Building a Pool of Transition Managers
Both an Art and a Science

KEY ELEMENTS

- Transition managers are the discretionary caretakers of the transition event, the restructuring of institutional portfolios from single or multiple investment managers/asset classes to a new allocation over a short-term horizon. Callan recommends that sponsors build a pool of managers for future use.

- Transition managers can be evaluated and compared using implementation shortfall analysis to capture the cost of transition events.

- Sponsors should use a series of profile “check points” to identify issues to consider when building out the transition manager pool.

“Gauging the quality of product/service deliverables and the competitiveness of transition managers can be difficult for fund sponsors.”

Bo Abesamis
Manager of Callan’s Trust, Custody, and Securities Lending Group
Transition management is the cost-effective and efficient restructuring of institutional portfolios from single or multiple investment managers/asset classes to a new allocation over a short-term horizon, with risk management at the core of the process. Transition managers are the discretionary caretakers of the transition event, employing expertise in the fields of project management, trade and execution, and risk mitigation.

In this paper, a sequel to our 2013 paper “Transition Management: Beyond the Basics,” we offer guidance on building a pre-selected pool of transition managers, drawing on lessons from our decades of experience in this specialized and highly important area. A pre-selected, pre-contracted pool of providers is imperative because it empowers the fund sponsor to huddle, brainstorm, and solicit ideas from multiple perspectives on pre-trade strategies to manage the transition event. The pool is a virtual ring fence around information leakage because the managers operate under nondisclosure agreements, and it serves to counter biases to vet out the efficacy of any recommended strategy. The pool is a cross-check on quoted fees and costs to manage low-ball bids, or for that matter a dampening lid on pricey strategies. The pool is also an effective tool to triangulate on a well-articulated strategy and to decipher the range of potential outcomes, including costs.

**Practical Observations from the Fiduciary Trenches**

Gauging the quality of product/service deliverables and the competitiveness of transition managers can be difficult for fund sponsors, since most organizations are not “in the market” on a consistent basis. Transition managers differ in their discipline, depth of engagements, asset class coverage, fee arrangements, thought process, transparency, fiduciary conduct, and culture.

How can one possibly compare outcomes when each transition event is unique, client-specific, and subject to a myriad of variables? To compound the issue, most firms have equal access to risk systems, trading technology, mathematical algorithms, and core operational and project management processes. There is no performance metric to articulate the track record of a transition manager, let alone a default index for performance attribution.

Although not perfect, the industry-accepted metric for a transition event is implementation shortfall, which compares the value of the assets at the end of the transition to the value of the portfolio assuming an

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**Exhibit 1**

The Components of Implementation Shortfall: Explicit and Implicit Costs

<table>
<thead>
<tr>
<th>Explicit Costs</th>
<th>Implicit Costs</th>
<th>Sources of Liquidity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commissions</td>
<td>Market Impact</td>
<td>In-Kind Transfer</td>
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<tr>
<td>Regulatory Fees, Taxes,</td>
<td>Opportunity Costs</td>
<td>Internal Crossing</td>
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<tr>
<td>and Exchange Fees</td>
<td>Information Leakage</td>
<td>External Crossing</td>
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<td>Custodian Fees</td>
<td></td>
<td>Open Market</td>
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<tr>
<td></td>
<td></td>
<td>Non-Displayed Liquidity</td>
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<tr>
<td></td>
<td></td>
<td>Principal Trade</td>
</tr>
</tbody>
</table>

Source: Callan
immediate, theoretically costless, shift to the destination portfolio, using Perold’s t-cost analysis.¹ The difference in value is the total expense to implement the change and captures the true cost of an individual transition event. Callan recommends assessing completed mandates, using implementation shortfall, over three- and five-year periods to evaluate the dispersion from the mean between pre- and post-transition measurements. This analysis should be adjusted for each asset class (i.e., equity, fixed income, non-U.S., capitalization range, balanced mandates, etc.) to analyze trends and patterns of behavior. With this data, sponsors should assess:

1. Consistency of process
2. Repeatability of results
3. Industrial strength of quantitative tools deployed for risk and cost assessment
4. Individual and multi-asset class strengths and weaknesses
5. Strategy development and solution sourcing
6. Team depth and temperament
7. Honest, thoughtful transparency

KYC (Know Your Client)
The optimal number of transition managers comprising the pool is driven by the client profile (i.e., asset size, allocation, manager structure, investment vehicles, and client-specific governance requirements). The ideal number of transition managers in the pool should be expansive enough to solicit strategies, but not so large as to become an administrative burden managing multiple vendors, consolidating multiple reports, and integrating the governance structure for proper oversight. Clients should assess the resources and appropriate staffing required for managing two or more vendor relationships.

