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Factoring in the costs and risks of fund manager transitions

So, you've completed an extensive review of an incumbent investment manager and decided that its future outperformance prospects just aren't as compelling as those of an alternative manager. The new firm's style characteristics, its fit within your overall portfolio and the proposed fee structure all look fine. In short, you're ready to give the green light for change.

Or are you? Do you have a feel for what sort of costs will be incurred in making the switch? Might these costs be equivalent to two months or 12 months of target alpha, or more? And have you considered the implications of your portfolio potentially losing market exposure for a period?

Some of the downsides of manager transitions are not easy to quantify (especially in advance) and what is difficult to measure tends not to get managed. But the reality is that when a manager is fired and another is hired, both expenses and risks enter the equation – with some a lot less visible than others.

This paper highlights some of the main transition considerations to assess, primarily with regard to equities, before going ahead with a manager replacement.

Liquidity is key

It is self-evident that, even if they are in the same sector, no two actively-managed portfolios are exactly alike – often far from it. Even two passively-managed portfolios can have their differences. Inevitably, stock sales and purchases will form part of a transition, and central to that process is market liquidity.

A basic *definition* of liquidity is the ability for securities to be bought or sold without causing a significant movement in price. A typical *measure* of liquidity is how many days it would take to enter or exit a position, usually with reference to historical average trading volumes. However, the average trading volume of a stock may disguise its true liquidity. Many stocks tend towards a low median trading volume but with a higher average distorted by occasional large trades. Further, the measure does not give a clear picture of how long it would take to liquidate a position during periods of market stress. Accordingly, some allowance needs to be made for these factors, as well as how sensitive asset price movements are to trade volumes.

Notable developments in the global trading environment over the last one-two decades which impact on overall market liquidity include the use of "dark pools" and "high-frequency trading" (HFT). Both of these have their proponents but both can attract controversy.

Dark pools are a type of alternative trading system that give certain investors the opportunity to place orders and make trades without publicly revealing their intentions during the search for a buyer or seller. The trades are usually reported to the exchange after orders have been executed. Dark pools offer the upside of reducing market impact for large orders, but have been criticised for their lack of transparency and because the inevitable fragmentation of trading could lead to less efficient pricing in traditional open stock exchanges.

HFT is a method of trading that uses powerful computer programs to transact a large number of orders in fractions of a second. Proponents of HFT point to resultant bid/offer spread compression as leading to cheaper transaction costs, while others claim it gives an unfair advantage to the most sophisticated players and only creates "ghost liquidity" in the market as it exists for only a tiny period of time.

Lost in transition

The basic challenge in a transition is how to move from a current to a new investment structure while minimising the costs incurred and managing the risks involved.

Trading costs vary widely day-to-day (and intra-day), depending on the sector and market conditions. In general terms, we would expect transition expenses in equities to be lowest for global/US mandates (large cap) and highest in emerging markets, with regional and small cap mandates sitting at various levels in between.

Trading costs may be divided into direct and indirect components. Direct costs are the visible component of a transfer and include:

- *Bid/offer spreads*, being the difference between the price at which a broker will buy and sell a stock. This spread will be tightest for relatively small trades in large and liquid stocks. For smaller and medium-sized companies, bid/offer spreads become a more important element of the total cost.
- *Pooled fund application/redemption spreads.*[1] This spread may be reduced or eliminated (as agreed) altogether under an "in specie"[2] redemption and application request. Cash redemptions will be transacted with the spread fully intact.
- *Broker dealing commissions.* This very visible element is the levy paid to market operators to undertake the trade. Commission rates for institutional investors vary on a regional basis depending on what service is provided; in particular whether or not it includes a company research service. However, rates are typically in the vicinity of 0.20% of the principal amount traded on a one-way basis (0.40% on a round trip basis). In some countries a material proportion of dealing is done net (i.e. no commission) with the broker acting as a principal and seeking to make a profit on unwinding the position taken on at favourable prices. This margin is effectively manifested in a wider buy/sell spread.
- *Taxes.* Stamp Duty applies in some countries, for instance the UK and Hong Kong (but not the US or Japan). Notably in the UK there is a levy of 0.50% on purchases, giving an additional transaction cost of 0.50% on a round trip basis. Capital gains tax issues are also relevant in some jurisdictions.
- Any fee paid to a *specialist transition manager* (see later discussion). This is normally charged on a project basis.

