Institutional investor best practice by 2025

Embracing an implementation platform designed to lower costs and improve outcomes

Russell Investments Research

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What will implementation for institutional investors look like in 2025? The investment management industry has witnessed dramatic change over the last five years and significant industry shifts continue to drive change in how institutional investors approach the management of their investment programs. Between now and 2025, we don't expect the investment opportunity set to expand materially, but we do expect how investors approach the overall management of their investment portfolios to evolve significantly. This new era will be driven both by asset owners' increased focus on fees and costs and the innovations investment firms are harnessing to help these asset owners seek improved risk adjusted returns at lower costs. Over the coming year, we're going to explore these shifts and evaluate how an implementation platform can help institutional investor improve outcomes.

Broadening the notion of incremental return

One of the questions asset owners are beginning to ask is: Are all return strategies of equal value? Is a cost savings tactic that is *certain* to save 10 basis points of fees equivalent in value to an alpha strategy that has the *potential* to add 10 basis points of return? We believe "certain" can contribute more value to your investment program than "potential," and the additional return created from judicious and prudent implementation is an often-overlooked facet of asset management that can add real value for investors. The benefits of careful implementation of investment portfolios can help investors achieve their goals with new focus and a modest change in process. This paper examines strategies investors can employ to improve their outcomes with modest changes in process – a clear focus on fee mitigation and transaction cost management.

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1. Maximize fee budgets by 2025

Today's institutional investor has a syndicate of different service providers, each providing disparate services at varying costs. Sub-adviser fees are generally the largest explicit cost for an investor and make up roughly 50% of the total costs associated with managing a large pool of assets.[1] In absolute terms, the resulting ratio of excess return to fees puts stress on risk adjusted net of fee outcomes at the total fund level for even very well-run portfolios.

Negotiating down asset manager fees is important to cost control; however, it's not the only strategy available to investors. Investors should also consciously allocate their finite fee budgets to the most attractive risk adjusted net of fee investment strategies. This will allow investors to work with the active management community to shift their focus to adding value over time by working with them to build high conviction/high active share portfolios, avoid overdiversification, construct more efficient RFPs, etc. In 2025, investors will have low-fee passive mandates for exposures they believe will not have profitable alpha and will have concentrated, high conviction mandates in areas where they see alpha opportunities.

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2. Accelerated mandate changes by 2025

Identifying better investment opportunities is one of the most essential parts of the investment process. Once these opportunities are uncovered, investors must pay the price (aka. transaction costs) to move assets to healthier investment strategies. Transaction costs account for approximately 25% of the total cost investors are paying to manage their investment portfolios according to the CEM study.[11] Mismanaged portfolio transitions can be very costly for large institutions, and therefore institutional investors have embraced specialist transition managers to minimize the transaction costs and manage transition risk for decades. Employing a transition manager almost certainly delivers better results than having disparate asset managers attempt to manage transitions across mandates. But with a deeper examination of the change process, we have learned that in nearly all cases, institutional investors have had a significant delay between the decision to terminate a mandate and the actual reallocation to a new mandate. During this interim juncture between decision and implementation, investors default to allowing the legacy manager to continue managing the assets until a new manager is identified and contracted. This procedural delay detains investor portfolios in out-of-favor strategies, while manager fees and transaction costs for this strategy continue to accrue.
We believe a better solution is to terminate the legacy strategy immediately after the decision to remove the legacy mandate is made and put the portfolio into a lower risk hibernation state with the help of an interim portfolio manager. Historically, investors have transitioned portfolios to index mandates in this interim period to minimize risk, but this is an expensive solution from a transaction cost perspective – requiring the investor to transition from active to passive, then back to active once a new manager is identified. Alternatively, using a custom interim portfolio management strategy can help optimize the portfolio to reduce tracking error to the benchmark, while preserving certain intended factor exposures and minimizing turnover and transaction costs. These interim management strategies prove to be less costly than completely restructuring a portfolio to an index and then transitioning from the index back to a new active mandate. The interim management strategy also provides fee savings, as the interim management fees are significantly lower than the average active manager fees. With lower transaction costs and manager fees, the interim strategy can be a better solution than the 'delay until the new manager is ready' paradigm most investor use today.

