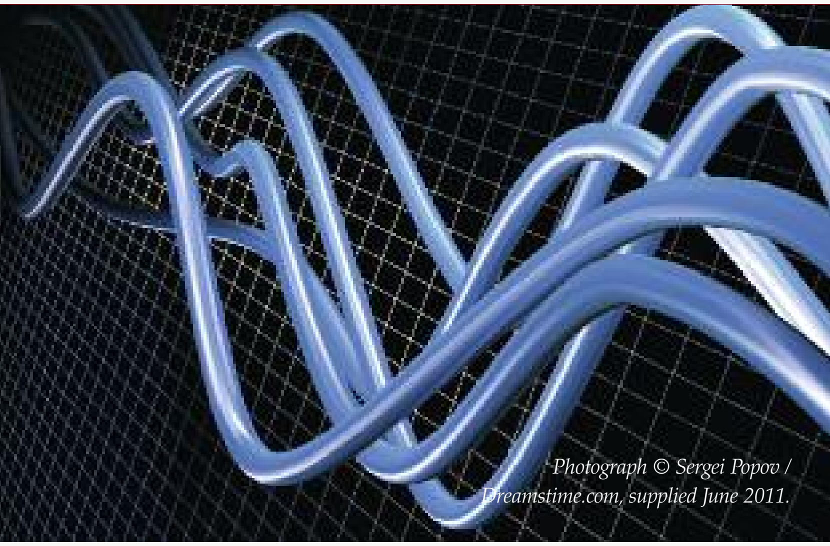
HOW TO TRANSITION €3bn INTO MANAGED ACCOUNTS



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The benefits of transition management are manifold, but not always apparent. In a profile of a high-value transition, Karin Russell, executive director, transition management at Morgan Stanley, showcases elements of the theory behind the transition management service and explains how this theory is translated into practice.

LD PENSION IS a foundation established in 1980 with the object of managing Denmark's "frozen cost of living allowances". The system was set up by the government to help adjust local wages through an automated process, to cover the inflation-driven cost of living increases. However, as part of a political agreement in 1976 some cost of living allowances were held back by the government. In 1980, the government entrusted LD Pension with the frozen element of the allowances, which by that time amounted to €1bn, and which was duly deposited in some 2.5m member accounts. The money was then scheduled to be paid out to those employees at retirement.

In the event, LD Pension did not receive any additional contributions in the intervening period, nonetheless the assets increased substantially in value as cumulative returns exceeded payments by the fund and reached €7bn.

In 2005, LD Pension formed its own asset management company called LD Invest A/S, with the purpose of providing LD Pension and other clients with investment advisory services. At the same time LD Pension entered into a five-year contract regarding investment advisory services for the majority of its investment portfolio. This contract expired at the end of 2010 and consequently the fund launched an EU-wide procurement process, resulting in the appointment of new investment managers for part of its assets. A number of transitions have taken place because of those changes over the intervening period and this case study involves one of them; namely the moving of equity assets from LD Invest A/S to three newly-appointed managers.

First phase

This phase is the most important in any assignment. It was important for us to define the objectives of LD Pension in this transition, which included moving part of the equity investments to external managers; the switch to a new value investment strategy, with more diversified holdings; the diversification of managers and asset holdings; maintenance and adjustment of a currency overlay though the transaction; adherence to specific investment guidelines before, during and after the transition; and, of course, to implement the transition as efficiently and cost effectively as possible.

We then went on to establish contact with all parties involved, signed contracts as well as confidentiality agreements, set up accounts, requested legacy and target asset lists, and set up electronic connections to the custodian Danske Bank. Close interaction with LD Pension, its new managers Danske Bank and Danske Invest, the fund's administrator, was paramount if we were to manage every moving part of the process throughout the transition. These moving elements included hedging overlays, market specific operational processes and investment restrictions, such as restrictions to trade on World Federation of Exchanges-approved exchanges only; a social responsibility exclusion list, and benchmark constraints.