Transition managers often think of their capabilities in isolation through the narrow lens of liquidation, and they forget the client’s profile dictates the construction of the transition manager pool. The transition pool should be able to handle all types of transition events, such as portfolio liquidation, drawdowns (i.e., capital calls and benefit payments), multi-asset class rebalancing, mandate changes, benchmark reconstitution, single-stock liquidation (company stock), the needs of target date and self-branded funds common in DC plans, and tax-advantaged considerations (tax-loss harvesting for high net-worth taxable investors). Based on our experience and observation of the industry, three would be the average number of managers within a pool and five the typical maximum.

Practical Considerations in Building the Pool
Profile “check points” can be a guide in developing the transition management bench:

Core Exposure Allocation: Many clients have an anchor portfolio, comprised of an index (passive) core allocation and often used for liquidity purposes. If an index manager has transition management capabilities, it deserves consideration in a panel.

¹ Implementation shortfall was introduced by Andre Perold, who defined it as the difference between the actual portfolio return and the paper return benchmark. (“The implementation shortfall: Paper vs. reality.” The Journal of Portfolio Management, Spring 1988: 4 - 9.)
**Fixed Income Capabilities:** The inherent principal construct and underlying challenges within fixed income (i.e., asset-backed, mortgage, derivatives, high yield, emerging debt, etc.) necessitates the need to engage a fixed income specialist within a transition pool. Not all transition managers are created equal, and fixed income capabilities may be lacking. Oftentimes, the underlying fixed income manager within a client investment structure has transition management capabilities. A crucial capability in fixed income transitions is the ability to deploy solutions for bank loans and large amounts of credit securities. For example, an ETF solution should be considered when clients are looking to transition credit portfolios that may be expensive to trade and take a significant amount of time. This solution can swap a large portion of the client’s credit portfolio for a very liquid vehicle (ETF) that can be easily traded in the secondary markets at lower costs than the original basket.

**Liquidity-Constrained Dimension:** Within liquidity-constrained spaces, a transition specialist in mid-, small, and micro-cap, including non-U.S. equities (both emerging and frontier), and currencies is imperative. Transition managers are often comfortable within large cap and very liquid asset classes, but can falter in liquidity-constrained mandates. The global infrastructure (e.g., trading and operations desks) of a transition manager in this area cannot be ignored.

**Custody-Related Discipline:** Custodian banks have developed operational discipline and depth of capabilities in transition management, and they deserve consideration within a transition management pool. They are often critical in markets involving specialized requirements (e.g., the U.K., which requires re-registration costs for transitions without an actual change in beneficial owner), as well as minimizing headaches for those transitions requiring extensive documentation.

**Multi-Asset Class Factor:** Based on our experience, a majority of transitions are initiated as an offshoot of multi-asset class allocation rebalancing. This forces the transition manager to have investment discretion and portfolio management capabilities to handle a multi-asset class transition, and Callan recommends a transition manager with multi-asset class capabilities, specifically equities and fixed income. Any analysis conducted on a multi-asset class transition requires a robust, integrated multi-asset class platform that normalizes the impact and friction of equities, fixed income, cash, currencies, etc., for analytical purposes. Certain transition managers have robust equity pre-trade analysis capabilities but some limitations with the fixed income sleeve, and may improvise a strategy for the liquidation of the fixed income securities.

**Hybrid Solution:** Callan believes in the agent model for transitions because it leads to better disclosure and transparency, and helps avoid self-dealing. However, there are instances in which a principal or hybrid solution (a combination of agent and principal) is necessary and probably the only solution for a quick exit. A transition manager with a hybrid solution is able to manage unwinding long-short portfolios, divestment considerations (e.g., liquidating securities related to guns and ammunition manufacturers), non-tradable odd-lots, defaulted securities, and other sticky transactions.
**Non-Systemic Requirements:** Clients are subject to a myriad of requirements and governance principles, forcing a growing subset of transition mandates to evolve over time. For example, the implementation of environmental, social, and governance (ESG) policies and engagement of diverse business enterprises by public funds resulted in the growth of capabilities beyond the traditional definition of transition management. Another area within this space is the ability to execute tax-loss harvesting for the tax-managed portfolios of high-net worth trusts and individuals. Ultra-high net worth asset pools employing institutional-like transition management is becoming more of a norm than the exception. Tax-aware transition management is also required for nuclear decommissioning trusts in the United States with both tax-exempt and taxable pools of assets.

**Other Considerations for the Pool**

The Global Financial Crisis brought to light the need to enhance the concept of transition management. The regulatory environment, specifically Rule 165 within Dodd Frank, increased the need for transparency and changed the overall business models of transition managers. Regardless of asset class capability, transition managers need to articulate and apply commensurate expertise in the following areas:

**Beta Management:** The transition manager’s capability to assume temporary fiduciary responsibility for a portfolio and manage a tracking portfolio against a customized benchmark is very important. Managing within a tracking risk target band with possible constraints on factor exposures, minimizing trading turnover, and providing related services for such a portfolio (e.g., proxy voting) are also critical skills. The transition manager should work with the client to identify the appropriate customized benchmark and tracking risk target band, depending on the anticipated length of the temporary assignment.

