TRANSITION MANAGEMENT EXPLAINED

RUSSELL INVESTMENTS RESEARCH

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Transition Management Explained

Introduction

After years of historically low volatility, and despite a drop off in 2023, since 2020 we have seen levels[1] rise to those not seen since the financial crisis in 2008.

Volatility brings with it not only an additional layer of risk when restructuring portfolios, but also typically additional costs.

In an environment where every basis point matters, Transition Management (TM) can deliver both significant cost savings, and thus positively contribute to total portfolio returns, and a framework around which to manage risk.

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:

- What is transition management
- The benefits of using a transition manager
- When to use a transition manager
- The costs and risks involved in transitioning assets
- How to mitigate those costs and manage risks
- How to decide if TM is right for you
- How to choose a transition manager
- A glossary of terms to help you navigate the jargon

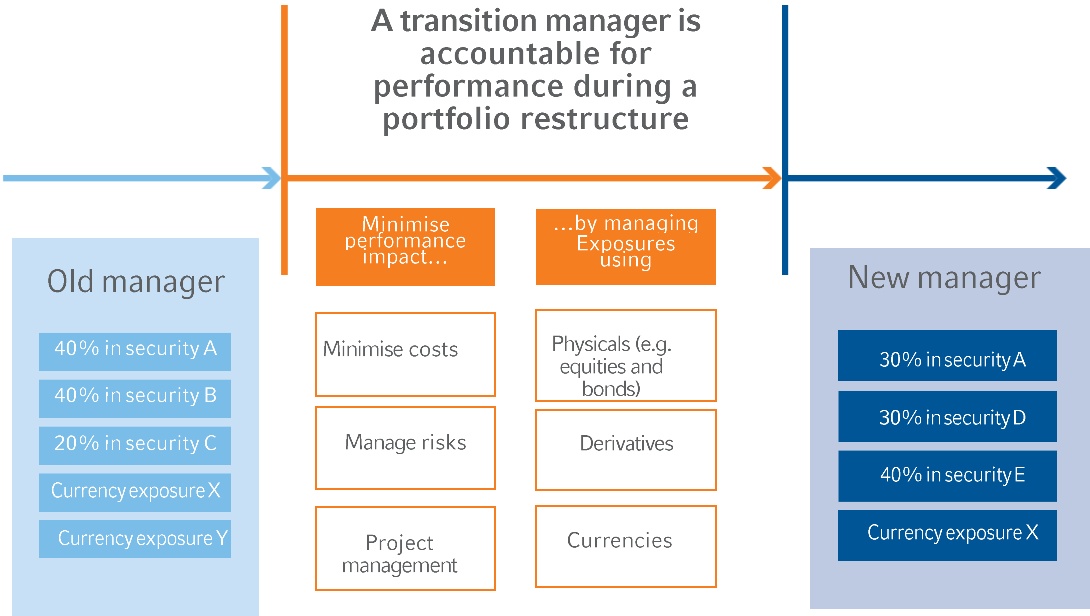
[1] As measured by VIX (Chicago Board Options Exchange's CBOE Volatility Index, a popular measure of the stock market's expectation of volatility based on S&P 500 index options)>

What is transition management?

Transition Management is the process of managing changes to an asset owner's portfolio of securities. 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 derivative 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 cashflows
- Mergers



Source: Russell Investments. For illustrative purposes.

The transition manager

Transition managers rarely operate as in-house teams, as only the largest of funds 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 organisation to which it is affiliated.

This issue, which we explore in Section 8, is perfectly illustrated by a quote from Clive Adamson, Former Director of Supervision of the UK FCA:

> *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.*[3]

[3] Adamson, Clive. "Fair, transparent and competitive: the FCA's vision for the asset management sector." Financial Conduct Authority, October 2013.

Is using a transition manager right for you?

What are the benefits of working with a transition manager?

