Russell Investments

Transition Management Explained

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Introduction

Interest in transition management (TM) has been rising in recent times, thanks to two driving factors. First, in a tough market environment where every basis point counts, TM can represent a significant source of cost savings and can positively contribute to total portfolio returns. Second, recent news coverage on lack of transparency and the departure of some providers from the marketplace has turned the investment spotlight back on this industry.

In December 2013 the Securities and Exchange imposed remedial sanctions and a cease-and-desist order to a TM provider for hiding fees in transactions. The SEC summarized the offense as: "Respondents held themselves out to the public as a unified conflict free agency broker that charged explicit commissions for equity order execution. In addition to explicit commissions, however, Respondents routinely took undisclosed 'trading profits' (TP) from global trading and transition management customers by routing customer orders to an offshore affiliate, which executed orders on a riskless basis and opportunistically added a mark-up or markdown to the price of the security."[1]

In February 2014, the industry attracted further attention when the Financial Conduct Authority (FCA) published the findings of its review of TM providers in the UK. The review (link below) highlighted the importance of the industry for asset owners, with over £165bn of assets transitioned annually in the UK via around 700 mandates. The FCA also emphasized the need for more rigorous governance on TM from investors, and for improved transparency and communication at some provider firms.

You can download the full FCA report here:
www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-01

With TM attracting increasing investor attention, our report is designed to help you understand:

- Why asset owners hire TMs
- The costs and risks involved in transitioning 5 assets
- How to mitigate costs and manage risks
- How to decide if TM is right for you
- How to choose a transition manager

[1]SEC (December 18, 2013). Summary, p. 2. Retrievable at: https://www.sec.gov/litigation/admin/2013/34-71128.pdf

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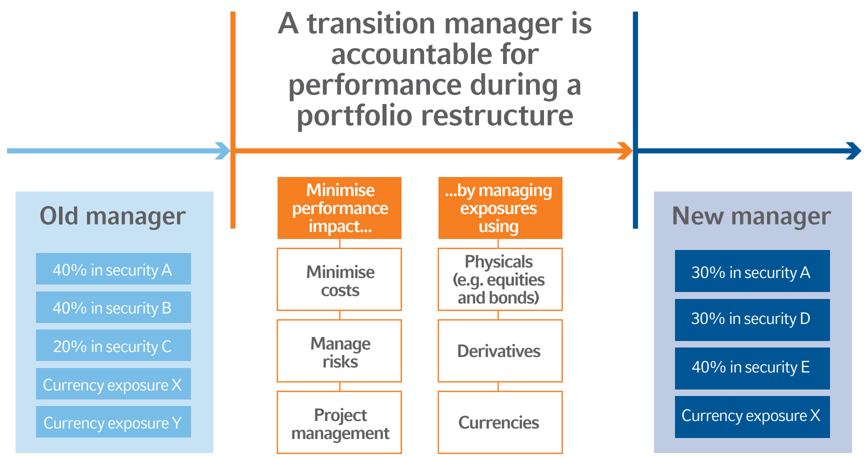
What is transition management?

Transition management is the process of managing changes to a pension fund's portfolio of assets. Often perceived as a short-term investment assignment, TM aims to reduce unnecessary costs and unrewarded risks associated with changes to investment exposures. These include physical securities (such as equities and bonds), currencies or derivatives exposures.

Common triggers for change that require TM are:

› Changes to a manager structure
› Strategic or tactical asset allocation changes
› Rebalancing the portfolio back to the strategic asset allocation
› Redeeming assets
› Investing contributions and other cash flows
› Pension fund mergers



For illustrative purposes only.

The transition manager

Transition managers rarely operate as in-house teams, as only the largest of funds are likely to have the right resources, experience and trading capabilities to successfully manage complex transitions. Instead, they are usually third-party specialist providers linked to an investment bank, asset manager, custodian, index provider or investment consultant.

Understanding the business model of your transition manager and how you interact with them is more important than the type of organization with which it is affiliated. This issue, which we explore in Section 8, is perfectly illustrated by a quote from Clive Adamson, director and supervisor of the UK's Financial Conduct Authority:

> *"When things go significantly wrong in a firm, it is not because it hasn't complied with a set of narrow regulatory rules, but because there is a fundamental flaw in the business model, in the culture, or business practices."*[2]

[2]Adamson, Clive. "Fair, transparent and competitive: the FCA's vision for the asset management sector." – *Financial Conduct*

Is using a transition manager right for you?

What are some potential benefits of working with a transition manager?

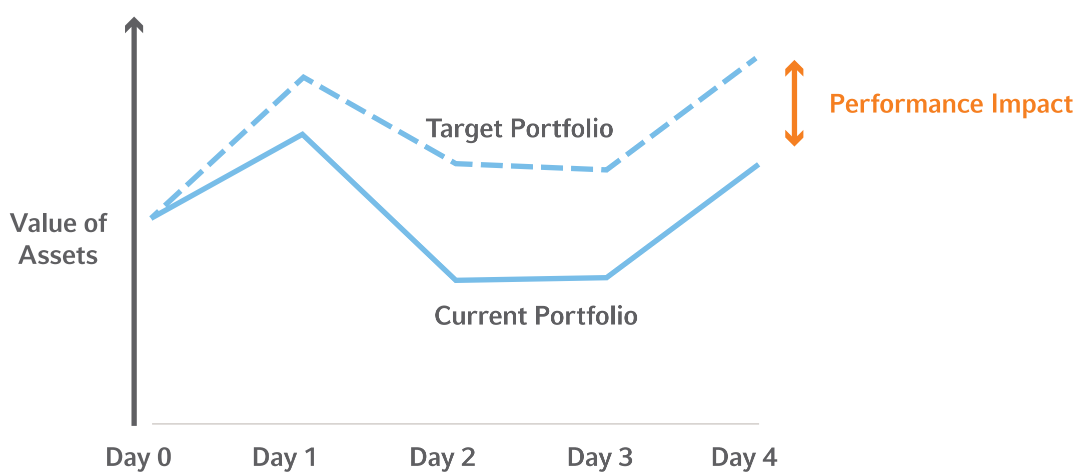
A transition manager is accountable for investment performance during the transition period, striving to **minimize the performance impact** of any restructure of assets. This can be achieved by:

1. **Minimizing unnecessary costs**. For example transition management could help asset owners minimize unnecessary costs if the new manager intends to hold some of the same securities as the old manager. If the pension fund sold all of the old manager's assets for cash and reinvested the proceeds with the new manager, the pension fund would incur trading costs on 100% of both the sales and the subsequent purchases.

   A transition manager tries to mitigate this risk by devising a trading strategy that minimizes the impact of differing portfolio characteristics (e.g., different exposures to cash or regional/country differences) on the overall performance. This type of trading strategy could involve the use of derivatives to manage the portfolio differences.

2. **Mitigating unrewarded risks**. Usually, transitioning from the old portfolio to the new portfolio can take a few days, but it can last weeks or, in complex cases, months. During this time, there is a risk that the performance of the portfolio being transitioned (current portfolio) can lag behind the new portfolio's returns.

A TRANSITION MANAGER HELPS TO MINIMIZE THE PERFORMANCE IMPACT OF ANY ASSET RESTRUCTURE



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Other potential benefits

Using project management skills and specialist trading capabilities, a transition manager can deliver other potential benefits for you, including:

- **Lower workload**: A transition can represent a significant drain on pension fund resources and can be closely linked with other activities, such as a strategic asset allocation change after an asset/liability study. A transition manager shoulders this burden for you, while keeping you, and all other potential stakeholders, fully briefed on all activities.
- **Transfer of risk**: Using a transition manager transfers the risk of any potential trading or operational issues – such as costs incurred from trading the wrong securities or from late settlement of trades – away from your pension fund.
- **Elimination of performance holidays**: There is always a delay between the time when an old manager is terminated and the time when the new manager has the new portfolio in place. Often the new manager doesn't take accountability for performance in this period, resulting in a "performance holiday." However, a transition manager assumes responsibility for performance during this period, ensuring there are no gaps in the overall performance history.
- **Detailed reporting**: What gets measured gets managed. The transition manager will give you a detailed report before the transition event, estimating expected costs and outlining the strategy for reducing costs and managing risk. This will be followed up during the transition with regular updates on progress and costs incurred. Once a transition is completed, the transition manager will provide an in-depth post-transition report, including detailed cost and performance attribution.

What are the drawbacks for working with a transition manager?

We believe the primary drawback for employing a transition manager is the additional documentation needed to engage a transition provider. This can create a delay in implementation if a transition management agreement is not in place with a provider. To alleviate this issue, it is recommended that investors contract with a transition management provider before the need arises. Transition management agreements are generally "evergreen" agreements that can be deployed at the time of a specific event. With a transition management agreement in place, investors can quickly engage a provider without delay to the process.

Should we employ a transition manager for every transition event?

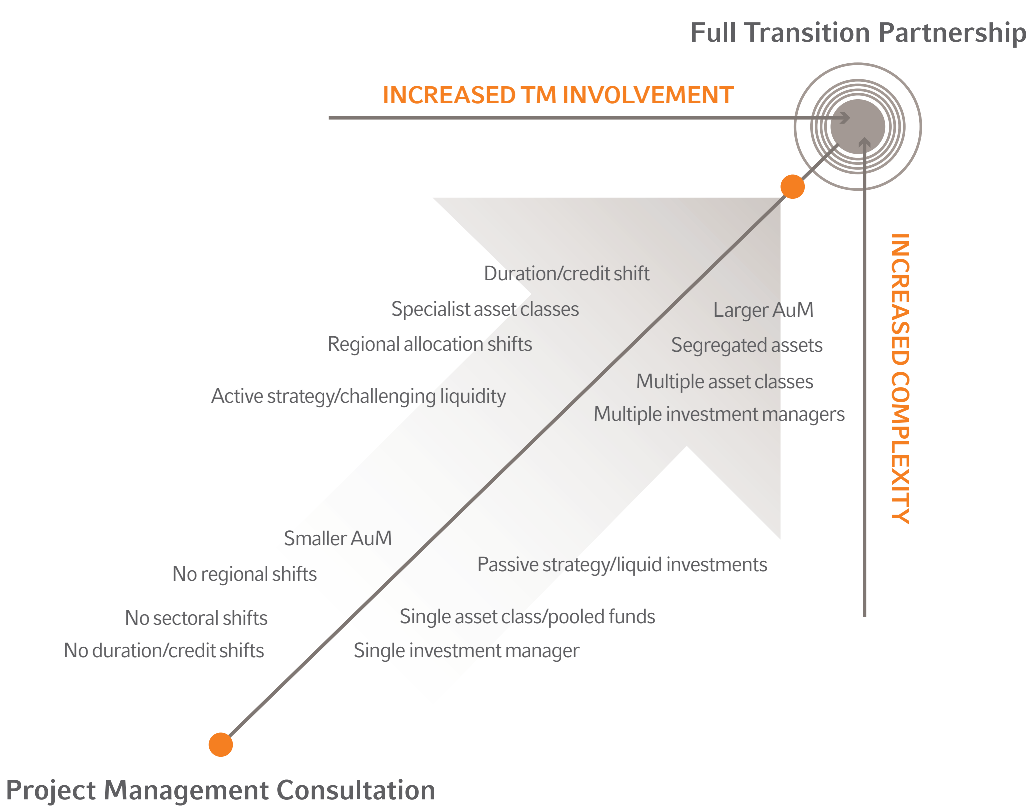
It makes sense to consider TM for each transition event, even if you ultimately reject it. You can employ a transition manager in a number of different roles. These can range from a consultative role to a full transition where the TM provider assumes full responsibility for strategy and implementation of the event.