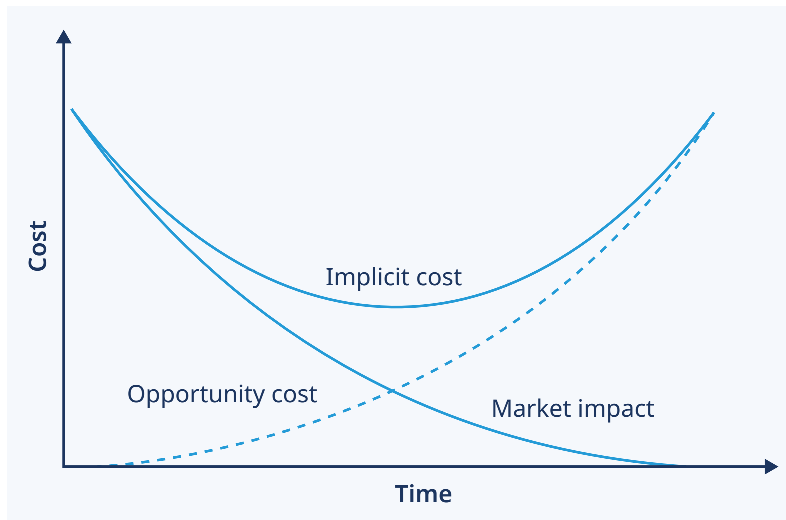
[1] The intention of such a spread in a pooled fund is to recoup the dealing costs incurred by the fund as a result of unit purchase/sale activity. The amount is retained by the applicable fund as opposed to being allocated to the fund manager. Where no spread applies, remaining investors in the pool share the burden of trading costs, thereby elevating the risk that long-term unit holders subsidise the costs generated by those coming and going.

[2] "In specie" refers to the transfer of actual securities from one manager to another manager. Where feasible, this avoids the need for cash sales and hence can save trading costs.

Indirect costs are less obvious but are nevertheless likely to exceed the direct costs, often by a substantial margin. The main examples are:

- *Market impact*. The very act of trading a large quantity of a particular asset (relative to typical daily volumes) over a fairly short period of time - or even declaring a desire to do so - can have a detrimental effect on market prices. This is particularly the case where smaller, less liquid, companies' stocks are concerned.
- *Opportunity costs.* A manager wishing to avoid the market impact discussed above may decide to delay trading, or to trade smaller parcels, to avoid impacting the market. If, however, the price of securities being bought rises (or the price of those being sold falls) before the trades are complete, an opportunity cost is incurred. Hence there is a trade-off to be made between these two factors (see illustration below).

The "trader's dilemma" – the relationship between market impact and opportunity cost



- *Out-of-market risks.* Whenever securities are being transacted, it can be difficult to maintain exposure to the asset class (i.e. market beta) and to currencies fully in line with the target exposure. This is because it may not always be possible to sell unwanted assets and purchase the desired ones simultaneously at fair prices. This can lead to unwanted exposures, particularly to cash, during the trading period. If these risks are not managed adeptly, unpredictable losses or gains can occur, especially if trading takes place in volatile markets.

  Basic strategies for minimising out-of-market risk include facilitating in specie redemptions, use of synthetic exposures (e.g. futures and/or derivative contracts to align effective exposure), completing required trades as quickly and efficiently as possible, and using any existing cash reserves to match the trade date of the buy order to the sell order.

While often attributed to the broader cost of running an investment fund, *administrative expenses* are also relevant to consider. This includes the time spent by fiduciary committees working through the merits and mechanics of a manager switch, any adviser fees paid to assist in the due diligence of replacement candidates, negotiation of new contracts including legal fees, rewriting of fund documents and marketing materials, communicating to stakeholders about the change, and custody (transaction and reporting) fees.

Operational risk also needs to be borne in mind, which is the prospect of loss due to failure of internal processes, people or systems. This risk tends to be heightened during a transition to the extent it is not a "business as usual" activity and involves greater trading volumes or complexity, thereby giving rise to potential implementation leakages. Operational risk can manifest itself in failed trades, lost entitlements, reconciliation delays, mismatches in applications and redemptions or unit pricing errors. Operational errors can be significant, and at times may arise from the need to rely on the accuracy of information supplied by third parties.

