BEST PRACTICE FOR FIXED INCOME RESTRUCTURES

EVALUATING FOUR PORTFOLIO TRANSITION STRATEGIES

RUSSELL INVESTMENTS RESEARCH

Best practise for fixed income restructures

Evaluating four portfolio transition strategies

Over the long run, excess performance over benchmark is difficult to achieve in fixed income markets. Squandering alpha with unmanaged transition events can erode hard-earned excess performance and may prevent investors from reaching their investment goals. A comprehensive transition management approach that seeks to minimise performance slippage during these events helps investors to reach their long-term risk and return goals.

The scenario

A pension fund would like to terminate an existing U.S. Core manager and hire a different manager. The investment committee does not want to give back years of hard-earned alpha during the transition. They are also concerned that the portfolio structure and transaction costs associated with manager changes could erode the excess performance over the benchmark they have accumulated in previous years. The investment staff has been tasked with finding the best solution for making this manager change while preserving alpha.

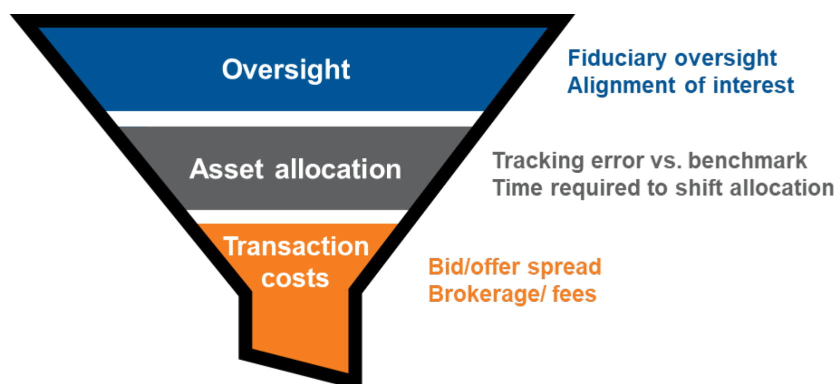
> *A transition is not a trading exercise; it is a risk management exercise. An investment adviser specialising in asset restructures and agency-only trading is the ideal entity to facilitate both simple and complex restructures.*

The challenge

Typically, investment officers, consultants, and other delegated fiduciaries of the board are tasked with identifying the best approach to minimise the performance impact of restructuring the portfolio. Some choose to let the outgoing/incoming asset managers manage components of the restructure without accountability for performance during the change. This is effectively leaving performance to chance and hoping that the unmanaged portfolio structure will not cost the pension too much, which is, basically, a coin flip.

Others take a more proactive approach. They want to understand the critical drivers of performance during this period of significant change and want to control and manage these drivers. The key drivers are the same as ongoing investment management mandates. Acknowledging these key drivers allows investors to evaluate different implementation options, and to choose a solution that best manages the key drivers of performance.

Key drivers of benchmark relative performance during a transition



Oversight

Maintain an investment advisor fiduciary standard of care and a duty of loyalty for assets in transition. Select a restructuring model that discloses all revenues and aligns the transition provider's interests with the interests of the investor (performance).

Why this matters

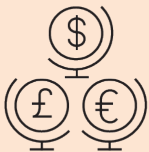
Without the fiduciary standard applied to the account, (a broker dealer does not have a fiduciary requirement), the plan's board inherits all risks associated with the re-allocation and could be responsible if fiduciary obligations are breached. As Peter Drucker once said, "What gets measured, gets managed." Performance accountability is essential to ensure that the provider manages the event to meet the investor's primary goals. Plainly, the provider must minimise the performance impact during all aspects of the restructure.

Asset allocation

Minimising tracking error to the benchmark (or the active target portfolio) throughout the transition is a key to success. Minimising the amount of time that the portfolio is in a transitional phase also reduces opportunity costs.

Why this matters

Opportunity costs associated with an unmanaged transition event can be the most costly aspect of the event, and can erode years of alpha in just a few hours.