A transition manager may add less value within very simple reorganizations, where the transitions happen within a single organization, instrument type and asset class. This can also be the case when transitions take place between pooled funds where in-specie transfers (taking securities in lieu of cash) are not available or are not cost-effective.

However, the need for an external transition manager increases in line with the complexity and time requirements of the transition event. The factors which influence the decision to employ an external specialist include:

- Involvement of segregated assets
- In-specie transfers are available or requested
- Exposure shifts
  - Duration change
  - Credit rating shift
  - Regional asset allocation shift
  - Sector allocation shift
  - Strategy shift (e.g., passive to active strategy)
- Multiple asset managers
- Multiple asset classes
- Inclusion of specialist asset classes
- High value of assets involved
- Specific trading benchmark required

THE NEED FOR AN EXTERNAL TRANSITION MANAGER INCREASES IN LINE WITH COMPLEXITY AND TIME REQUIREMENTS



In some cases, it may initially appear that a transition manager is not needed, but the opposite is often true. This could be the case for a simple manager restructuring within emerging markets or for a change in corporate bonds. Price volatility over short time periods (within a day) can be high in these markets. Without a transition manager to manage this risk, a pension fund could be hurt by adverse price movements.

Also, a transition manager can use local experience, expertise and broker relationships to advantage in specialist markets like these, which offer less transparency on liquidity (the ease of buying or selling) and spreads (one of the potential costs of transacting). This can significantly lower the expected cost of the event and reduce the overall investment risk.

Consulting a transition manager in the planning stages for potential transition events can be helpful. If the activity is a straightforward, low-value, pooled fund reallocation, it may not make sense to appoint a transition manager to manage and execute this event. However, a consultation process could still be informative. A TM specialist can help in the planning stages of this type of event, helping to ensure the objectives are met at optimal risk and cost. An example would be ensuring that the timing of investment and disinvestment is managed to minimize out-of-market risk.

Can our in-house team manage the transition?

Possibly, but only if your in-house team has the right resources, trading capability and experience. (See Section 8 for guidance on picking the right transition manager.) You should take the same objective approach to judging your internal team as you would with a third-party provider. Also, bear in mind that during the transition period, your in-house team will likely be the sole fiduciary over the assets, which includes performance accountability.

Should our outgoing manager transition the assets?

Only if your outgoing manager, or its affiliate, offers TM as a specialist standalone service. It must also take accountability for performance during the transition period and have the expertise to manage your specific event. If not, the manager has little incentive to maximize cost savings for you and could use the transition to restructure its existing portfolio on more favorable terms for its remaining investors.

Can our incoming manager do the job for us?

As with the outgoing manager, only if your incoming manager, or its affiliate, offers transition management as a specialist standalone service, will be accountable for performance during the transition period and can demonstrate the skill and expertise required for that specific event. If not, the manager could ask for a performance holiday until it restructures the incoming assets. This leaves no one measuring or, more importantly, accountable for performance during the transition period.

It's important to note that if you do use your incoming manager to restructure the assets, you should demand the same level of reporting and oversight that you would of a specialist transition manager, ensuring complete transparency over the whole restructuring period.

Should we allow our investment consultant to manage transitions?

A number of investment consultants do offer basic transition services. This mainly happens where the transition is just a coordination exercise involving no market trading. You should demand the same level of reporting and oversight that you would of a specialist transition manager. However, not all investment consultants have specialist transition teams, so check that they have the right expertise for your specific event and that they will accept the same level of accountability that you would expect from a specialist TM provider.

Should we use a transition manager when funding from or into cash (i.e., for "one-sided events")?

The potential benefits of employing a transition manager – including increased transparency, avoiding performance holidays and cost and risk reduction – are the same whether or not one side of the transfer is from or into cash. In fact, the exposure risk during a transition can be greater when moving into or out of cash, and the larger and more complex those transfers are, the greater the potential benefit from using a transition manager.

Transition costs

Transitions involve two types of costs that need to be managed: explicit and implicit.

Explicit costs

Explicit costs can be objectively measured and include:

› **Pooled fund transaction fees:** charged by pooled funds to exit or enter a fund, e.g., anti-dilution levies

› **Brokerage commission:** fees paid to transact a trade. Typically, transition managers take remuneration in this form

› **Management fee:** a transition manager may charge an explicit asset-based fee for managing the transition

› **Custody fees:** fees paid to a custodian to change ownership details

› **Taxes and exchange fees:** examples include SEC fees for stock sales

Implicit costs

Implicit costs are harder to measure and include:

› **Spread**: Also known as the "bid/offer" or "bid/ask" spread, the spread is the difference between the highest price someone is willing to pay for a security and the lowest price at which someone is willing to sell it. The spread narrows as the number of buyers and sellers increases, i.e., the more liquid the stock. This translates into lower potential cost. (See "An example of spread: Converting your holiday money" on page 11.)

› **Foreign exchange**: Commissions from trading foreign exchange can be quoted as an explicit amount, but are usually quoted as an implicit cost via a spread on the executed price. Sometimes, pension funds automatically hand over foreign exchange trading to a manager or custodian and they agree on commissions in advance. These commission levels are priced assuming relatively small trade volumes. However, for large trade volumes, as in the case of a transition, these existing fee arrangements may be unsuitable and unduly expensive.