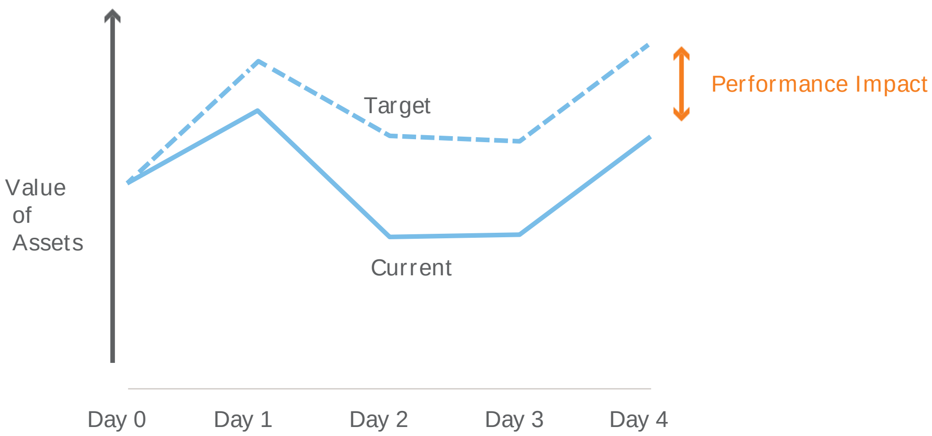
A transition manager is accountable for investment performance during the transition period, striving to **minimise the performance impact** of any restructure of assets. This is achieved by:

1. **Minimising unnecessary costs.** An example is if the new manager intends to hold some of the same securities as the old manager. If all of the old manager's assets were sold for cash and the proceeds reinvested with the new manager, the portfolio would incur trading costs on 100% of both the sales and subsequent purchases.

   A transition manager tries to mitigate this risk by devising a trading strategy that minimises 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 minimise the performance impact of any asset restructure



Source: Russell Investments. For illustrative purposes.

Other benefits

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

- **Lower workload:** A transition can represent a significant drain on an asset owner's 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 the asset owner or manager.
- **Elimination of performance holidays:** There is always a delay between the time when the old manager is terminated and the time when the new manager has its 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 their 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.

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.

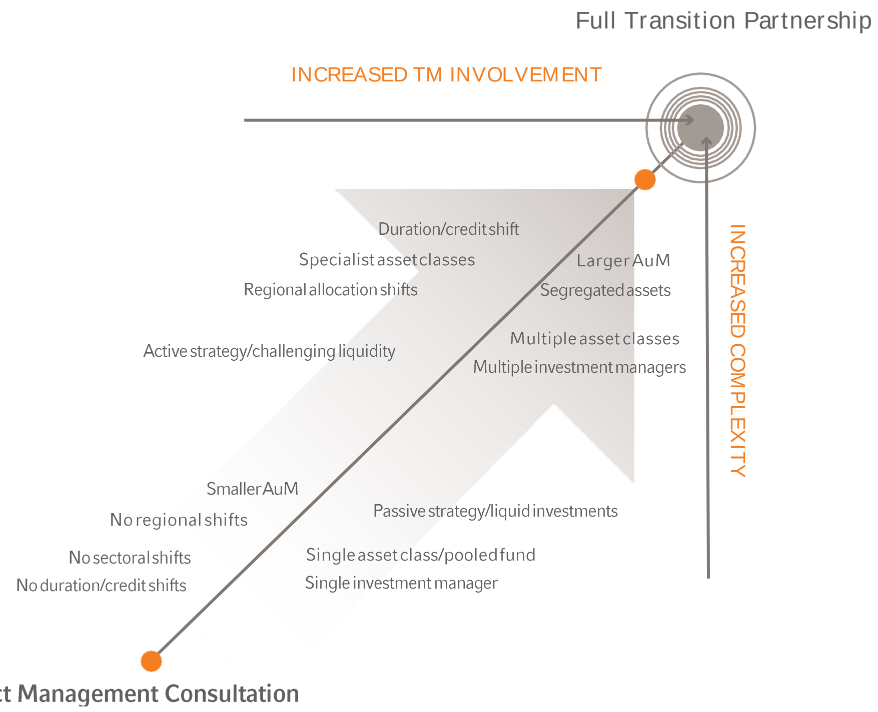
These can range from a consultative role to a full transition partnership where the TM provider assumes full responsibility for strategy and implementation of the event.

A transition manager may add less value within very simple re-organisations, where the transitions happen within a single organisation, 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 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



Source: Russell Investments. For illustrative purposes.

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, the portfolio could be hurt by adverse price movements.

Also, a transition manager can use local experience, expertise and broker relationships to their 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.