Transaction costs

Prudently trade all assets associated with the restructure by utilising an implementation partner experienced in portfolio restructures. Use one that avoids conflicts of interest and one that seeks to provide the best execution for the client.

Why this matters

One cannot evaluate the cost of a restructure without an estimate of costs ahead of a transition. Furthermore, if a transition is not evaluated using a consistent performance measure (T Standard implementation shortfall), it is impossible to objectively evaluate the cost of the restructure.

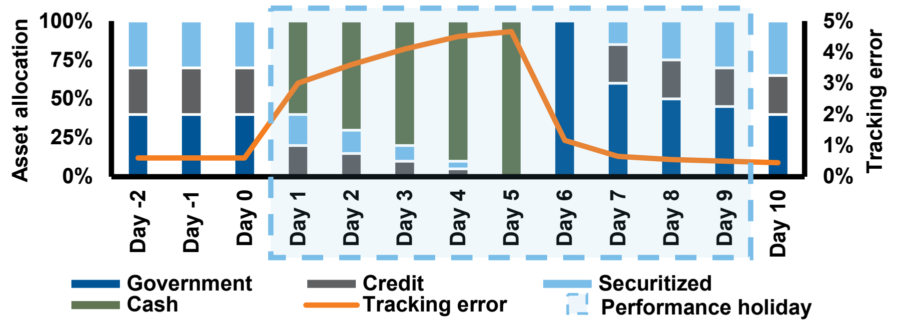
The options

There are several options for conducting portfolio restructures; however, this paper focuses on the four portfolio restructures that are most commonly considered, although only one option represents the optimal solution for the investor. For each transition strategy, a timeline is provided along with a graphical representation of the changes that occur within the portfolio over the course of the proposed transition. Daily changes in tracking error to the benchmark, daily changes in portfolio structure/composition, and performance holidays are noted for each option to illustrate the key risks being taken with each strategy.

> *...this paper focuses on the four portfolio restructures that are most commonly considered...*

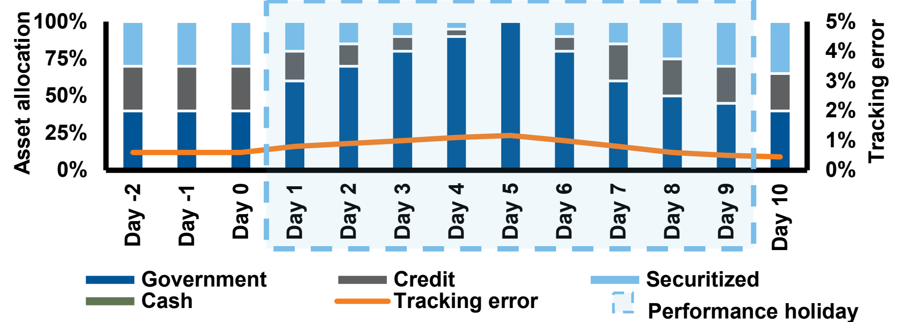
Strategy option A: Terminated manager liquidates portfolio to cash

- **Day 0:** Terminate legacy manager and performance accountability ends
- **Days 1-5:** Legacy manager liquidates to cash
- **Days 6-9:** New manager builds their target portfolio
- **Day 10:** New manager is accountable for performance



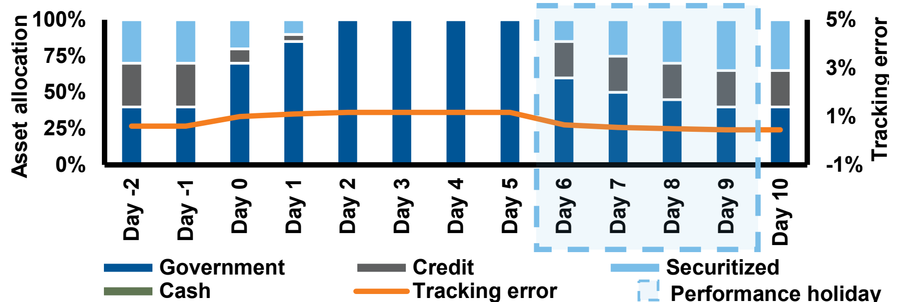
Strategy option B: New manager restructures to target portfolio