› **Market impact**: Buying an investment may cause the price to rise, while selling it may cause the price to fall. If a security trades frequently, you would need to be trading a larger amount before you affected its price. Conversely, if a security does not trade frequently and you have a large quantity to trade, you will likely adversely impact the price.

- **Opportunity cost**: In theory, you would aim to move into the new portfolio with the new manager with no delays. In practice, this can take time. During this period, there will often be a difference in performance between what you actually hold and the portfolio you are trading into. The difference in performance that is attributable to the overall movement of the market is called opportunity cost. This opportunity cost could be positive or negative, depending on the relative price movements of the old and new portfolios.

AN EXAMPLE OF SPREAD: CONVERTING YOUR HOLIDAY MONEY

In the past, when you exchanged your U.S. dollars for the local currency of your holiday destination, it was common to compare the commissions you paid to the agent that converted your currency. The rates at which they converted your money were broadly similar.

Today, most places convert currency at 0% commission. However, in practice, their commission is just hidden in the exchange rate they offer you. Unless you have paid a premium (another form of commission) to guarantee the same conversion rate when you change back any unused currency, the rate you get may be unfavorable to you. In other words, if you converted your money, didn't use any of it and converted it back, you could be worse off even if there were no changes in the currency rates offered. This is due to the spread.

As illustrated in the table below, which shows the "buy" and "sell" rates* of U.S. dollars (USD) to Euros (EUR) and South African Rand (ZAR), the spread will be greater for less-traded currencies – South African Rand in this case.

CURRENCIES CONVERTED	BUY RATE	SELL RATE	DIFFERENCE
USD: EUR	1.2939	1.2937	0.02%
USD: ZAR	11.0138	11.0037	0.09%

Source: www.tranzfers.com as at June 25, 2014

* Bloomberg WMCO bid/offer rates as of September 12, 2014.

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Transition risks

Transitions involve two types of costs that need to be managed: explicit and implicit.

Financial risks

Examples include:

› **Exposure risk**: Any mismatch between the exposures in the new and old portfolios could lead to losses due to the performance difference of the mismatch during the transition. The main drivers of market exposure risk are differences in asset classes, regions, sectors, capitalization, country or currency. Individual security holdings can also lead to exposure risk, especially if they are volatile or illiquid.

› **Trading risk**: Poor trading strategies can lead to inferior trade pricing. Examples include trading in quantities which are too large, leading to excessive market impact, and failing to use a variety of execution venues to obtain the best quote. The latter is a particular issue in markets where there is no central exchange, such as in bond markets.

› **Information leakage**: Telling other traders what you intend to trade, for example, when getting quotes from different brokers, may allow them to position their own books to your detriment.

Operational risks

Examples include:

› **Communication risk**: Many transactions can be highly complex, so poor communication can trigger any of the risks in this section.

› **Settlement risk:** If a trade made during a transition is not settled, this can create a number of problems. It could lead to financial consequences in the form of fines, interest claims, or "buy-ins." And the failure of one security to settle could lead to settlement issues with other securities, as the necessary funds might not be available. Given the large volume of transactions in a transition, accurate settlement procedures are essential to avoid unnecessary additional costs.

› **Trading risk**: The risk of trading a security that the fund does not currently own or wish to own.

› **Currency overdrafts**: The correct trades must be executed and the corresponding currency must be available to make proper settlement. Incorrect currency balances can lead to overdrafts in other currencies.

Minimizing costs and risks

Pension funds typically use transition specialists to employ a number of strategies to reduce unnecessary costs and mitigate unrewarded risks during a transition.

Minimizing explicit costs

Taking an in-specie transfer

In-specie transfers are the process by which a portfolio of securities (usually a complete slice of the underlying fund benchmark) is taken in lieu of a cash redemption from, or subscription into, a fund. Where in-specie transfers are allowed within funds, they can represent an invaluable way to reduce overall transaction costs.

Examples of ways transaction costs can be reduced are:

› In-specie equity securities are generally transferred at closing prices without additional trading costs, whereas cash redemptions/subscriptions can be charged transaction fees to reimburse the fund for the trading costs incurred by the shareholders of the fund.

› Securities received from an in-specie redemption can be used to build the new portfolio, thereby reducing overall turnover and hence costs.

Where a transition involves pooled vehicles, the transition manager must conduct a cost/benefit analysis to see whether in-specie transfers would work to the client's benefit. Your transition manager should demonstrate clearly that any in-specie transfers reduce cost or risk overall. That's because most transition managers are remunerated via brokerage commissions from trading activities and in-specie transfers can lead to additional market trading.

Maximize retentions (also known as "in-kinds")

By identifying securities in common between the old and new managers, you can significantly reduce overall transition costs, as these securities do not need to be traded.

In fixed income markets, the number of common securities is typically much lower than in equity markets. This is because there are many more securities with similar characteristics, such as bond issue by the same issuer, but with different maturity dates or coupon amounts. Effective transition managers increase retention levels by negotiating between the two parties so that securities with similar characteristics, rather than exact matches, are retained.

Crossing

Trading assets in the open market creates a number of costs. However, when transition managers find a buyer or seller outside the open market, some of these costs can be reduced. Crossing can save costs by reducing market impact and spread.

Common ways to "cross" assets are to find a buyer or seller from:

- **Internal crossing networks**: This includes other transitions or other sources ("liquidity pools") at a related company, e.g., old manager, new manager, another asset manager, custodian or the transition manager.
- **External crossing networks**: This includes specialist networks built for this purpose, such as E-Crossnet and POSIT®.