You can benefit from consulting a transition manager in the planning stages for all potential transition events. If the activity is a straightforward, low-value, pooled fund re-allocation, it may not make sense to appoint a transition manager to manage and execute this event. However, you might still benefit from a consultation process. 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 minimise out-of-market risk.

Can our in-house team manage the transition?

Possibly, but only if your in-house team has the right resource, 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 to a third-party provider. Also, bear in mind that during the transition period, your in-house team will very likely be taking on fiduciary responsibility over the assets - and that includes being fully accountable for performance too.

Should our outgoing manager transition the assets?

Only if your outgoing manager, or its affiliate, offers TM as a specialist standalone service. They 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 maximise cost savings for you and could use the transition to re-structure its existing portfolio on more favourable 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 TM when funding from or into cash (i.e. for 'one- sided events')?

The potential benefits of employing a TM – 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 TM.

Transition costs

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

1. 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 Stamp Duty on UK stock purchases

2. 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 buy 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 example below.)
- **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, asset owners automatically hand over foreign exchange trading to a manager or custodian and they agree 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 euros 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 will be unfavourable to you. In other words, if you converted your money, didn't use any of it and converted it back, you would 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 Sterling to EUROs and Swedish Kroner, the spread will be greater for less-traded currencies - Swedish kroners, in this case.

CURRENCIES CONVERTED	BUY RATE	SELL RATE	DIFFERENCE
GBP: EUR	1.1446	1.2624	10%
GBP: SEK	12.797	15.1856	19%

Source: Eurochange 27 July 2023. Comparing buy and sell back rates.

Transition risks

Transitions involve typically two broad types of risks that need to be managed: financial and operational.

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, capitalisation, 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.

Minimising costs and risks

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

Minimising 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 securities are transferred at mid prices (i.e. mid-way between the highest price someone is willing to buy a security at and the lowest price at which someone is willing to sell it), whereas cash redemptions/subscriptions are often traded at less favourable prices due to the spread cost.
- 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.

Maximise retentions (also known as 'in-kinds')

By identifying securities in common between the old and new manager, 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. Good 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 is 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. Over-emphasis on crossing can lead to sub-optimal 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.

Minimising spread and market impact

Using a variety of trading (or 'execution') venues minimises 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 whilst 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

Opportunity cost can be managed in a number of ways, for example:

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 including:

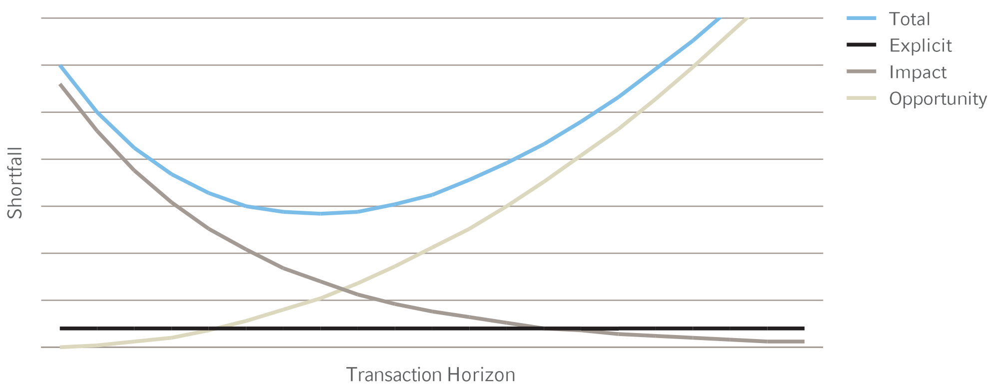
- Using derivatives to ensure appropriate market exposure is maintained and minimise the return difference between the old and new portfolio
- Using currency forwards or futures (types of derivative contracts) to effectively neutralise the risk represented by the difference in currencies between the old and new portfolio 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 portfolio 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 minimise opportunity cost. However, this could result in trading in large volumes, which could in turn negatively affect prices, thus causing 'market impact'.

A good transition manager will find the optimal transition time horizon which minimises market impact and potential opportunity costs. This is illustrated in the chart opposite 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.

Exhibit: Transaction cost trade-off



Source: Russell Investments. For illustrative purposes.

Balancing internal crossing benefits with opportunity cost

Maximising 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. Firstly, 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. Secondly, waiting for the right time to cross may prevent other trades being carried out in a more timely manner.

