Enhanced Portfolio Implementation

The next evolution in portfolio implementation to reduce costs and improve portfolio returns with centralized portfolio management

Russell Investments Research

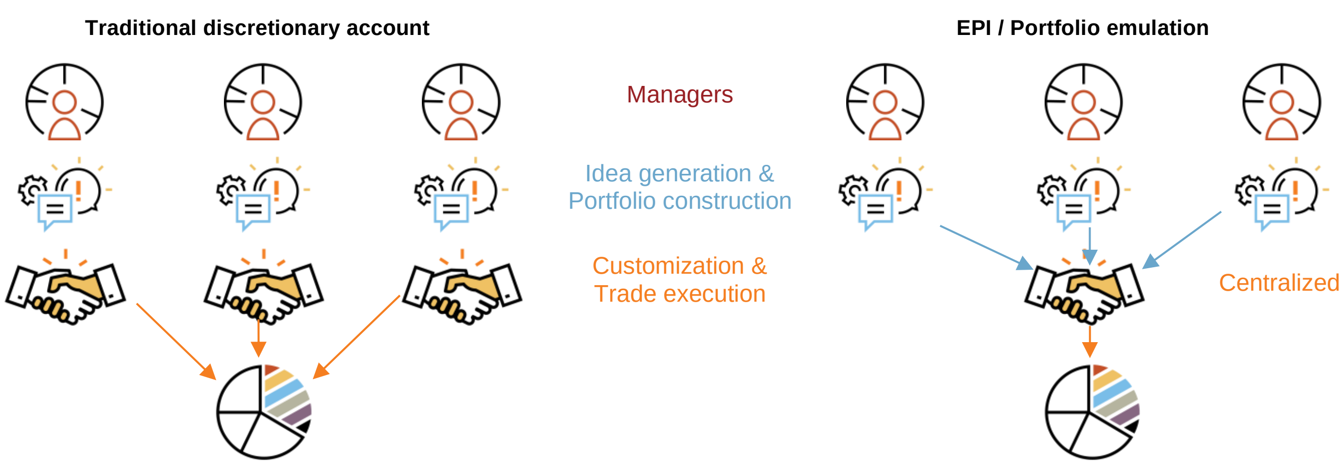
Travis Bagley, CFA, Director, Transition Management

By reducing costs to deliver better performance outcomes, Enhanced Portfolio Implementation (EPI) is a key innovation for active institutional investing. EPI forms an emulation strategy designed to deliver improved investment performance, and also provides investors with more control over the implementation process while reducing many of the burdens of a multi-manager discretionary account structure.

What is Enhanced Portfolio Implementation (EPI)?

EPI, or otherwise known as Portfolio Emulation, is an implementation model specifically designed to improve investing outcomes through the centralization of investment implementation. Rather than using separate discretionary account structures, portfolio emulation seeks to harness manager insights and consolidates them into a single portfolio.

Exhibit 1: Traditional discretionary account vs portfolio emulation



Source: Russell Investments

Key benefits for investors

The goal of portfolio emulation is to track the performance of single or multiple model portfolios in the same asset class within a single account, which includes the following benefits:

Eliminating offsetting trades

In the traditional discretionary account structure, you can observe the conflicting buy and sell transactions of the same securities by the individual investment managers. In a portfolio emulation strategy, however, the centralized approach seeks to avert underlying managers' execution of offsetting trades (i.e., trades that add costs without materially altering the composition of the fund's holdings). Managers buying and selling the same security incur negative results from transaction costs and incur unnecessary realization of capital gains for taxable accounts.

Our portfolio emulation research found that managers may not trade against each other at exactly the same time in exactly the same securities. However, wait a day, a week or a month – and the amount of trading overlap between managers increases dramatically. The emulation process of netting managers' offsetting trades results in a meaningful reduction in portfolio turnover (relative to the traditional fragmented discretionary account structure). The emulation process typically implements once a week, or on a fortnightly basis, to benefit from the managers' insight, while minimizing transaction costs and custody fees.

Eliminating trivial positions and inconsequential trades

Small positions and trades may be meaningful to an individual manager; however, in a large institutional investor's portfolio they may have an insignificant impact. By eliminating small holdings and trades, the portfolio's custody fees and trading costs are reduced with virtually no impact on the overall pre-cost return expectation of the portfolio.

