3 trends in implementation

Russell Investments

Sound implementation decisions in turbulent times can improve outcomes

"You may not control all the events that happen to you, but you can decide not to be reduced by them." - Maya Angelou

Volatility in global equity and fixed income is challenging for both strategic planning and the implementation of decisions. The anxious state of our global economic and political environment produces severe market swings in both positive and negative directions. Trade/tariff negotiations, dynamic Federal Open Market Committee (FOMC) policies combined with an inverted yield curve amplify investor anxiety, which is expressed with surprisingly large daily movements of interest rates, currencies and equity prices. Exogenous risks with binary outcomes require investors to manage portfolio changes more carefully than ever. Even small changes to a portfolio can have serious implications if risk is not carefully managed with thoughtful implementation. As an example, Russell Investments capital markets forecast for U.S. equity market returns is 2.6% annually for the next five years. A U.S. equity manager change could cost just 15 bps in transaction costs, but if the market exposure is not properly managed in the transition, the investor could easily lose an additional 40 bps in opportunity cost, eroding 20% of the expected return for that year.

Framing the problem is informative, but more important for investors is determining what can be done about it. Managing risk is the simple answer, but with a more in-depth examination, we realize that we must first identify how we measure risk, and that risk measurement standard should be consistent across the portfolio. Secondly, investors must quantify the risks associated with portfolio changes and control these risks through efficient implementation strategies. As we head into the last stretch of a volatile 2019, investors should be aware of some positive and some troubling trends we have witnessed in portfolio implementation.

Trend 1

One troubling trend we have seen over the past few years is an increased move away from *T Standard Implementation Shortfall* for measurement of transition events. One of the unfortunate outcomes of an industry that is continually competing to win new business based on low-cost estimates is that not all providers are measuring cost consistently. *T Standard Implementation Shortfall* has been the standard for measuring transition events as it represents time weighted performance and captures all costs: transactional and opportunity. However, in recent years, we have seen transition providers estimate and report cost on a methodology that starts the implementation shortfall performance clock at the same time and price point the provider is executing at. The best example of this is when a provider quotes the costs with a market-on-close (MOC) trading strategy combined with reference prices at those same closing prices. *T Standard Implementation Shortfall* does not allow for starting the

> *…the only measurement that captures the true cost of a transition event.*

performance clock simultaneously with the start of trading. Reference prices must go back to the prior night's close before trading begins to capture all costs including opportunity costs. And thus, the MOC strategy and measurement does not capture the costs of the MOC trading, nor does it account for any opportunity costs associated with waiting until the close to begin trading Making things even more confusing, providers often call this same day MOC benchmarking "implementation shortfall", but it should not be confused with *T Standard Implementation Shortfall* as they produce very different results. Consumers of transition management need to be aware of these different measurement techniques and recognize that *T Standard Implementation Shortfall* is the only measurement that captures the true cost of a transition event.

> *This trend is disturbing as these transitions accompany a 'performance holiday,' with no transparency to the cost.*

Trend 2

Another troubling trend we have witnessed is large investors foregoing an implementation specialist and relying on money managers to transition assets between mandates. This trend is disturbing as these transitions accompany a "performance holiday," with no transparency to the cost. In few instances, this may be a logical solution; however, in a vast majority of changes to public market portfolios, it is best practice for institutional investors to engage a transition manager or overlay services provider to help manage portfolio changes. This is especially so in the current geopolitical environment where volatility continues to be the story and prudent risk management combined with costs minimization is paramount to investor success. Geopolitical risks such as the trade war/deal between the United States and China will keep markets guessing and increasingly volatile. Add to this the hyper focus on FOMC policy in the United States, where market expectations will ultimately be reconciled with reality, you will see a market environment that requires rigorous exposure management to avoid surprises in benchmark relative performance.

> *This explicit fee structure provides more transparency to the transition costs and the business model of the transition provider.*

Trend 3

A positive new trend we have witnessed is an increasing use of cost-plus pricing for transition management projects. This explicit fee structure provides more transparency to the transition costs and to the business model of the transition provider. Cost-plus pricing details the transaction processing costs (i.e., execution venue access and clearing costs) and separates them from the transition management fee collected by the provider. Traditionally, the trade processing costs were embedded in the commission rates and coupled with the transition management fee, with no attribution of either cost component. This added transparency also has the benefit of adding clarity to transition management trading models. Certain trading models compete by focusing on low commission rates, while trading with sub-standard venues with no clearing costs or even receive trading rebates. These zero cost or rebate venues are attached to trading structures that allow high frequency traders to use the information to their benefit and therefore to the detriment of the transition clients. By understanding the trade processing cost/revenue equation of a transition provider, an institutional investor can ask more pointed questions regarding trading structure and can make better decisions regarding which provider has an incentive structure that is best aligned with the investor's implementation goals.

Implementation matters, especially in volatile times. Properly framing your implementation goals is the first step in the right direction. Applying best practice strategies to achieve these goals improves the probability of performance success.

If you would like more information on these trends or any other implementation topics, give us a call.

For more information

Call Russell Investments at **800-426-8506** or

visit **russellinvestments.com/us/solutions/institutions/customized-portfolio-services/transition-management**

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