



TRANSITION MANAGEMENT

UNDERSTANDING TRANSITION MANAGEMENT

Dispelling the Top Five Myths

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Five years ago transition management was an unknown service among most plan sponsors. Today transition management is used by all types and sizes of funds. Like any new investment concept, until you have been through a transition, transition management can be difficult to really understand.

Each year, institutional investors shuffle between \$2 trillion and \$2.5 trillion among portfolios¹. Given the continued search for alpha, new funding requirements under the Pension Protection Act of 2006 and financial reporting changes under the FASB Statement No. 158, most industry analysts expect the number of portfolio restructurings to increase.

As the pace of plan restructurings continues to accelerate, it's important to be able to separate the truth from the transition management myths.

MYTH #1 – *The lower the commission rate, the better the trade.*

For many plan sponsors, the primary criterion for selecting a transition manager is the commission rate. These sponsors believe finding the lowest commission rate is an objective measure that can be used to support the transition manager selection with their plan's investment committee or board of trustees.

In fact, commissions are only the tip of the iceberg. Implicit costs – those costs that aren't obvious – can amount to several times the size of commissions. These implicit costs include market impact, bid/ask spread and the opportunity cost of not obtaining the target portfolio return.

To illustrate, the explicit commission cost of a large cap U.S. equity trade is 10 basis points². This same trade, however, could incur additional implicit costs of 68 basis points³. Assuming a traded value of \$100 million, commissions would amount to \$100,000, while implicit costs could total \$680,000 – nearly seven times the commission expense. The commissions and implicit costs of a small cap or international trade would be even higher.

Low commission rates also can give brokers an incentive to earn money off other elements of the trade through sales trading or crossing with their firms' proprietary trading desks. For this reason, basing transition manager selection solely on the commission rate and ignoring the effect of implicit costs can hurt your fund's performance.

MYTH #2 – *The higher the internal crossing rate, the lower the implementation shortfall.*

Transition providers with large index fund businesses can internally cross transition buy and sell portfolios with flows going in and out of their index funds. This has the appearance of being a costless trade because the fund sponsor pays no commission and incurs no market impact or bid/ask spread costs. But an internal cross under the U.S. Department of Labor Class Exemption 2002-12 does not occur until the close of day, which exposes your fund to the risk of significant opportunity cost if prices move away during the day and you fail to obtain the target portfolio return.

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Internal crossing can reduce commissions and spread, but it also can increase your risk. Committing a high percentage of the trade to the internal cross reduces the transition manager's flexibility to use other sources of liquidity including external crossing, dark servers and open market trading. Internal crossing is a valuable source of liquidity, but it should be used thoughtfully.

MYTH #3 – There is a 50/50 chance that opportunity cost will be either positive or negative.

Opportunity cost represents the risk of not obtaining the target portfolio return, and is the effect of everyone else's trading of the securities in the legacy and target portfolios. The sources of opportunity cost include delay in trading, tracking error between the legacy and target portfolios, and information leakage.

Typically, plans implement a transition for one of the following reasons: to replace a manager with poor performance, to achieve diversification, the defection of key personnel or because of a change in the plan's asset allocation policy. Because you generally are moving from an investment style that is out of favor to one that is in favor, you are selling from weakness and buying into strength. This is especially true if you are one of many plans exiting or entering the same strategy at the same time. As a result, opportunity

costs are inherently skewed toward adversely affecting funds, and do not have a 50/50 chance of being positive or negative.

MYTH #4 – Broker/dealers have a technological edge over other transition manager models.

Broker/dealers historically have been perceived to have a higher trading expertise. But trading venues such as crossing networks and algorithmic strategies – once exclusive to broker/dealers – are now readily accessible and have helped re-level the transition management playing field. Firms that you didn't think of as trading powerhouses have essentially the same technology as the largest broker/dealer investment banks do. Many of these firms have significant technology budgets and resources committed to their transition management business.

MYTH #5 – A fiduciary is not worth a premium.

Transition managers who fall under the Investment Advisers Act of 1940 are required to act solely in the interests of the transition client. These transition managers are prohibited from entering into conflicted situations such as trading ahead of the client's trade (prehedging), trading for their own proprietary account or receiving compensation from the other side of the trade. Each of these practices could benefit the transition

manager at your expense. In addition, fiduciaries are responsible for handling many of the transition's administrative tasks including processing corporate actions, voting proxies, reconciling assets and monitoring cash positions.

Regardless of whether the fiduciary charges a premium or not, knowing the transition manager's interests are fully aligned with yours can provide you with a higher level of comfort during the transition event.

PROTECT YOUR FUND BY KNOWING THE FACTS

As the demand for transition services continues to increase, providers will intensify the claims they are making as they attempt to get your business. To ensure you are making the best decision for your fund, it is important to separate fact from fiction when contemplating a shift in assets and selecting a transition manager.

Footnotes

1. Institutional Investor, "Street Shuffle," June 2006.
2. Based on an average commission rate of 4.1 cents per share calculated by Greenwich Associates and an average closing price of \$40.21 for the Russell 1000 Index calculated by the Quantitative Services Group LLC (QSG) for the three month period ending February 28, 2006. Similar calculation using securities in the Russell 2000 small cap universe results in explicit and implicit trading costs of 16 bps and 111 bps, respectively.
3. Based on trade data from buy side institutional investors that provide transaction data for anonymous inclusion in the QSG universe through T Cost Pro® for the three month period ending February 28, 2006.

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