A change of costume

THE SHAKE-UP OF A LARGE PORTFOLIO OF SECURITIES CAUSED BY A MERGER, ASSET REAPPRAISAL OR CHANGE IN INVESTMENT STRATEGY CAN MEAN A COMPLETE AND EXPENSIVE ASSET MAKEOVER. **SAM LUNDQVIST** EXPLAINS HOW A THIRD-PARTY TRANSITION MANAGER CAN DO THE BUSINESS AND ADD VALUE IN THE PROCESS.

We've all got bogged down in the details some time or another, losing sight of the bigger picture. Transition management is one of those services where it is only too easy to miss the forest for the trees. Dark pools of liquidity, algorithmic trading strategies and non-linear tracking error reduction are all topics of real value, but there is a danger of digging so deep into the details of these often complicated concepts that the fundamental benefits of transition management services and products are lost. So let's go back to basics.

WHAT IS TRANSITION MANAGEMENT? Asset owners often make changes in their investments. These changes come about for lots of different reasons, such as necessary changes in investment managers or updating of the overall asset allocation in the investment portfolio. A lot of time and effort is rightfully spent on due diligence to make sure that the target structure is right for the level of risk and return that is warranted by the investor.

Once the investment decisions have been made, the asset owner faces the challenge of implementing them. While in theory moving from the legacy structure to the target structure is simple, in reality it can be extremely complicated, costly and risky, not to mention time-consuming. And this is where a specialised transition manager can help. The goal of transition management is three-fold:

- to minimise the cost of asset movements;
- to minimise the risk of asset movements; and
- to project-manage the whole exercise.

But while this pitch sounds attractive, what clients need to assess is whether there really is a value-add in using transition management. To put it another way, are transition managers worth their salt? To find out, let's look at the cost minimisation element in transition management and see whether the promise holds water.

Cost minimisation is often the first thing transition managers talk about and the first thing their clients want to hear. An unfortunate reality is that moving assets from the legacy to the target structure will incur costs, particularly in the trading phase (selling/buying of securities). Depending on the markets, the time frame involved and the specific securities, these costs can be significant. So what can a transition manager do to minimise these costs?

MINIMISE TRADING Since trading costs money, it's a good idea to trade as little as possible. Transition managers often talk about in-kind or in-specie securities. These are securities that are held in the legacy structure that are still wanted by the target structure. It makes no sense to sell them just to turn around and buy them again, incurring unnecessary costs. It may seem like a no-brainer but without proper co-ordination it is easy for such superfluous trades to occur. All it takes is for the legacy manager and the target manager to be told to get on with dealing with their respective portfolios; the legacy manager will sell all the securities and provide cash to the target manager, who will then proceed to build the new portfolio. This scenario still happens, and the more complicated the transition the bigger the chance that in-kind/in-specie opportunities are missed.

Redemptions (subscriptions) in relation to pooled vehicles are another area where trading can be minimised. Many pooled vehicles offer the client the opportunity to redeem (subscribe) its assets in securities (in-kind transfer) instead of cash. In many cases, this may

lead to lower overall costs, as these securities can be used to build up the target portfolio without having to be paid for in cash. A transition manager who can see all the moving parts and with experience of performing the cost/benefit analysis for pooled vehicles will ensure such opportunities are maximised.

SECURITIES MARKETS ARE NOT THE FRIENDLIEST OF PLACES, WITH EVERYONE TRYING TO FIND WHAT INFORMATION THEY CAN IN ORDER TO USE IT TO THEIR ADVANTAGE.

DISCOUNTED COMMISSIONS In the vast majority of transitions, the transition manager will be able to trade at lower commissions than the client or the asset managers involved. This is due to a number of good reasons. First, there is absolutely no need for any research (on stocks, etc) during transitions, so transition trades can be done on a cheaper, execution-only basis. Second, most transition managers run very large trading operations, so their sheer scale of trading allows them to drive down commissions even further. Finally, transition management is an extremely competitive business. To win business from clients, transition managers need to "sharpen their pencils" to stand a winning chance, which is not a bad thing at all from a client's point of view.

In short, transition managers pay for themselves merely by ensuring lower commission costs for clients. Then there all the other cost minimising, risk reducing and project management benefits that transition managers bring to the table.

MINIMISE THE BID/OFFER SPREAD AND MARKET IMPACT Most securities trade on a bid/offer spread, the market impact of an asset transition is another cost that needs to be addressed. Just as the price of a house will rise if there is a lot of interest in it, the price of a security will go up if there are more buyers than sellers, and down if there are more sellers than buyers.

This is particularly true for more illiquid securities. A transition manager is well positioned to minimise both spread and impact costs. Often this is done by "crossing". Let's address the bid/offer spread first. An example of a cross is as follows. Assume the bid/offer spread for security ABC is 99–101: if you want to buy the stock you need to pay 101, and if you want to sell it you will get 99 for it. A cross is a trade where you are able to achieve a price that is better than the bid/offer. The best such cross is the mid-point cross where, in the example used, both parties would trade at 100, eliminating the bid/offer spread.

Transition managers work very hard at finding these crossing opportunities. Often they can find "the other side of the trade" from another transition they are managing, or another trading flow across their trading desk.

A more recent phenomenon is the so-called crossing network. This is a virtual exchange where buyers and sellers meet to trade at mutually beneficial prices. Most often the crossing network consists of a computer (often referred to as the "black box") that processes and matches the orders that buyers and sellers send into it.

These systems have proved very successful and there are now a large and growing number in the marketplace. Good transition managers operate the black boxes themselves or have access to a number of them in order to provide effective execution to clients.

In addition to minimising (or eliminating) the bid/offer spread, crossing can minimise market impact. Since these crosses are often anonymous and done at the mid-point price, there is no information the general market can use to deduce if these trades have more buyers or sellers at a particular point in time. As a result, there is no impact (up or down) on stock prices from these trades.

Table 1: Transition comparison

The table shows the cost of a hypothetical UK equity transition of £100m as an unmanaged operation compared with one managed by a transition manager.

	Unmanaged	**Managed**
Legacy portfolio valuation	£100m	£100m
Target portfolio valuation	£100m	£100m
Estimated in-kind	0%	35%
In-kind amount	£0	£70m
Traded amount	£200m	£130m
Estimated commission	0.10%	0.04%
Estimated commission	£200,000	£52,000
Estimated crossing	0%	25%
Estimated bid/offer spread and market impact (adjusted for crossing)	£500,000	£243,750
Estimated UK stamp duty	£500,000	£325,000
Total estimated transition cost	**£1,200,000**	**£620,750**

MARKET ANONYMITY The final cost aspect is anonymity, which is extremely difficult to quantify but a real cost nonetheless.

Securities markets are not the friendliest of places, with everyone trying to find what information they can in order to use it to their advantage (and often to the disadvantage of the provider of that information). It is critical to keep as low a profile as possible when trading to minimise the chance that someone else using the same knowledge that you are will trade against you. If, for example, another party finds out you are planning a big purchase in a particular stock, then they may go ahead and buy that stock right away, drive the price up, and close out their bet when you enter the market. They would then net a nice profit, whereas you would trade at a worse price.

A transition manager is well positioned to ensure that no information about the pending activity leaks to the marketplace. All that the market will see is that transition manager A is out trading, but as transition manager A does that every day of the week there is very little that can be gleaned from this activity.

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