Minimising operational risks

The easiest way to minimise 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.

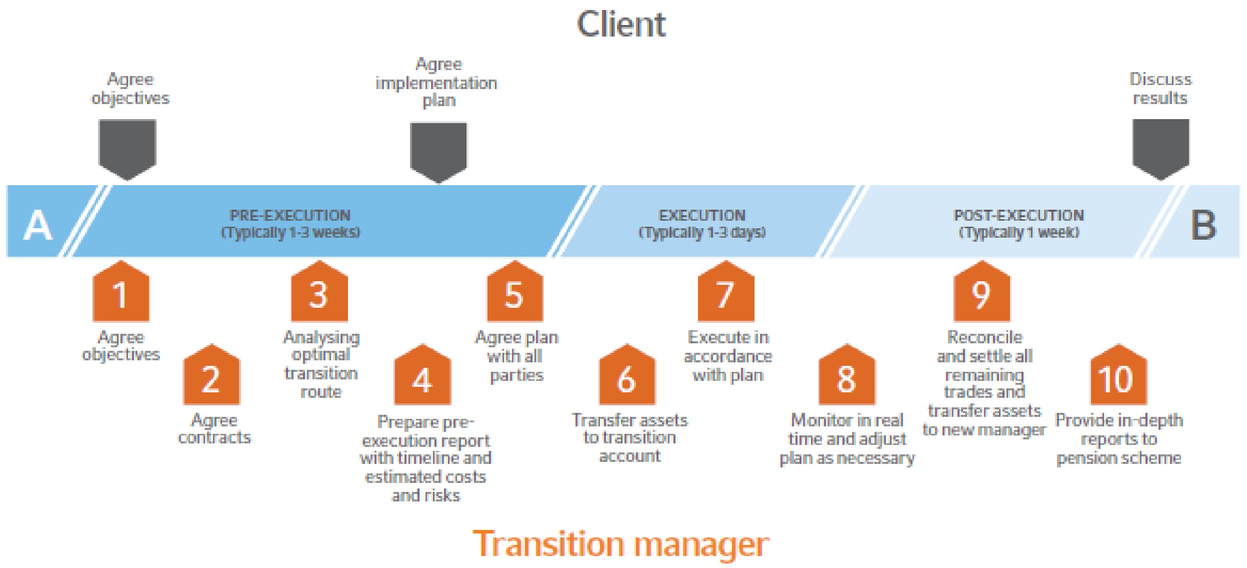
The lifecycle of a transition

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.



Source: Russell Investments. For illustrative purposes.

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.
    - non-disclosure 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:
    - analysing 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.

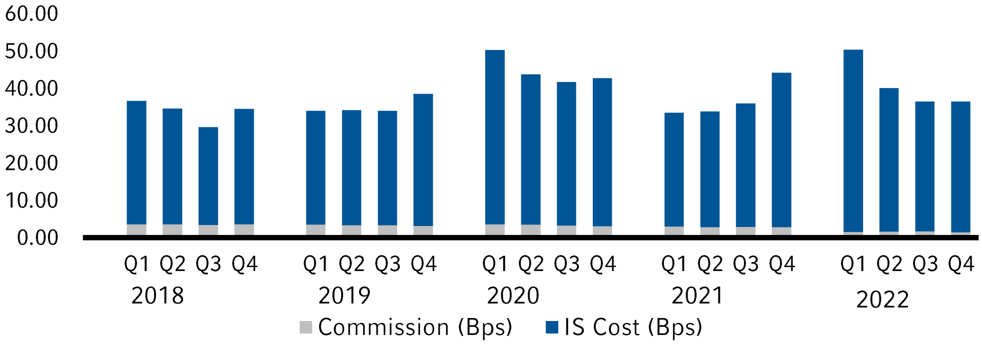
Choosing the right transition manager for you

Choosing the right transition manager for your fund can be challenging. There is often little transparency on how providers are remunerated and lack of standardisation 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 events that 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 US, demonstrates that explicit commissions and fees actually represent one of the smallest components of overall trading costs (see chart below).

