or have color on the size and direction of a firm's proprietary flows. If the transition manager knows that the firm's trading desk is eager to increase or decrease a particular position, this may bias the trading strategy of the event. Such biases are unlikely to favor the client.

Significant flow views mean that the transition desk has an institutional belief in the direction or magnitude of fund flows. An example might be a transition manager's awareness that there is about to be a large fund restructuring with factor or sector rotation. The manager may trade the client's securities at a faster or slower pace, depending upon the sign of the flow. In such case, the client may benefit from this insight, if the transition manager was correct.

To gauge and compare the effectiveness of the approaches described above, the T Standard has proven to be an effective performance measurement tool. The all-in impact of a transition upon the value of client assets needs to be accurately and transparently measured before the merits of a given approach can be debated.

MOTIVES AND INCENTIVES

If a transition manager decides to flood the market opening with trades, regardless of market impact, observers might reasonably question the motive. Perhaps the manager held a view that the market was moving in the wrong way for the client, and believed that waiting would be more costly than pushing prices. A client would be able to gauge the wisdom of the strategy by looking for price reversion in the following trading days.

If the transition manager runs a principal business with its own proprietary portfolio, another explanation is possible. The decision may have positioned the manager's firm to profit from the market impact incurred from trading aggressively and from the later price reversion. The manager may even suggest that the decision was intended to helpfully "provide liquidity," even as trading went against the client's portfolio. This would be not so much a performance measurement problem – any trade measure can be gamed – as a business model problem. To avoid such conflicts of interest, clients might use only those transition managers who act as "pure agents, "in which capacity they cannot trade against their clients.

RELATED READING

Collie, R. (2003). "Performance Standards for Transition Management". *Journal of Performance Measurement*.

Collie, R. and Murphy, A. (2008, June). "The new trustees guide to trading costs". *Russell Research*

The T Standard and Implementation Shortfall – How are they different?

Kirschner, S. (2011, November). "Transition management: Eight guidelines for choosing a trusted provider". *Russell Research*. Available at: http://www.russell.com/us/institutional-investors/research/transition-management-8-guidelines-for-choosing-a-trusted-provider.page

For more information:

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Important information

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