Additional benefits of emulation relative to traditional discretionary accounts include:

- Reduced operational costs with centralized custody and accounting, particularly for international mandates where account registrations can be burdensome with time delays
- Potential for reduction in headline active management fees
- Access to a broader range of managers that might otherwise have either been prohibitively expensive or only available for larger mandates
- Simplified regulatory reporting (e.g., MiFID[1] II reporting) in some jurisdictions
- Pre-implementation analytics and risk management at the total fund level, providing actionable insight before implementation
- Taxable clients can have tax-efficient strategies employed in the centralized emulation account level, minimizing the tax implications of ever-changing manager insights
- Transparency and control of portfolio trading costs

These cost reductions provided by emulation strategies are designed with the goal of providing superior performance outcomes than the traditional fragmented discretionary account model. They also offer the investor an additional level of customization (e.g., ESG[2] filters) that is not easily implemented within a traditional structure.

> *These cost reductions provided by emulation strategies are designed with the goal of providing superior performance outcomes than the traditional fragmented discretionary account model.*

How are emulation strategies evaluated?

Emulation strategies are measured by evaluating the performance of the actual account relative to the transaction free target composite of all manager model portfolios. Then the turnover reduction and subsequent cost savings from the emulation strategy are incorporated into the comparison to quantify the net performance differential between the model portfolios and the actual emulation account. Additionally, the tracking error is monitored to ensure that the emulated portfolio is closely tracking the target composite.

Exhibit 2: Excess returns versus target composite[3]

	3-YEAR
Excess returns vs. Target composite (post cost)*	0.44%
Holdings alpha (emulated portfolio – transaction free model portfolios)**	-0.07%
Implicit/explicit cost savings (cost reduction with emulation relative to discretionary account management)***	0.51%
Turnover reduction (reduction in value traded with emulation relative to discretionary account)	-40%
Tracking error (emulation portfolio vs target model composite)	**0.65%**

Source: Russell Investments. For illustrative purposes only.

Russell Investments' experience and track record with portfolio emulation

Russell Investments pioneered multi-manager funds in the 1980s, and we believe this heritage gives us a unique advantage in creating an emulation solution. We combine our knowledge and understanding of investing with our global implementation capabilities to create a unique emulation process that our clients can employ, which seeks to improve investment results. Since 2009, and based on our live history in enhanced implementation across a variety of geographies and mandate types, Russell Investments' emulation strategy strives to consistently provide:

- Reduced turnover
- Reduced total commissions
- Reduced spread and impact
- Reduced service provider fees
- Improved after-tax outcomes
- Preservation of manager insights

Emulation can be efficient in all equity asset classes, from U.S. equity to emerging markets. For example, higher transaction cost markets (e.g., small-cap, U.K. equity and emerging markets) have experienced significant savings thanks to the emulation model cost and fee structure. Future improvements in market structure and technology will allow almost all asset classes to benefit from emulation strategies. As of December 31, 2021, Russell Investments' EPI AUM is $77.4 billion (USD) and over 100 managers have used our EPI program globally.

Who manages the relationships with the various investment managers?

The investment managers can be engaged by Russell Investments on behalf of the client, or the client can directly engage with the investment managers and request that their mandate be implemented via the emulation process. Some investors prefer that Russell Investments manage the individual investment managers, while others choose to directly contract with their managers. Either option works for the emulation process.

What's the cost of an emulation program?

A basis point asset management fee is received by Russell Investments for the emulation platform. This fee will vary depending on the size and type of mandate. In general, the fee is much lower than active manager fees and should provide the investor with a net cost benefit (when all the savings of emulation are compared to the emulation fee).

Why should investors consider adopting the emulation strategies?

The potential for improved performance

The improved performance potential can be a compelling argument to move to an emulation investment process; however, there are several other factors investors should consider when contemplating if emulation is the right strategy for them.

Managers' intra-day trading generally has added little value

The most frequent argument against emulation is that investment managers add value through intra-day trading of portfolios, and the emulation process prevents managers from making "fast-twitch" decisions on the portfolio. Russell Investments researched this argument[4] and found that any additional value created by investment managers with intra-day trading was 9 bps compared to the expected cost savings effects from the emulation process of c.16bps. It also found that EPI resulted in a more efficient implementation of multi-manager views, regardless of manager style or approach (Estimated 25% turnover reduction for 16bps of cost savings, 3bps performance drag and 19bps of performance gain overall after including expected trading improvements).[5] In addition, Russell Investments' has a long heritage of evaluating managers' trading capabilities where, in line with the above research findings, we have consistently found during the period examined that the costs of traditional discretionary account exceeded any value added through manager trading acumen.[6]

Attitudes are changing as the regulatory burden increases

Additionally, investment managers' attitudes on trading are changing, given regulatory changes which can affect trading structures around the globe. Bundled research and execution have come under scrutiny and the economics of internal trading desks have become less attractive for investment managers. With advancements in technology, we believe the properties of emulation are becoming even more appealing for investors.