- **Day 0:** Terminate legacy manager and performance accountability ends
- **Days 1-5:** New manager liquidates portfolio while maintaining benchmark duration
- **Days 6-9:** New manager builds their target portfolio
- **Day 10:** New manager is accountable for performance



Strategy option C: Fiduciary TM restructures to treasury basket

- **Day 0:** Terminate legacy manager
- **Days 1-5:** Transition manager liquidates portfolio while maintaining benchmark duration and performance accountability
- **Days 6-9:** Performance holiday while new manager builds their target portfolio
- **Day 10:** New manager is accountable for performance



Strategy option D: Fiduciary TM restructures to target portfolio

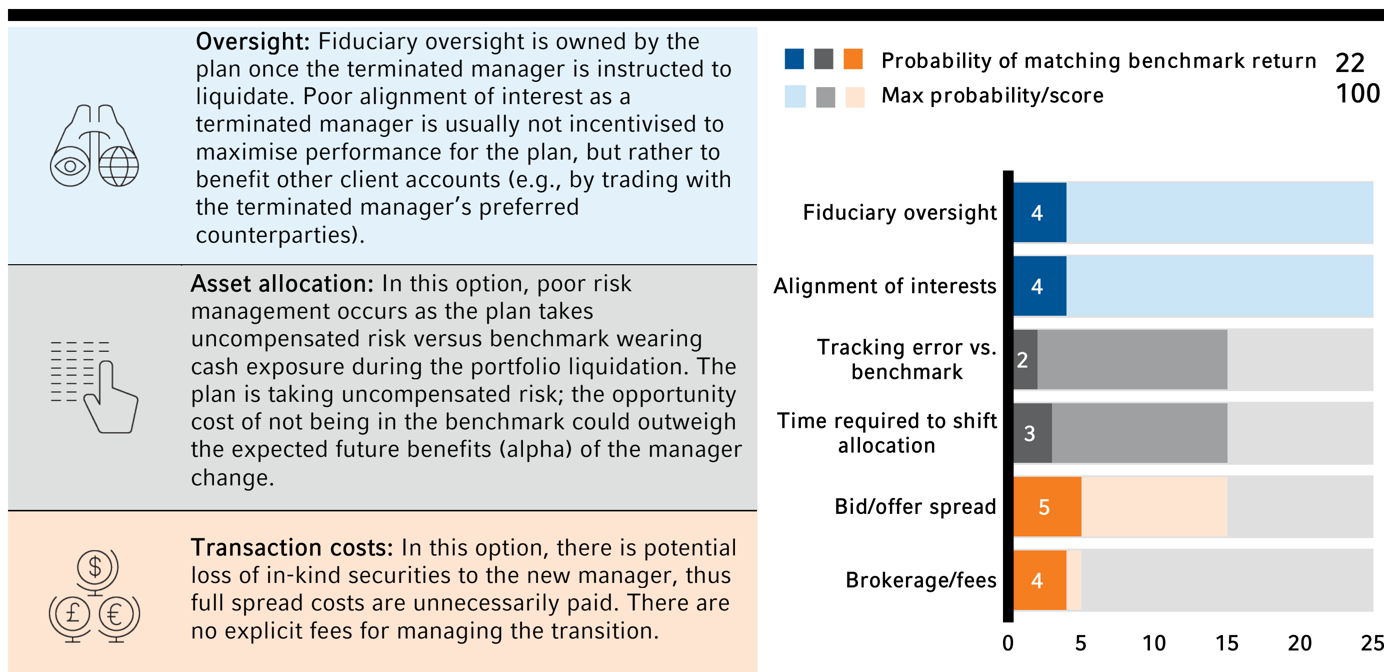
- **Day 0:** Terminate legacy manager
- **Days 1-6:** Transition manager liquidates legacy portfolio while simultaneously building the new manager's target portfolio ensuring benchmark duration
- **Day 7:** New manager receives completed target portfolio and is immediately accountable for performance

