As the Titanic found to its cost, moving through the iceberg-filled waters of the North Atlantic can be treacherous. Transitioning your pension assets in today’s financial markets can also prove disastrous, if not properly navigated and managed.

Understanding the transaction costs involved in a portfolio restructure and, ultimately who has responsibility for them, has become a much greater area of focus over the last few years as the regulatory landscape has radically changed. Added to this, a difficult investment environment with at best low returns has become the reality.

With the changes to fiduciary responsibilities, restructuring and transitioning of funds has become more frequent and complex. Trustees are searching for the right asset and performance mix to meet the future liabilities of their funds.

### LOOK BEYOND COMMISSIONS

Many investors and trustees may have heard of the iceberg of transaction costs. However, the continued client focus on the shrinking explicit basis points commission proves that much of the detail associated with it has not been fully understood. Like all icebergs, only a small portion is visible to the naked eye and this piece can easily be navigated around. The real danger is lurking below the surface, and for the unsuspecting investor it can be the cause of foundering and increased costs.

The notion that a transition needs to be “managed” has become more accepted both by consultants and clients, and this has led to more appointments of transition managers. Competition within the transition space is fierce and explicit commission rates are being driven down. However, the commission cost is generally just the smallest part of the iceberg and together with taxes, which are an unavoidable trading cost, is the part that appears above the waterline.

### THE ICEBERG EFFECT

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### OPPORTUNITIES BELOW THE SURFACE

Implicit costs represent the largest percentage of total costs. Fortunately, they provide the greatest opportunity to add value through careful selection of a suitable implementation strategy and comprehensive risk controls.

1. Based on Greenwich Associates average commission rate of 2.8 cents per share for the one-year period ended 31 May 2010 and an average closing price of $40.76 for the Russell 1000 Index as of 31 May 2010.
2. Source: Quantitative Service Group LLC (QSG). Based on trade data for the three-month period ending 30 June 2009 from buy-side institutional investors that provide transaction data for anonymous inclusion in the QSG universe through T Cost Pro®

Note: this data comes from third-party sources and is not reflective of our commission rates or transition management rates.
To understand the real total cost involved with a transition one needs to be able to quantify costs. It’s the role of the transition manager to ensure clients understand the cost components and the performance consequences of varying strategies.

The true total cost of any transition can only be seen when the components below the waterline are known; these are spread cost, market impact and opportunity cost.

**SPREAD COST**

Spread cost is the difference between the cost of buying and cost of selling a security, the bid and ask. The spread is variable and depends very much on the type and liquidity of a security. Many of the largest, blue chip stocks have tight spreads but as one invests away from high capitalisation and high liquidity securities the spreads will tend to widen. Aside from liquidity, the time of day can also vary the size of spread. Most markets are busy around the open, close and the period when the U.S. markets are also open to trade. At other times spreads can widen to accommodate the lower liquidity available in the market. It is your transition manager’s role to be able to estimate spreads and where possible work to reduce their size.

**MARKET IMPACT**

With market impact, the quicker the execution in the market the more impact on price movement is observed. This is logical when considering the demand for liquidity, which may not be readily available. When setting the trading strategy the transition manager should discuss the expected time line and risk appetite. The longer the trading timeline the lower the market impact cost should become as less liquidity is demanded from the market.

Crossing networks will often use the passive trading argument as their selling point and they can reduce spreads and market impact. Some transition managers may offer very high cross rates but this may only be achieved by long periods of crossing. Historically, transitions often took multiple days if not weeks to complete the implementation phase. In reality the extended trading time horizon is only really necessary for the largest and less liquid restructures.

Whilst awaiting a cross, whether internal to the transition manager or a scheduled match from one of the external networks, the market has not stopped and continues to trade. Attention needs to be focused on the likely market impact cost and spread savings of the crossing level seeking to be achieved. This is true in all restructures, but especially in volatile markets or where the trade is directional. In these scenarios a shorter implementation period will usually be necessary.

Within the overall strategy it is important to understand the balance between reducing market impact and increasing opportunity cost.

**OPPORTUNITY COST**

Potentially the biggest and most unpredictable area of the iceberg is opportunity cost. Opportunity cost is in reality the cost of doing nothing and not trading. When market impact is reduced by the use of more passive trading strategies and crossing networks, the probability of higher opportunity cost as time elapses increases. By taking more time over the implementation than is necessary and by utilising and waiting for natural liquidity in the market, an element of market timing is introduced into the transition.

Most clients’ stated aim during a transition is to restructure in the most cost-effective method. The performance benchmark should be struck at the time a restructure starts. As time elapses, the growing uncertainty introduces more risk that will often not be accounted for in transition cost projections. With market impact, costs can be measured as implemented, but with opportunity cost any volatility or unexpected company news will have the potential of adding costs. It is, of course, possible for the market to move in one’s favour but the purpose of the transition exercise is to maintain existing value and not introduce more risk. It is the role of the new manager to add value and increase fund performance.
Clients may well focus on the commission because of the difficulty in measuring many of the other costs.

MANAGING TOTAL COST

Northern Trust’s execution goal is to find the optimum balance of crossing and open-market trading to minimize total implicit costs, keeping in mind two key points:

- If executed too quickly, the manager will incur high trading costs.
- If executed too passively, the manager will incur high opportunity costs.

REDDUCING THE IMPACT

The importance of a managed transition is evident when the total costs associated with restructuring are fully understood. What might be described as the optimal trading strategy, aims to implement at the lowest point of all the above costs and doing this will reduce spread and market impact, and control opportunity cost. These strategies will use crossing when necessary, but not to the detriment of being out of a constantly trading market. This keeps the primary goal of maintaining asset value throughout the implementation phase of an assignment.

Commission is only a very small part of overall cost. An unmanaged transition can cost up to hundreds of basis points and when we consider explicit commission is only 5 – 10 basis points of that, the balance of costs needs much greater attention. Many transition mandates are decided solely on the explicit commission, with the winning margin as small as one basis point. The real focus needs to be on the remaining costs as they are the true areas of concern. Clients may well focus on the commission because of the difficulty in measuring many of the other costs. However, it is incumbent on transition managers to explain these costs, ensure clients understand them, and develop strategies that successfully tackle them.

As with avoiding the dangers of an iceberg, a careful path also needs to be steered during a transition to avoid both the above and below the waterline costs. For a successful journey from one manager to the next all aspects of the route, both hidden and visible, need to be understood.

FOR MORE INFORMATION

Transition Management Group
London: +44 (0)20 7982 3419
Chicago: +1 312 557 5173
nt_tm_global@ntrs.com