Operational burden is reduced

Lastly, one major benefit for investors is the reduced operational burden relative to the traditional fragmented discretionary account structure. For instance, setting up international sub-accounts only once regardless of managers that come and go. Envision never needing to set up a transition account, transfer securities between managers or resolve reconciliation issues between the custodian and investment managers. This reduction in required resources provided by the emulation process allows investors to focus resources on other higher value-added priorities that could improve performance results.

This reduction in required resources provided by the emulation process allows investors to focus resources on other higher value-added priorities that could improve performance results.

Russell Investments portfolio emulation case studies[7]

The following are real-life examples of emulation strategies Russell Investments has managed on behalf of clients since June 2014. The emulation strategies have had net performance improvements (inception-to-date or ITD)[8] of:

- Emerging market equities — 26 basis points
- Global equities — 25 basis points

Exhibit 3: Emerging Markets global case study example[3]

Emulation portfolio versus target composite (annualized)

	ITD	5-YEAR	3-YEAR	1-YEAR
Excess returns vs. target composite (post cost)*	0.26%	0.26%	0.44%	0.09%
Holdings alpha**	-0.15%	-0.21%	-0.07%	-0.46%
Implicit/explicit cost savings***	0.42%	0.47%	0.51%	0.55%
Commissions per annum****	0.03%	0.04%	0.04%	0.04%
Spread & impact*****	0.39%	0.43%	0.47%	0.51%
Turnover reduction (relative)	-39%	-42%	-40%	-34%
Tracking error (emulation portfolio vs. target composite)	**0.60%**	**0.54%**	**0.65%**	**0.45%**

Emerging Markets Equity Portfolio, inception June 11, 2014, ending June 30, 2021. Past performance is no guarantee of future results.

Exhibit 4: Global Equity case study example[9]

Emulation portfolio versus target composite (annualized)

	ITD	5-YEAR	3-YEAR	1-YEAR
Excess returns vs. target composite[10] (post cost)*	0.25%	0.28%	0.24%	0.21%
Holdings alpha**	-0.12%	-0.09%	-0.12%	-0.12%
Implicit/explicit cost savings***	0.37%	0.37%	0.37%	0.34%
Commissions per annum****	0.04%	0.05%	0.04%	0.04%
Spread & impact*****	0.33%	0.32%	0.32%	0.30%
Turnover reduction (relative)	-36%	-40%	-38%	-38%
Tracking error (emulation portfolio vs. target composite)	**0.43%**	**0.44%**	**0.51%**	**0.63%**

Global Equity Portfolio, inception June 11, 2014, ending June 30, 2021. Past performance is no guarantee of future results.

Why consider portfolio emulation now?

Apart from the material cost reduction benefits that emulation can deliver at a time when the asset management industry is under enormous pressure to reduce costs, the best way to understand the question, “Why now?” is to examine the philosophy of emulation relative to the traditional fragmented discretionary account structure. Imagine an alternative universe where the first institutional investors implemented a centralized emulation model and thus emulation became the standard approach. Now envision the introduction of a concept to break a portfolio into fragmented parts, which increases costs, operational burden and complexity, and all this to allow investment managers to add value through intraday trading. Although, there may be some value in discretionary manager trading; the additional costs of a fragmented implementation can overwhelm the additional return potential of trading in a vacuum. We strongly doubt the fragmentation discretionary account strategy would have a fighting chance to displace emulation in any universe. The question is better stated, “Why not now?” Maybe the discomfort of breaking with tradition will prevent some investors from moving to portfolio emulation but remaining comfortable will come with a cost.

The arrogance of success is to think that what you did yesterday will be sufficient for tomorrow.

William Pollard

[1] MiFID II is a legislative framework instituted by the European Union to regulate financial markets. It replaces MiFID which was a European Union law which standardizes regulation for investment services across member states of the European Economic Area. Source: Investopedia.com

[2] ESG stands for environmental, social and governance factors considered in responsible investing.