Evaluation

When a fiduciary is evaluating each of these options, they are often weighing competing priorities and information from different sources involved in the process. For each option, we have scored components of the three drivers of performance: fiduciary oversight, asset allocation and transaction costs. A higher score for each component reflects a higher likelihood that benchmark-relative returns will be managed throughout the transition. The maximum evaluated score reflects the weighted priority of the component to achieve benchmark performance.

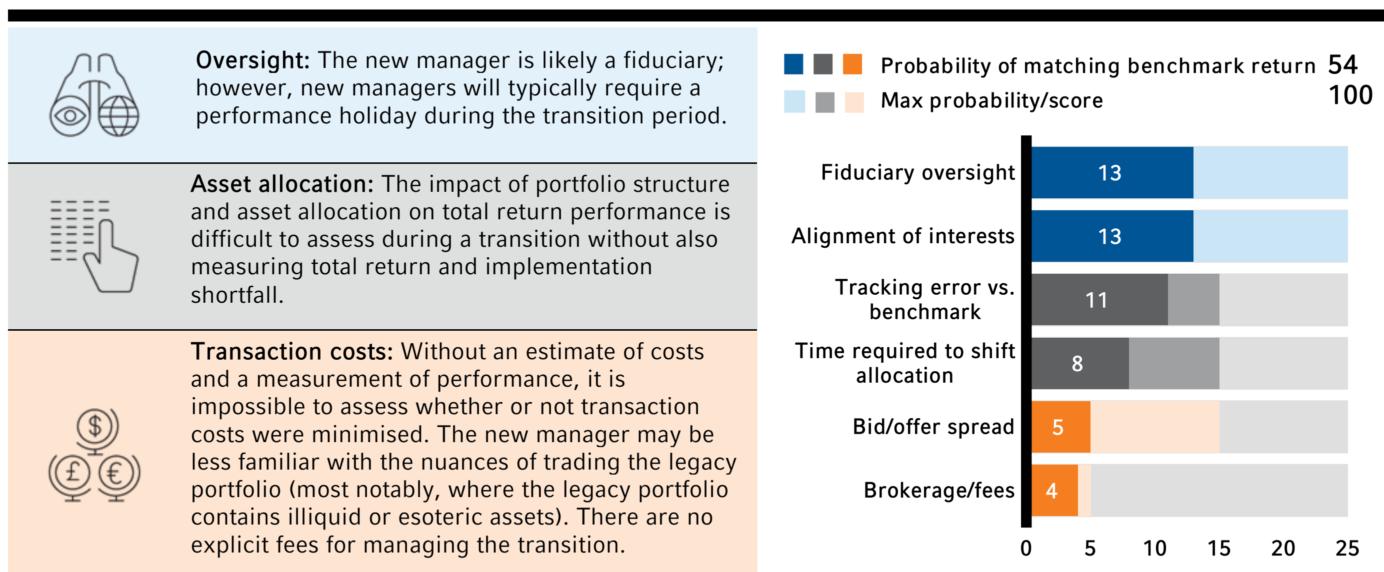
Evaluation of strategy option A: Terminated manager liquidates portfolio to cash

This is the easiest option logistically; however, it is the least aligned with the interests of plan participants.