However, while crossing can be a valuable tool for transition managers to source liquidity and reduce costs, it is important to stress that crossing should not drive the overall trading strategy; it should be one tool in the strategy. Overemphasis on crossing can lead to suboptimal overall performance, and large crossing rates do not necessarily mean lower costs or better risk management.

Furthermore, "shopping" transition orders to the market when looking for crossing opportunities can cause information leakage and market impact. Intelligent crossing strategies, such as using various electronic communications systems networks (ECN) and alternative trading systems (ATS), can reduce the negative impact by anonymously accessing liquidity. Other strategies to maintain discretion include asking for "blind" bids, where you ask for quotes based on portfolio characteristics rather than portfolio holdings, and routinely soliciting "blind" bids on phantom portfolios to help disguise real bids.

Minimizing spread and market impact

Using a variety of trading (or "execution") venues minimizes the risk of poorly executed trades. Furthermore, it can reduce trade costs, spread and market impact. Using multiple trading venues also enables the transition manager to break the trade up into small tranches while still maintaining the overall risk profile of the trade as a whole. This also helps disguise the overall size of the trade and ensures that a smaller "footprint" is left in the market, reinforcing client confidentiality.

Managing opportunity cost

Managing exposure risk

Some strategies, such as crossing or redeeming pooled fund assets for cash, can appear to reduce costs. However, they can actually create unintended (and unrewarded) investment risks.

When designing an investment portfolio, the biggest influence on risk and return is the asset allocation decision. The same is true for transition events. That is why it's fundamental that the transition strategy takes into account the asset allocation impact of any trading decisions. Managing the asset allocation changes in a transition helps to reduce performance volatility between the old and the new portfolios and therefore limits any potential opportunity cost.

To achieve this, transition managers use strategies which may include:

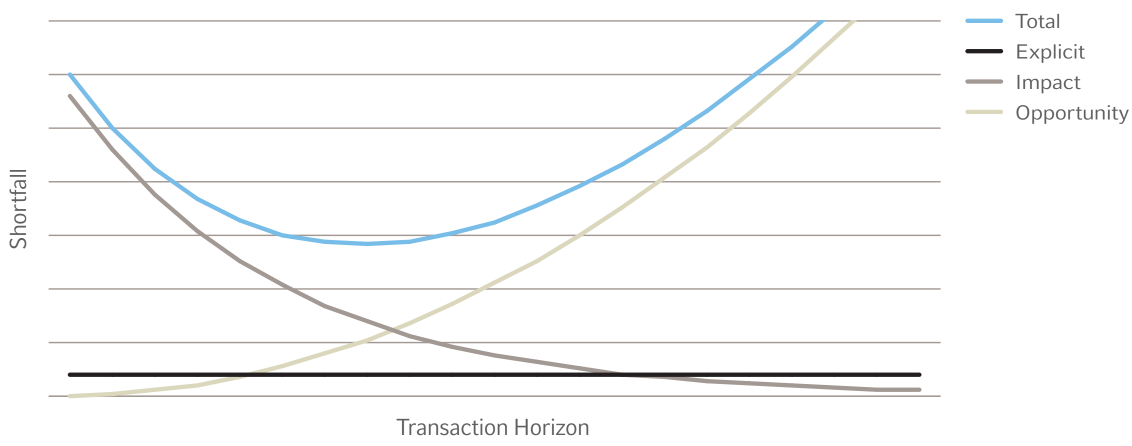
- Using derivatives to ensure appropriate market exposure is maintained and to minimize the return difference between the old and new portfolios
- Using currency forwards or futures (types of derivatives contracts) to effectively neutralize the risk represented by the difference in currencies between the old and new portfolios at the onset of the transition.
- Conducting risk analysis to help decide the optimal balance between speed of execution and risk management. Often a significant amount of the risk (expressed as tracking error) between the old and new portfolios is concentrated among relatively few securities. The transition manager aims to identify these positions and, liquidity permitting, to trade them as early as possible in the implementation period.

Balancing market impact and opportunity cost

As opportunity cost increases over time, at first glance it is intuitive to transition to the new portfolio as soon as possible, as this is the strategy that will most likely minimize opportunity cost. However, this could result in trading in large volumes, which could in turn negatively affect prices, by causing "market impact."

A good transition manager will find the optimal transition time horizon that minimizes market impact and potential opportunity costs. This is illustrated in the chart below which shows the two conflicting factors affecting the time horizon. The optimal time horizon will depend on the transition manager's expectation of daily trading volumes of the securities being transitioned and performance volatility between the old and new portfolios.

TRANSACTION COST TRADE-OFF



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Balancing internal crossing benefits with opportunity cost
Maximizing the amount of any "internal crossing" makes sense in theory, as it can reduce spread and explicit costs. However, in some cases it may come with implicit costs and risks. First, if there are any delays in timing of the internal cross (for example, many index funds cross at the end of the day or wait for crossing opportunities with an internal index fund), the opportunity cost of waiting may outweigh any potential cost saving, especially since the securities most likely to be crossed are the most liquid ones that can be traded quickly and efficiently in the market. And second, waiting for the right time to cross may prevent other trades being carried out in a more timely manner.

Minimizing operational risks

The easiest way to minimize operational risks is to employ a transition specialist with the resources, infrastructure and experience to project-manage each transition. This is particularly important for complex transitions, i.e., those involving multiple managers, multiple asset classes, specialist asset classes or high values.

The life cycle of a transition

So, once you've engaged a transition manager, what happens next?