3. Centralized implementation by 2025

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Portfolio implementation has traditionally been delegated to sub-advisors, each with their own unique implementation process. Large institutional investors nearly always employ multiple sub-advisors to provide them with a diverse set of investment strategies. As a result, in most instances each sub-advisor operates in a silo, without transparency to the larger total portfolio experience. This myopic approach creates redundancies in the implementation process and adds significant costs to the investor. Historically, there has been a lack of transparency to the implementation costs from sub-advisors and thus investors cannot manage costs they cannot observe. For example, currency trading cost became a focus in the industry after several court cases[2] demonstrated that foreign currency trading for pension plans was much costlier than generally reported. Historically, many asset managers have put low priority on currency trading, considering it outside of explicit performance reporting requirements, and only an operational task to settle underlying security trades. With investors more focused on costs, this historic view is changing, and the industry has responded with foreign currency trading cost analysis and a shift from principal to centralized agency foreign exchange providers to manage currency execution and minimize costs.

Currency trading is only a piece of the transaction cost equation and investors are becoming increasingly savvy to cost minimization strategies through effective implementation. A new innovative approach to portfolio implementation – *Portfolio Emulation* (or *Enhanced Portfolio Implementation*) – is gaining traction now and we anticipate it will be the best-practice approach for managing multi-manager portfolios by 2025. Portfolio emulation is designed to reduce transaction costs and sub-advisor fees, while providing more transparency to the implementation costs of each investment strategy. Portfolio emulation is rapidly gaining market acceptance as the optimal approach for implementing multi-manager mandates. This approach offers a fundamentally new method of multi-manager composite construction that shifts implementation from the manager level to the composite level through centralizing trading responsibility at a single point – and you can read more about it in our Portfolio Emulation paper.

Implementation best practice 2025

Fees

Asset manager fees will continue to be a focus for investors and best practice will seek to maximize the value of manager fee budgets, hire high conviction managers for active mandates to avoid over diversification and get the most ‘bang for their investment buck.’

Interim portfolio management

The use of interim portfolio management as a tool to accelerate mandate change, reduce transaction costs and lower management fees will play an increasingly larger role in managing portfolio changes.

Centralized portfolio implementation

Centralizing portfolio implementation and unifying currently disparate trading functions will fundamentally change how institutional investors approach portfolio management, by lowering transaction costs and management fees, while providing more control over portfolio assembly and management. Structural changes to implementation such as Agency FX and Portfolio Emulation are already in motion and as investors observe the improved outcomes from these implementation constructs, they will migrate to implementation platforms for incremental return. (See Portfolio emulation paper & Agency FX case study)