[3] Source: Emerging Markets (EM) Equity Portfolio. Data as of 30 June 2021. Enhanced Implementation Inception: 11 June 2014. Figures are annualized.

*Net Return change = Gross return delta + Cost savings.

**Gross return delta = holdings only performance difference between EPI and the manager models

***Cost savings = Commissions per Annum + Spread & Impact. These figures are assumed savings based on the calculation assumptions defined for each.

****Commission per Annum = Turnover Reduction (actual) x Commission Rate. Russell Investments' Commission Rate is used for both EPI and the managers to provide an equal comparison.

*****Spread & Impact = Turnover Reduction (actual) x Trading Costs; Russell Investments = actual trading cost; Manager Models = ITG model costs.

******Stamp Duty = Buy turnover x 50bps.

Please note that the brokerage assumed in this analysis (EM 10bps) is higher than we may charge – making results highlighted more conservative than would have experienced over the same time period with an equivalent period. Past performance is not a guide to future performance.

[4] Source: Pritamani, M. (2010). "Emulating multi-manager equity portfolios," Russell Investments Research; Ross, L., Velvadapu, P., Wang, N. (2019) "Does intra-day trading add value".

[5] Past performance is no guarantee of future results. Performance is gross of fees. If fees were applied, the performance would have been lower.

[6] Gvozdeva, E., Velvadapu, P. (2019) "Emulation multi-manager equity portfolios"

[7] Case studies provided for discussion purposes only. Individual client results will vary based on individual circumstances and market events. There is no guarantee that all clients will experience the same positive results.

[8] Period from inception June 11, 2014 to June 30, 2021.

[9] Source: Global Equity Portfolio. Data as at 30 June 2021. Enhanced Implementation Inception: 11 June 2014. Figures are annualized.

*Net Return change = Gross return delta + Cost savings.

**Gross return delta = holdings only performance difference between EPI and the manager models

***Cost savings = Commissions per Annum + Spread & Impact. These figures are assumed savings based on the calculation assumptions defined for each.

****Commission per Annum = Turnover Reduction (actual) x Commission Rate. Russell Investments' Commission Rate is used for both EPI and the managers to provide an equal comparison.

*****Spread & Impact = Turnover Reduction (actual) x Trading Costs; Russell Investments = actual trading cost; Manager Models = ITG model costs.

******Stamp Duty = Buy turnover x 50bps.

Please note that the brokerage assumed in this analysis (Global /6bps) is higher than we may charge – making results highlighted more conservative than would have experienced over the same time period with an equivalent period. Past performance is not a guide to future performance.

[10] The target composite (post cost) represents the return of the collective model portfolios adjusted for transaction costs.

Connect & Follow us

Call Russell Investments at **888-751-8352**

Visit **russellinvestments.com/us/solutions/institutions/customized-portfolio-solutions**

About Russell Investments

Russell Investments is a global asset manager with a unique set of capabilities that we believe is essential to managing your total portfolio and to meeting your desired outcome. At Russell Investments, we stand with you, whether you're an institutional investor, a financial adviser, or an individual guided by an advisor's personalized advice. We believe the best way to reach your desired outcomes is with a multi-asset approach that combines: asset allocation, capital markets insights, factor exposures, manager research and portfolio implementation.

Important information

Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional.

Securities products and services offered through Russell Investments Implementation Services, LLC, part of Russell Investments, a SEC Registered investment adviser and broker-dealer, member FINRA, SIPC.

Russell Investments Implementation Services, LLC is a wholly owned subsidiary of Russell Investments US Institutional HoldCo.

Russell Investments' ownership is composed of a majority stake held by funds managed by TA Associates, with a significant minority stake held by funds managed by Reverence Capital Partners. Russell Investments' employees and Hamilton Lane Advisors, LLC also hold minority, non-controlling, ownership stakes.

Frank Russell Company is the owner of the Russell trademarks contained in this material and all trademark rights related to the Russell trademarks, which the members of the Russell Investments group of companies are permitted to use under license from Frank Russell Company. The members of the Russell Investments group of companies are not affiliated in any manner with Frank Russell Company or any entity operating under the "FTSE RUSSELL" brand.

First used: June 2018. Revised: May 2022

RIIS-04177 (05/25)