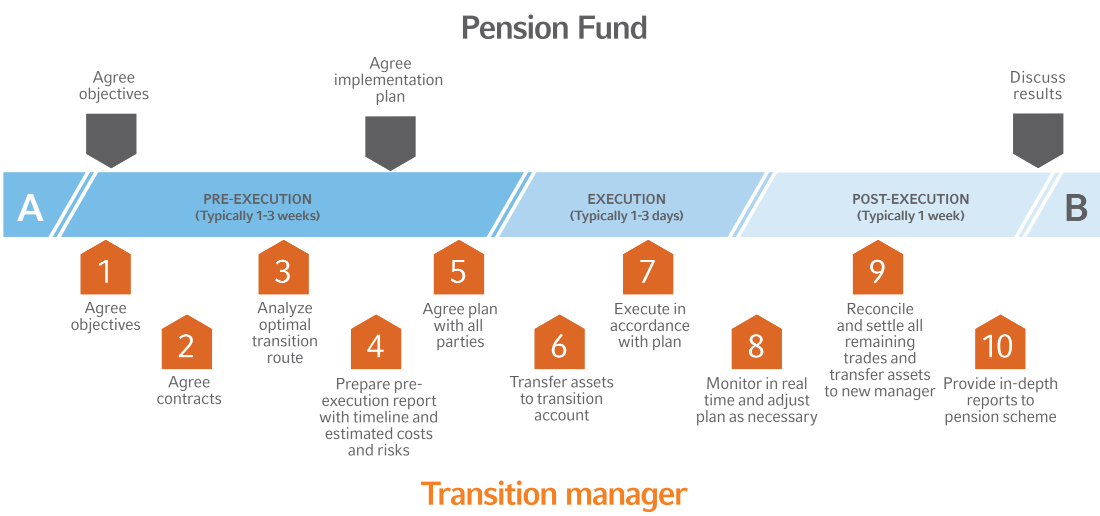
Successful TM is underpinned by three key criteria:

› A specialist project manager that is accountable for performance throughout the transition.

› A detailed transition strategy from the outset.

› Detailed and objective measurement of the actions needed to deliver each outcome.

A typical transition is split into three distinct phases: pre-execution, execution and post-execution.



Provided for illustrative purposes only.

Stage 1 – Pre-execution (planning)

Typically the longest phase, this involves meticulously planning each stage of the transition, focusing on:

› Identifying objectives, constraints and risk tolerance: setting expectations.

› Contracting between all relevant parties. Typical agreements include:

  – A transition management agreement, including terms and conditions for trading.

  – Due diligence Know Your Client (KYC) documents.

  – Letters of authority to custodians and managers to accept instructions from the transition manager.

  – Nondisclosure agreements between the managers and transition manager.

- Researching all investments involved to identify the optimal route to transition which balances cost savings and risk mitigation, for example:
  - Analyzing pooled fund exit options.
  - Identifying retention opportunities.
  - Researching crossing opportunities.
- Developing the implementation/trading strategy alongside the quantitative research and trading teams.
- Preparing a detailed pre-transition report which includes a detailed timeline and estimates of cost and implementation shortfall.
- Contacting all relevant parties, setting appropriate expectations and outlining the timeline to be followed. This is important, as it reduces one of the biggest operational risks: communication risk.

Stage 2 – Execution

The length of this stage can vary depending on the complexity of the transition, but usually takes just a few days. Steps include:

- Transferring assets to the transition account held with a custodian (either used by the old, new or transition manager).
- Identifying all securities being retained by the new manager.
- Trading the remaining securities.
- Monitoring the transition and making any necessary adjustments to the plan along the way.
- Providing regular updates on progress and costs.

Stage 3 – Post-execution (reporting)

Once the last trade has been executed, the transition manager works closely with everyone involved to make sure all trades are reconciled and settled in a timely fashion. Next, the assets are transferred to the new manager. The transition manager also produces the post-transition report, which will be presented to the client after the transition is concluded.

The goal of the post-transition report is to:

- Tell the "story" of the event in an easily digestible format.
- Report on the overall result and highlight any differences from pre-transition estimates.
- Report on the strategy deployed.

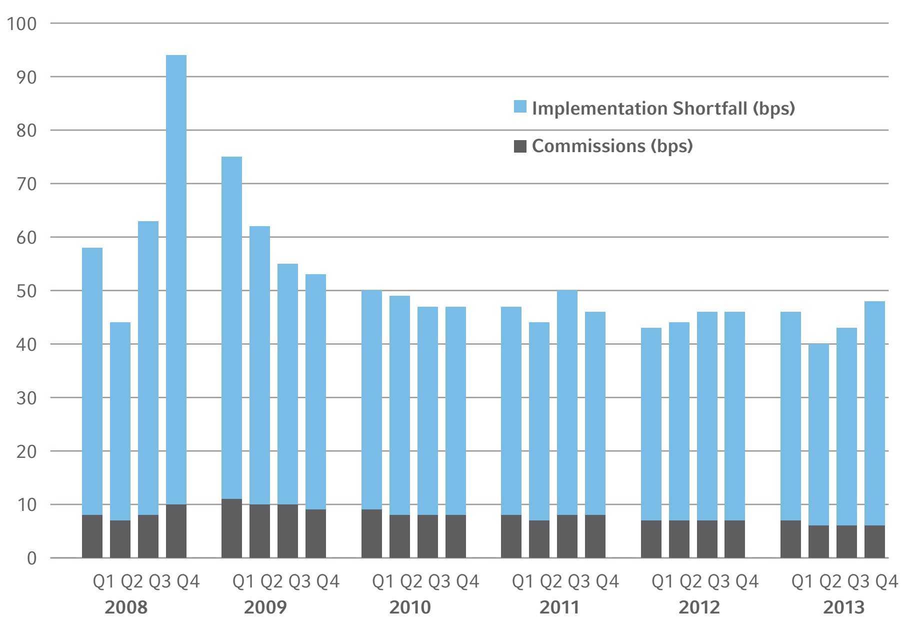
Choosing the right transition manager for you

Choosing the right transition manager for your fund can be challenging. There is often little transparency on how providers are remunerated, and lack of standardization across track records makes it hard to compare like for like. In some cases, this can work against you by allowing providers to hide implicit costs or cherry-pick the events they include in their performance track records.