Considering use of a transition manager

The extent of fund manager switches occurring in today's markets, together with the availability of dedicated transition management services, mean that the engagement of a specialist manager will frequently be worth considering even by moderate-sized institutional investors. The role of a transition manager is to take responsibility for the execution of the entire process and the results. This is achieved in part by utilising a project management approach which applies pre-set procedures and draws on established relationships within a dealing network.[3]

No two asset transitions are the same. Whether or not it is advisable to employ a transition manager will depend on the complexity of the trades involved, the absolute size of the portfolio and the amount of value at risk from market volatility. As a broad rule of thumb, we believe that at least some of the factors below should apply before engaging a specialist transition manager:

- The total transaction volume (purchases plus sales) are in excess of approximately US$50 million.
- The transition is not expected to be run-of-the-mill due to the transaction complexity or a lack of internal resources.
- Out-of-market risks are elevated due to a material portion of the transfer not projected to occur in specie (say, greater than 10%-15%).
- Investor tolerance for out-of-market risk is low.
- There is sufficient time to go through a transition manager appointment process that includes appropriate due diligence.
- The degree of trust in the terminated manager is low.

To elaborate on the last point, if a transition manager is not used, by default the responsibility for the selling down of any stocks rests with the terminated manager. Prima facie, this scenario does not represent a strong alignment of interests with the investor, albeit that the terminated fund manager will have an incentive not to depress the prices of stocks they still have holdings in on behalf of other clients. An alternative is to assign the legacy portfolio to the new manager for adjustment. A difficulty here is that invariably a "performance holiday" will be sought during this period, and the new manager is unlikely to approach the sell-down task with the same care as the legacy manager would, which could in turn impact prices received.

For a specialist transition manager, a key aspect of successful implementation is the ability to assess and utilise a broad range of trading strategies. This may include making use of internal or external crossings (matching order flows in opposing directions), agency market trades (regular trades through a broker) and principal trades (where the broker guarantees execution on a pre-determined basis). For managing market risk, Exchange Traded Funds or derivative overlays may be utilised. Particular trading strategies adopted will differ by transition and will be affected by market structure, availability of liquid hedging instruments and market conditions at the time.

Logically, the demand for specialised transition management is likely to increase in the future. Institutional portfolios are becoming more diverse in asset types and more global in exposure, while at the same time market trading environments are growing increasingly complex. It is also worth noting that, while specialist transition management has its origins in the equity sector, it has evolved into fixed interest markets.

[3] Mercer provides transition consulting services through its Sentinel division.

A way forward

We suggest the following points should form part of a decision process when considering a manager change:

- Adding degrees of sophistication to a transition process can enhance outcomes significantly. That said, no process is costless, and outcomes below 0.5% should not be assumed as typical.
- Fear of transition costs and risks should not preclude replacement of a manager. High quality manager selection will often result in net pay-offs over time. However, all relevant influences on the net return to investors should be factored into decision-making.
- It is true that transition costs are difficult to predict with a high degree of accuracy. However, take steps to deduce a likely range of outcomes (or at least an order of magnitude) in order that they can be accorded some weight.
- As best as can be foreseen, is the appointment period of the new manager likely to be long enough to offset the switch costs? An appropriate investment horizon needs to exist in order to make the action worthwhile.
- Be aware that segregated mandates offer most flexibility in transitions, providing latitude for crossing stock positions among managers when making changes to the underlying manager mix. Where pooled vehicles are involved, this tends to elevate out-of-market risk due to the need to manage cashflows around a unit redemption/ application process.
- To what extent can existing security holdings be transferred across to the new manager? Transitioning funds in specie minimises transaction costs and, in some jurisdictions, reduces assessable capital gains. Note that in specie transfers are generally still possible with pooled vehicles and serve to circumvent any buy/ sell spread applying to units in the fund.
- What is your fund's tolerance for being out-of-market? Asset prices rarely stay static for long. Do not under-estimate the scope for significant change in portfolio value (positive or negative) as a consequence of not having measures in place to manage market exposure.
- What is your fund's "need for speed" in terms of getting the new structure established? This will affect the balance of costs potentially incurred. For instance, a goal to implement the change as quickly as possible might serve to reduce out-of-market risk but at the expense of pushing up market impact and direct costs.
- How well suited are current market conditions for a transition? When volatility is high, spreads widen, there is less liquidity in the market and more risk factors to manage. For similar reasons, times around peak holiday periods are best avoided. The "now versus later" question is hence something to assess on net benefit.
- Weigh up the merit and viability of using a specialist transition manager. Such a manager will assist in determining a suitable strategy, take control of the execution process, and employ sophisticated techniques as seen fit. Any appointment should consider the operating framework and controls environment of the specialist transition manager. Engaging such assistance comes at a cost. However, in terms of overall outcomes, it may end up more than justifying the amount paid when balanced against the potential risk implications otherwise.

To sum up, making changes to fund manager appointments from time to time is an inevitable part of being an investor. Giving thought to the issues outlined in this paper, ahead of putting your "money on the move", will help clarify the potential costs and risks and keep undesirable surprises to a minimum.

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