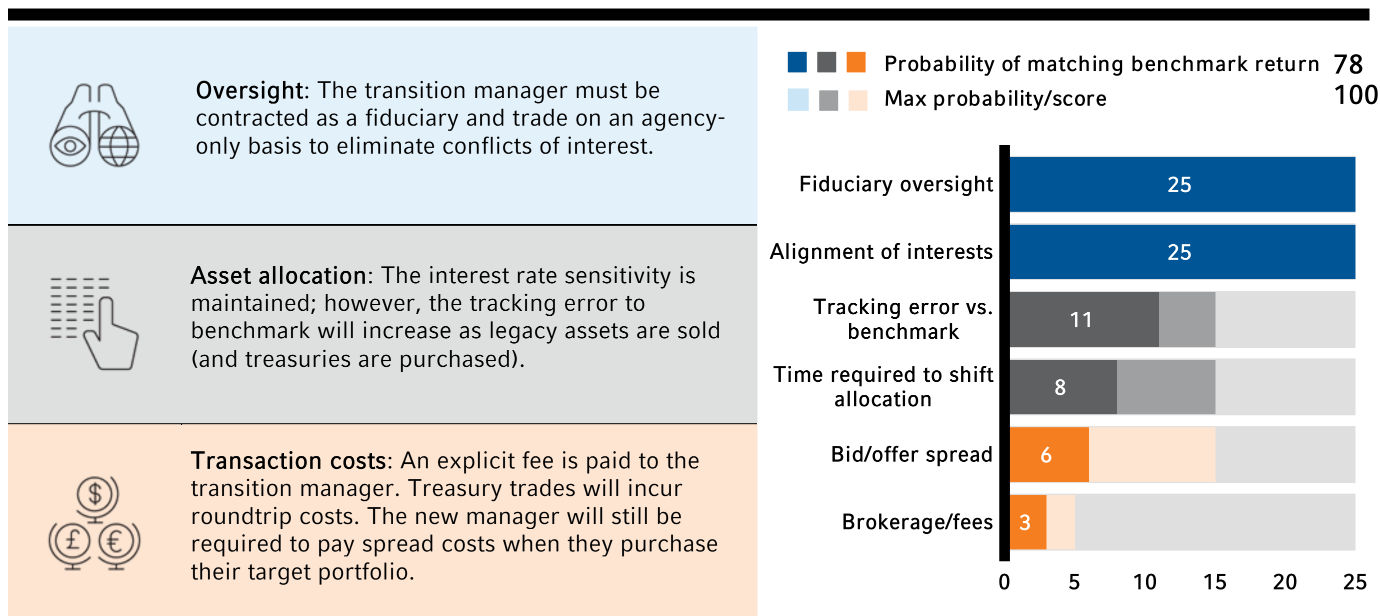
Evaluation of strategy option B: New manager restructures to target portfolio

Having the new manager sell the legacy portfolio has more properly aligned interest; however, the new manager is not accountable for performance until the target portfolio is complete.



