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Selecting a Transition Manager

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The buzz on transition management has grown significantly in the financial services industry. Almost every conference for plan sponsors dedicates a session to transition management, and articles on the topic proliferate in the financial press. Why all the attention?

Plan sponsors constantly face the challenge of moving funds among asset classes, modifying investment strategies, and changing investment manager rosters. Although transitions are commonplace in the market, they are not everyday events for the plans; as a result, few plans have the resources to manage and implement transitions on their own. Instead, they seek to outsource the administrative burden to an experienced transition manager.

Whether a transition is precipitated by an asset allocation study, a manager review, or, in the case of a private plan, a corporate merger or acquisition, the goals for the transition remain the same: to reduce the costs and risks. Commission is the easiest component of cost to understand, quantify, and control. The implicit costs, market impact (also called slippage) and opportunity cost, are neither transparent nor easy to quantify. The situation is further complicated because efforts to reduce market impact (slow, careful trading) increase the risk of opportunity cost.

The final component of cost is operational risk, the failure to coordinate activities among the many parties involved in a transition, as well as systems and human error. Operational errors run the gamut from small (one untimely settlement) to potentially disastrous (buying and selling the wrong securities or the right securities in the wrong amounts).

A plan that does not have the resources to control these risks in-house and requires the services of a transition manager must answer other questions. What is the most appropriate measure of cost for the transition, and how does one choose a transition manager? Critics malign the use of two common trading benchmarks, the closing price and the volume-weighted average price, out of fear that the transition manager will manipulate the benchmark, especially if its commissions are tied to the benchmark.

Suspicions aside, a more relevant concern is that these benchmarks fail to address the plan's top priority: to fully fund the new portfolio. For example, if the plan's legacy portfolio is valued at $100 million in assets on the day the transition begins, the plan would clearly prefer to have $100 million, rather than $99 million, in the target portfolio at the end of the transition.

Therefore, the most relevant measure of cost to the plan sponsor is implementation shortfall, or the difference between the value of the portfolio at the beginning of the transition versus the value of the portfolio at the end of the transition, net of all commissions and fees.

One weakness of implementation shortfall is that it does not take into consideration moves in the market, actions that cannot be controlled by either the plan or the transition manager. Therefore, a plan may decide that

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