INTERIM INVESTMENT SOLUTION

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This publication is part of a series of case studies on key drivers of transition management, reflecting Northern Trust's commitment to leading-edge solutions.

On occasion, a dramatic situation will occur that forces a pension plan to quickly fire a manager (e.g., due to team liftout) or replace a manager (e.g., due to firm closure). In these situations, it is important to understand interim investment options so you can promptly respond to an unexpected manager change and determine the most appropriate next steps.

Interim investment has increased in usage since 2008, due largely to turbulent markets and an increasingly dynamic manager selection process. Without the ability to engage a manager on an interim basis, pension plans are often forced into difficult decisions in which even the best courses of action are undesirable.

This case study focuses on one plan's process for implementing an interim investment solution.

SCENARIO

In the summer of 2009, a pension fund with an $80 million global equity mandate needed to transition quickly because their current investment manager was closing. The portfolio was very concentrated (63 positions) and had a tracking error of 5.59 percent to its benchmark. The fund believed a new manager search would take approximately six months and needed to identify an interim solution.

ROLE

Northern Trust served as both transition manager and interim investment manager. Our role was three-fold.

- **Reduce** risk (defined as slippage versus benchmark) associated with transition to the target mandate.
- **Create** a temporary investment solution that would meet the fund's short-term investment needs as it sought a new global manager.
- **Reduce** costs associated with transition to the interim solution.

SOLUTION SCOPE

In consultation with the pension, we identified three key criteria for the interim investment solution.

- **Maintain** exposure to the global mandate throughout the process (ACWI ex-U.S. benchmark).
- **Maximize** in-kinds between legacy portfolio and interim portfolio.
- **Create** a solution requiring minimal adjustments during the interim time period (estimated at between three and six months).

CONTINUED

Northern Trust explored three customized solutions for interim management.

1) **Futures.** This was quickly ruled out because of liquidity constraints and roll costs. Futures would not address the second and third stated criteria.

2) **Exchange Traded Funds (ETFs).** ETFs provided the necessary exposure to be a more viable solution. However, ETFs would not address the second criteria. We proposed both using a single ETF (ACWI ex-U.S.) and a basket of ETFs (EAFE, Canada and Emerging Markets). Northern Trust provided the data below to the client.

ETF SOLUTION

SOLUTION	TICKER	NAME	ALLOCATION TO BENCHMARK	LAST PRICE	SHARES REQUIRED	30-DAY ADV	TRADE AS % OF ADV	TRADE AS EXPENSE RATIO (BPS)
Single ETF	ACWX	iShares MSCI ACWI Ex-U.S.	100.00%	$33.05	2,360,060	109,961	2146%	35
Basket of ETFs[1]	N/A	N/A	100.00%	$41.40	2,054,372	31,575,752	8%	39

1 *Composed of three ETFs – EAFE, Canada S&P/TSX 60 and Emerging Markets. Data is blended based upon underlying ETFs' weight relative to ACWI ex-U.S. benchmark.*

3) **Portfolio Optimization.** This solution addressed all criteria. Portfolio optimization entails using securities from the existing portfolio to help replicate the benchmark index. The data at the right was provided to the pension.

PORTFOLIO OPTIMIZATION

SOLUTION	TRACKING ERROR	IN-KIND %	ESTIMATED TRANSITION COSTS (%)
1)	1.65%	21%	0.38%
2)	2.91%	57%	0.31%

DECISION

We prepared four cost analyses (two for the ETF solutions, two for the optimized portfolio solutions). After reviewing the reports and discussing choices, the client decided to proceed with an optimized portfolio solution to reduce tracking error to 2.5%, which enabled Northern Trust to retain more than 50% of the portfolio in-kind and reduce trading costs considerably.

INTERIM INVESTMENT PERFORMANCE

PORTFOLIO	START DATE	END DATE	PERFORMANCE (PCT)
Transition	$76,421,825	$93,837,305	22.79%
EAFE	1,289.03	1,594.50	23.70%
Variance			0.91%
Annualized Variance			1.34%

PERFORMANCE

Northern Trust transitioned to the interim portfolio and the client began the process of selecting a new manager. The new manager was funded approximately six months later.

Throughout the interim investment period, Northern Trust maintained a fiduciary role and monitored the account for corporate action and proxy voting activity. In addition, we provided periodic updates to the client on tracking error performance. During the six-month period, no optimization (hence, no trading) was needed, as the portfolio was at or better than the intended tracking error.

SUMMARY

The client in this case study began with a concentrated portfolio of only 63 holdings and needed an interim investment solution since the current manager was closing down its fund. Transitioning to an index fund was cost-prohibitive as 91% of the portfolio would have to be traded to achieve benchmark allocation. Instead, the portfolio was optimized to reduce tracking error while keeping trade costs down. The entire cost of the exercise over six months was 91 basis points, including tracking error and cost of the transition. This solution minimized single-stock risk during the interim time period, while also providing the necessary time to seek out a new investment advisor.

FOR MORE INFORMATION

To discuss the creative, customized solutions Northern Trust can provide, please contact the Transition Management group at 312.557.5173 or ntgi_transition_management@ntrs.com.

ACWX prospectus: http://us.ishares.com/content/stream.jsp?url=/content/repository/material/prospectus/acwx_prospectus.pdf

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