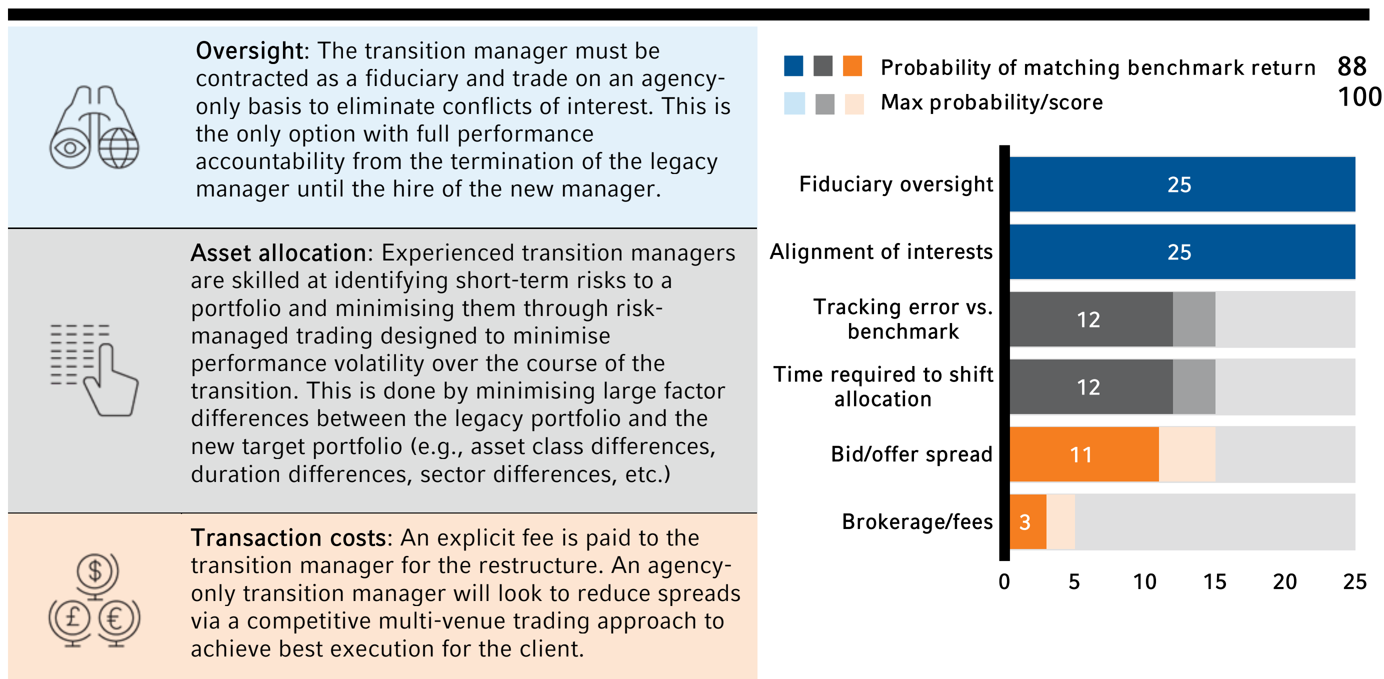
Evaluation of strategy option C: Fiduciary TM restructures to treasury basket

A transition manager will provide performance accountability during the legacy portfolio liquidation; however, purchasing a duration-neutral basket is not ideal (see next option). Although broad market exposure will be maintained (interest rate sensitivity only), there are transaction costs that will be incurred by the new manager as they sell the treasury basket and purchase their target portfolio.



Evaluation of strategy option D: Fiduciary TM restructures to target portfolio

Of the methods discussed, this method allows for the best, risk-managed and most cost-effective transition of assets into a new allocation. An agency-only transition manager hired as a fiduciary provides transparency into the costs of a restructure and a risk-managed approach to transitioning into a new allocation.



Summary

Plan fiduciaries must regularly evaluate the best approach for portfolio restructures. The merits of strategy option D (Fiduciary TM restructures to target portfolio) clearly highlight the fact that this should be the default for fixed income restructuring; however, we continue to see the other options used, which ultimately subject investors to significant and uncompensated opportunity costs and sometimes transaction costs as well. Alpha is difficult to achieve, and wasting hard-earned alpha with unmanaged transition costs is completely unnecessary and is generally not a prudent approach. Russell Investments believes that incentives matter and that it is critical to engage a firm that specialises in managing the unique challenges presented by a transition.

We believe strategy option D provides the best governance, risk management, and management of costs for plans looking to restructure their fixed income assets. A transition is not a trading exercise; it is a risk management exercise. An investment adviser (as defined by the Investment Adviser's Act) specialising in asset restructures and agency-only trading is the ideal entity to facilitate both simple and complex restructures.

Russell Investments has specifically built the implementation services business with the goal to best meet the needs of a multi-manager fund complex, which is a skillset that is uniquely applicable and aligned to those same challenges faced by institutional asset owners around the world.

Contact Russell Investments to learn more about our unique approach, experience, and unrivaled transparency for asset transitions.

QUESTIONS?

Call Russell Investments at (02)-9229-5221 or visit russellinvestments.com/au

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