Exhibit: Commissions are just part of the picture

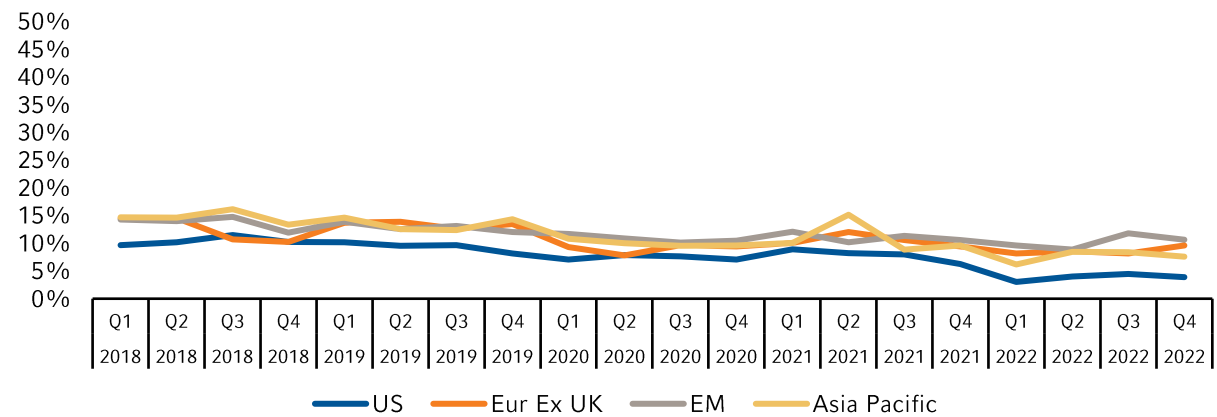


Source: Investment Technology Group. U.S. Trading costs: Commissions and implementation shortfall based on ITG's peer group. Data as of 31 December 2022.

In the chart above, opportunity cost typically represents the biggest part of implementation shortfall (the orange bars) for equities, with spread and impact representing the next biggest part. For bonds, interest rate volatility typically represents the biggest part of implementation shortfall.

The above chart just looks at US equities, but does this premise still hold true for other regions? The answer is a clear yes. As the chart below illustrates, in fact with generally falling commission rates, in most cases commissions have fallen to typically under 10% of total trading costs, with the US falling to under 5%. So more than ever the focus should be on the implicit costs of trading like market impact and not the cost of execution as represented by commissions.

Exhibit: The percentage of total trading costs represented by trading commissions



Source: Russell Investments. Data as at 31 December 2023.

The answer is a clear yes. In fact, with generally falling commission rates in most cases commissions.

Guidelines for choosing a transition manager

Choosing the right provider is largely a question of trust, and 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[4]:

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 their 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. **You wouldn't employ an asset manager without first reviewing their historical performance, so demand to see your transition manager's track record.** Evidence suggests a greater correlation between past and future performance of 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 resource to help you make the decision. A recent survey (source below) found that a disproportionate number of events were far worse than expected (if outcomes are normally distributed), suggesting that when events went badly, it was by a larger magnitude. Thus all the more reason to understand the reasons behind any outlying events and to do a thorough review of their results.
4. **Contract appropriately.** Firstly, 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. Secondly, 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 highest fiduciary 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 will 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 your 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 they quantify any remuneration they will earn at the total-firm level to ensure full transparency. Understand any inherent conflict 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 may be involved in the transition act in this way. Such below-the-line fees come out of your assets and may be subsidising 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 internalise trade flow as much as possible, similar to investment banks. However, this could work against the client's interests. Low commissions may be associated with high levels of internalisation, which can detract from performance. And internalisation 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. This consistency of reporting is critical for you to be able to effectively compare providers and their cost estimates.

Source: MJHudson/Blue Sky Group - Transition Management Performance – Meeting or missing expectation – February 2021.

[4] The Glossary explains some of the commonly-used industry terms used in this section. We have italicised these terms.

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 derivative transactions; principal trading profits from foreign exchange transactions; and additional commissions for internal or external cross trades.

Broker/dealer - is a company that trades securities for its own account or on behalf of its clients.

Explicit costs - These costs are typically transparent and can be objectively measured, e.g. brokerage commissions, taxes and fees, pooled fund dilution levies, 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

Internalisation (or 'internalising trade flow') - A number of transition managers access trading opportunities from their own internal client base. 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

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 characterised 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.

Principal trading - Where a broker uses its own inventory to fill the order for the client.

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 to more easily compare 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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