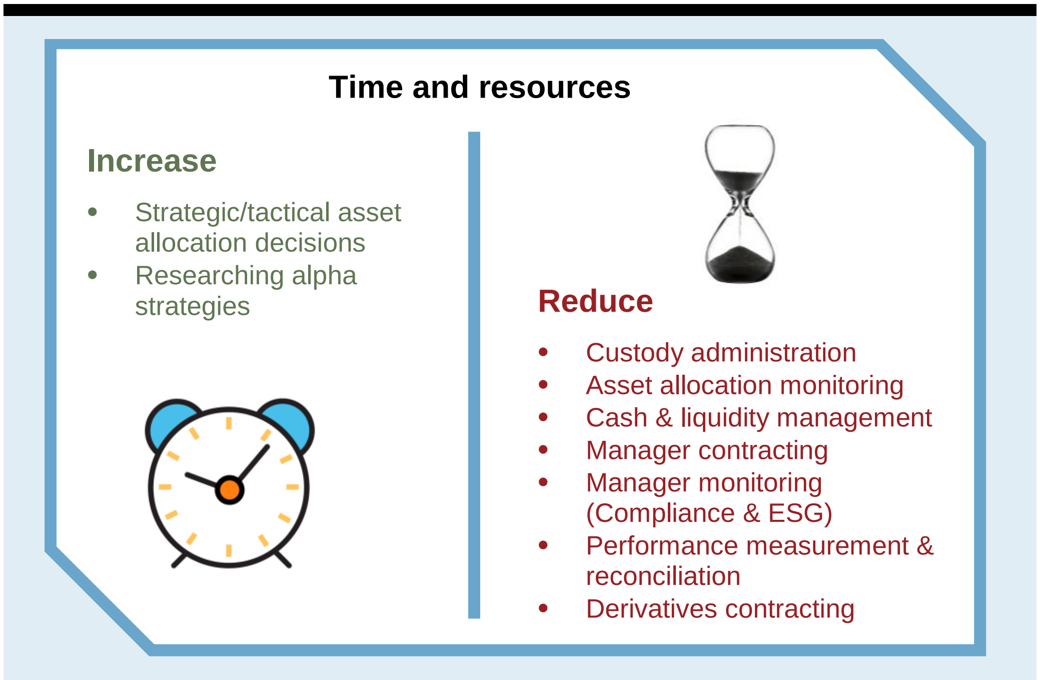
Conclusion

Regardless of what the future holds, we can be confident that investors will continue to seek to improve their investment outcomes. We believe better implementation will be an increasingly important theme in the years to come. Better implementation helps provide efficiencies, transparency and explicit focus that create genuine cost savings, which should improve return with more certainty than relying solely on the alpha strategies provided by the investment industry. Although implementation services are available to investors today, how they are consumed will be the key difference in the future. In 2025, investors will seek out integrated implementation platforms providing a collective set of capabilities rather than disparate services patched together to accomplish stand-alone investment goals. Investors will also look for firms offering a single implementation engine, which leverages capabilities in portfolio management, risk management and trading, combined with consultative strategy and operational scale. The combination of these capabilities is what creates a powerful implementation platform.

While the implementation platform has the potential to lower costs and reduce risk, its biggest benefit could be the shift of many operational burdens from the investor to the implementation platform partner. Investors want more time to focus on researching alpha strategies. Having access to a platform that holistically manages implementation has the added benefit of reducing the resources institutional investors need to manage their investment operations – as illustrated in Exhibit 1.

> *In 2025, investors will seek out integrated implementation platforms providing a collective set of capabilities rather than disparate services patched together to accomplish stand-alone investment goals.*

Exhibit 1: Institutional investor resource allocation with implementation platform



As 2025 approaches, large institutional investors will broaden their notion of incremental return to include cost savings from implementation efficiency. We believe the certainty of return from cost savings will drive investors to embrace the type of implementation platform we describe in this paper to improve investment outcomes. Today, investors should consider beginning adopting the best practice of finding an implementation partner with a platform to reduce implementation costs and fees in the future. The right implementation platform partner can help provide incremental return that is more certain than almost any other strategy, while improving control and reducing operational burden for institutional investors.

[1] Flynn, C., Dosanjh, T., Simmonds, J., Wang, F. (2018). “Transaction Costs Amongst Large Asset Owners.” *CEM Benchmarking Inc.* Available at: http://www.cembenchmarking.com/Files/Transaction_Cost_Amongst_Large_Asset_Owners_-_Sept_2018.pdf

[2] *The United States Department of Justice*. (2016, July 26). “State Street Bank to Pay $382 Million to Settle Allegations of Fraudulent Foreign Currency Exchange Practices” Available at: https://www.justice.gov/opa/pr/state-street-bank-pay-382-million-settle-allegations-fraudulent-foreign-currency-exchange
Freifeld, K., Raymond, N. (2015, March 19). “BNY Mellon to pay $714 million to settle foreign exchange cases”. *Reuters*. Available at: https://www.reuters.com/article/us-bny-melln-forex-settlement/bny-mellon-to-pay-714-million-to-settle-foreign-exchange-cases-idUSKBN0MF1WH20150319

Related reading

Bagley, T. (2018). “Portfolio emulation: The next evolution in portfolio implementation to reduce costs and improve returns with centralized portfolio management.” *Russell Investments Research*. Available at: https://russellinvestments.com/us/insights/articles/portfolio-emulation

Russell Investments. (2019). “Agency FX trading program: A reduction in cost by outsourcing and centralizing with one specialist provider”. *Russell Investments Client Case Study.* Available at: https://russellinvestments.com/-/media/files/us/institutions/case-studies/agency-fx-trading.pdf

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