Don't focus on brokerage commission alone

It is understandable that clients often look for the provider with the lowest explicit commissions, as this is seemingly the area they can most directly influence. However, as we all know, the lowest price doesn't necessarily mean lowest overall cost or best result. There are greater potential costs for the uninitiated. Investment Technology Group, a transaction cost-analysis provider in the U.S., demonstrates that explicit commissions and fees actually represent one of the smallest components of overall trading costs (see chart below).

COMMISSIONS ARE JUST PART OF THE PICTURE



Source: Investment Technology Group. Commissions and implementation shortfall based on ITG's peer group. Volatility annualized is the 60-day historical volatility for the S&P 500 index. Data as of Dec. 31, 2013.

In the chart on page 19, opportunity cost typically represents the biggest part of implementation shortfall (the blue bars) for equities, with spread representing the next biggest part. For bonds, interest rate volatility typically represents the biggest part of implementation shortfall.

Therefore, a focus on low commission levels alone can overshadow more important selection criteria, such as:

- **Risk management capabilities**. Pay particular attention to each provider's management of market exposure risk – such as interest rate exposures for bond transitions – and procedures for managing operational risk.
- **Trading quality**. Effective transition managers use a wide variety of trading venues to ensure competitive pricing for their clients. This is particularly important for securities with a limited number of buyers and sellers, such as in emerging markets.
- **Project management skills**. This is particularly important for complex transitions which involve multiple managers or multiple asset classes.
- **Client service capabilities**. An experienced provider can give you realistic estimates of the transition costs and expected variation. They can also provide continuous updates during the event, including any necessary deviations from the plan. They can also provide clear and detailed reporting after the event.

Guidelines for choosing a transition manager

Choosing the right provider is largely a matter of trust, and your decision hinges on finding the option that represents the most compelling value proposition for you. While there is no simple formula for selection, these guidelines may help you choose a provider you can trust[3]:

1. **Plan ahead**. Do your due diligence up front and pick a provider well before you actually need one. Last-minute selection and bidding decisions can lead to price-sensitive information leaking into the market, insufficient scrutiny of providers and, potentially, abandonment of the provider search.
2. **Understand the provider's capabilities, including its strengths and weaknesses**. Take the same rigorous approach to hiring a transition manager as you would to hiring an asset manager. Pay close attention to factors like team structure and experience, philosophy, process and performance history. Pay particular attention to when transition providers have done well previously and when they have struggled, e.g., for different asset classes or levels of complexity.

[3]The Glossary explains some of the commonly used industry terms used in this section. We have italicized these terms.

3. **You wouldn't employ an asset manager without first reviewing historical performance, so demand to see your transition manager's track record**. Evidence suggests a greater correlation between past and future performance for a transition manager than for a traditional asset manager, so it is important to thoroughly review each provider's performance history. As with picking an asset manager, use a third-party expert to help you choose a provider if you lack the in-house expertise and resources to make an informed decision.

4. **Contract appropriately**. First, if you have a relationship with an affiliated company of a transition manager, e.g., a custody or asset management relationship, don't automatically assume that using the existing contract is appropriate for the transition business. Negotiate the transition management contract separately. Second, demand the same level of oversight as you would from your asset managers. Engage the services of a provider who is obligated to act in the best interests of your fund by contracting at the fiduciary level—the highest level possible.

   You may be happy to contract with your transition manager as a broker/dealer, but educate yourself about the level of disclosure in the provider's business model, the activities of any of its affiliates, and the sources of explicit and implicit revenue it can generate from your transition. Beware of delegation provisions in your contract that may dilute the fiduciary responsibility of affiliates involved in the transition, or that may direct the provider to use affiliates or allow for principal trading.

5. **Understand how providers can generate revenue**. The industry code of practice, the T-Charter, states that transition managers should "disclose all sources of remuneration." Go further by demanding that your potential provider quantify any remuneration it will earn at the total-firm level, to ensure full transparency. Understand any inherent conflicts of interest, such as whether the provider can trade securities for its own account, i.e., act as principal, or whether any affiliates of the provider involved in the transition may act in this way. Such below-the-line fees come out of your assets and may be subsidizing the commission rates being quoted. There is no free lunch. If a transition provider appears to be offering a very low commission rate, there is a good chance that additional revenue is being drained from your assets without your knowledge.

6. **Know where trading happens**. Some transition managers choose to deal through an independent network of external brokers and liquidity sources, in a trading process similar to that of a large asset manager. Others internalize trade flow as much as possible, similarly to investment banks. However, the latter could work against your interests. Low commissions may be associated with high levels of internalization, which can detract from performance. Internalization models may lead to information leakage, as transition order flow can be revealed to market participants.