**Liquidity Management:** The transition manager should be able to assist a client in identifying pockets of liquidity and harvesting them appropriately, and have the skill to help formulate a client liquidity profile encompassing all asset classes and funding requirements.

**Securities Lending:** The transition manager must be familiar with the operational complexities of securities lending to avoid triggering events that could lead to unintended consequences. Securities lending forces a transition manager to be adroit and knowledgeable about gating and redemption restrictions, including recall of securities that are out on loan to avoid potentially material losses.

**Defined Contribution Expertise:** Transition management in DC plans involves some of the most complex transactions, requiring astute awareness of daily valuation and the NAV process, specifically materiality thresholds. The ability to coordinate with recordkeepers and custodian banks, and managing glidepaths, is an acquired skill and learned by doing it (right). The preponderance of target date funds with their

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2 For more information, see the Report to Congress on Implementation of Enhanced Prudential Standards - January 2018
3 For more information, see our blog post “What’s Under the Hood of Your Index Vehicle? Securities Lending.”
multi-asset class structures across different investment vehicles (e.g., separate accounts, institutional mutual funds, commingled funds, collective trusts, and/or other line items) adds an operational wrinkle to the task, compounded by different investment vehicle liquidity and fund opening regimes. Expertise in navigating and avoiding blackout periods is a critical capability.

**Derivatives Expertise:** Transition managers may need skill in managing legacy derivatives exposures. Swaps, futures, options, and asset-backed securities can be problematic during the liquidation process and trigger an escalation in costs. The impact of liquidating the long portfolio without managing the derivative exposure and collateral could be catastrophic.

**Knowledge of Alternative Investments:** The ability to unwind alternative investments, specifically absolute return strategies, necessitates a hybrid solution. This is very apparent in the liquidation of market-neutral portfolios wherein multiple levels of liquidation are required—prime brokerage, underlying long, pair-offs, and collateral.

**Disclosure and Transparency Discipline:** The current regulatory and market environment requires a deeper level of disclosure and transparency of fees and costs, both explicit and implicit. A transition manager should therefore embrace full disclosure and transparency as part of its culture of stewardship and accountability. Callan believes that this factor is non-negotiable, and what differentiates transition managers. Another relevant area is the impact of MiFID II in the use of soft dollars and the procurement of research and trading. Starting this year, a heightened vigilance is required of transition managers to disclose their compliance with MiFID II and certain soft-dollar arrangements related to transition events conducted for clients.

**Conclusion**
Identifying capable transition managers is a combination of art and science, since both qualitative and quantitative factors should be used. On the quantitative side, fund sponsors can use implementation shortfall analysis to compare the effectiveness of transition managers.

To evaluate qualitative factors, Callan recommends analyzing a series of check points to make sure that transition managers have the range of capabilities needed for the task (or identify areas in which they fall short) and the client can draw upon the optimal skill set to manage the transition event.

As the portfolios of fund sponsors become more complex, greater demands will be placed on transition managers, and it is critical that fund sponsors evaluate potential managers across a range of issues, such as their ability to handle multi-asset class allocations, alternatives, specific governance issues (e.g., ESG principles), and DC plans.

Callan recommends that fund sponsors evaluate transition managers before they need them, and build a pool of them to be prepared when a transition event occurs. Success comes to those who are prepared.

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4 See my blog post for more details on MiFID II: "In Context: Markets in Financial Instruments Directive (MiFID) II"
About the Author

Virgilio “Bo” Abesamis III is an Executive Vice President and the Manager of Callan’s Trust, Custody, and Securities Lending group. He specializes in operational due diligence in the areas of safekeeping, asset servicing, trade processing, and portfolio restructuring, including securities finance. Bo is also responsible for passive and index portfolio and short term cash management manager due diligence in support of Callan’s Global Manager Research group. He is the practice leader within Callan in the evaluation and operational due diligence of investment vehicles ranging from mutual funds to commingled funds. Bo is a shareholder of the firm.

Bo joined Callan in 1987 in its Client Report Services group to assist in the development of Callan’s performance measurement tools. He moved to the Capital Markets Research group with responsibilities involving asset/liability modeling, manager structure, benchmark and database reviews, style analysis, and research. Bo then went on to manage the Specialty Performance Measurement group at Callan with an emphasis on analytics involving non-traditional asset classes, namely international, alternative investments, and real estate. He also assisted in the development of Callan’s International Consulting Services and Defined Contribution Consulting Services groups.

Bo earned an MBA with a double major in Finance and International Business from the University of San Francisco and a BS Management degree in Accounting and Finance from Ateneo de Manila, Philippines.
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<td>Atlanta</td>
</tr>
<tr>
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