7. **Understand how trades will be priced**. This is especially important if a provider acts as principal or represents the other side of the trade by using an internal liquidity pool. The impact of uncompetitive pricing on crossed trades can swamp performance. Additionally, some providers may embed the execution costs paid to trading venues or clearing brokers in the price of the trade. This is a practice, often referred to as "net trading," to reduce the above-the-line fees and appear to be cheaper than other options.
8. **However, the idea that these trades are in some way less expensive is an illusion, because the costs are just less transparent**. In a transparent business model, execution and clearing costs are paid explicitly through commissions, not hidden in the trade price.
9. **Be discreet**. Keep your cards close to your chest. Until you have hired a manager you trust, limit the information you share with potential providers – and the outside world.
10. **Demand use of the T-Standard for measurement**. Implementation shortfall calculations can be manipulated to your disadvantage in two common ways: by excluding certain activities, or by choosing when to begin the performance calculation. Proper use of the industry standard known as the T-Standard helps capture the effects on portfolio performance from all transition activity. (See the Glossary for a fuller definition.) This consistency of reporting is critical for you to be able to effectively compare providers and their cost estimates.

Glossary

Above-the-line fees – Transition management fees agreed to by the client and fully auditable after the event. Most often, this means an explicit commission on each trade or a flat fee for transition services.

Below-the-line fees – Non-transparent fees charged to the client within the trade execution price. These additional fees paid to the transition manager, or to its affiliates, may well turn out to have been neither fully agreed to prior to the event nor fully disclosed after the event. They include riskless principal mark-ups on securities or derivatives transactions; principal trading profits from foreign exchange transactions; and additional commissions for internal or external cross trades.

Broker/dealer – A person or firm in the business of buying and selling securities, operating as both a broker and a dealer, depending on the transaction. The term broker-dealer is used in U.S. securities regulation parlance to describe stock brokerages, because most of them act as both agents and principals. A brokerage acts as a broker (or agent) when it executes orders on behalf of clients, whereas it acts as a dealer (or principal) when it trades for its own account.

Explicit costs – These costs are typically transparent and can be objectively measured; e.g., brokerage commissions, taxes and fees, "pooled fund transaction fees", custody costs, asset management fees.

Fiduciary – A person or body that stands in a position of trust to another person (the beneficiary). The fiduciary has scope to exercise some discretion and its action will affect the beneficiary's legal or practical interest.

Fiduciary responsibility (or "fiduciary obligation") – The relationship wherein one person has an obligation to act for another's benefit, i.e., takes full accountability for the actions and results.

Implicit costs – Typically not transparent and harder to measure, such as bid/offer spread, market impact, opportunity costs.

In-specie transfer – The process by which a portfolio of securities (usually a complete slice of the underlying fund benchmark) can be taken in lieu of a cash redemption from or subscription into a fund.

Internalization (or "internalizing trade flow") – A number of transition managers search for trading opportunities within other internal trading business units. This is often in the form of "sales trading" (but can also be in the form of index crossing), where the transition manager will look to match trades from the transition with trades that their other clients (or even they themselves) may want to execute. Often sold to transition clients as "internal crossing," transition clients need to be comfortable that these trades are in their best interests and fit with the optimal trading strategy, as managers often earn commission from both sides of these trades (usually not quantified to the transition client). Clients should ask their transition managers to quantify the additional benefit that accessing this internal source of liquidity had over other liquidity sources.

Implementation shortfall (IS) – Generally accepted industry standard for measuring the cost of a transition. IS captures all of the costs associated with a transition, including brokerage, taxes, fees, foreign exchange, bid/ask spread, market impact and opportunity cost/gain. IS compares the actual transition portfolio return with that of the new portfolio return, assuming the new portfolio had been built on the day before the transition commenced and at zero cost.

Legacy portfolio – Portfolio of the outgoing manager. This can either be a complete portfolio in the case of a termination, or a slice of a portfolio if only part of a mandate is being terminated.

Liquidity – The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is often characterized by high levels of trading activity with illiquidity associated with low levels. Assets that can be easily bought or sold are known as liquid assets.

Liquidity pools – Any venue where a security can be traded.

Opportunity costs – The difference between the actual costs incurred and those estimated. In a transition this is typically represented by the stock-specific performance differential between the legacy and target portfolios.

Riskless principal trading – A broker/dealer receives a customer order and immediately executes an identical order in the marketplace, while taking on the role of principal, in order to fill the customer order. The broker/dealer does not take inventory risk in this transaction, but will generally apply a mark-up/down to the price of the trade to receive compensation for the transaction. The security may never actually hit the dealers inventory.

Performance holiday – The period that runs from when an incoming manager has taken control over the transferred assets until the date the manager completes any restructuring activity and their performance history officially commences.

Retentions (also referred to as "in-kinds") – Securities that are common to both the legacy and target portfolios.

Target portfolio – The new manager's portfolio. This can be a new mandate being awarded to a new manager or an increase to an existing mandate.

T-Charter – Established in 2007, the T-Charter represents a set of 10 principles drawn up by the transition management industry to provide greater transparency into how transitions should be managed, resourced and measured. The T-Charter also provided pro forma templates for all cost estimates for easier comparison of transition managers' cost estimates.

T-Standard – Established in 2003 by Russell Investments, the T-Standard has been adopted as the industry-standard methodology for treatment of the critical factors that drive portfolio performance during a transition. The T-Standard Implementation Shortfall is the arithmetic difference between the return on the legacy portfolio and the return on the new portfolio, performed on a daily basis. The T-Standard measure of implementation shortfall (IS) was adopted by the T-Charter as the recommended default calculation for IS.

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Russell Investments is a global asset manager and one of only a few firms that offers actively managed multi-asset portfolios and services, which include advice, investments and implementation. Russell Investments stands with institutional investors, financial advisors and individuals working with their advisors using our core capabilities that extend across capital market insights, manager research, asset allocation, portfolio implementation and factor exposures to help investors achieve their desired investment outcomes.

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