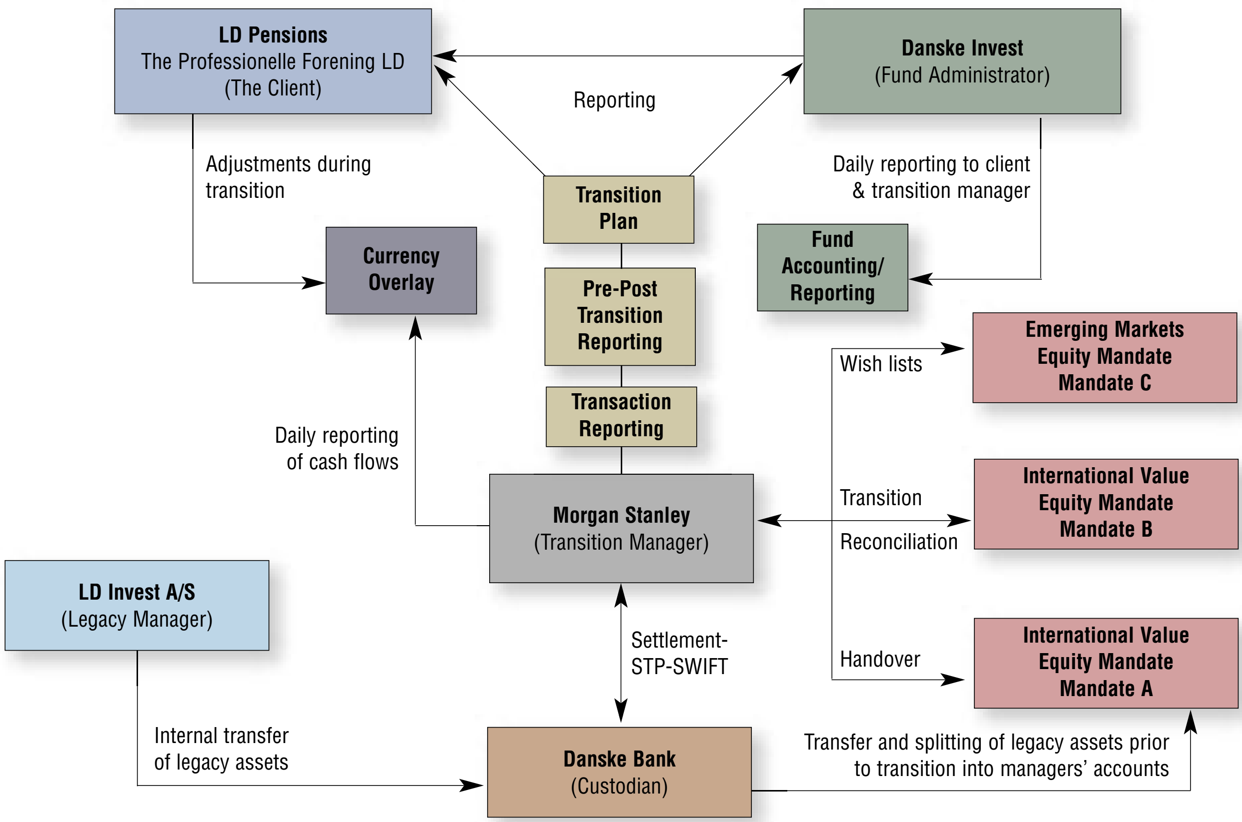
Moreover, we developed a transition plan, which outlined all the important steps involved in the transition, its objectives and its timetable. The plan was regularly updated during the course of the project to reflect the changes required.

Second phase

Once we received the client's wish and legacy asset lists, we conducted a pre-transition analysis. This analysis, which establishes the mechanics of the transition, was important to determine any expected costs and risks in the restructure. We modelled the portfolio interaction between legacy and target assets, which provided us with a level of detail necessary to form the transition strategy. Areas of importance were liquidity, tracking error, volatility, spread and asset/currency allocation changes.

From an investment perspective, the analysis highlighted that to restructure the current portfolio we needed to transact $3.2bn of equity transactions. We were moving from a highly

LD Pension restructure



concentrated portfolio to a more diversified portfolio of securities and countries. The transition also brought with it an illiquid tail and a liquidity imbalance between the buy and sell portfolio. From a delta perspective, we were delta neutral in each of the regions, which was surprising, but within the regions, we had some significant country and currency shifts. Finally (but significantly) with LD Pension running a currency overlay, this also played a focal point in the setting out of the risk management strategy.

From an operational perspective, the client required the transition to take place across the three new manager accounts instead of a designated transition account. The assets therefore had to be split and moved into the relevant accounts ahead of the restructure. This needed careful consideration due to operational implications in areas such as cash flow management. While the most suitable implementation strategy would have been to manage the transition in the three accounts independently from each other, it was important to transition all assets together for the benefit of reducing overall implementation shortfall costs. Inevitably though, it would be at the expense of direct operational risk.

Third phase

The day before trade date, we received final legacy asset lists as well as wish lists from the managers, which were screened against investment and trading guidelines one more time by both the client and us. We then created the target portfolios, crossed them against the legacy assets and prepared respective trade lists.

The next day trades were distributed to the trading desks in each region for execution in line with the agreed trading strategy. One of the tools utilised by the traders was MS PORT, an algorithm designed to reduce risks and control implementation shortfall. MS PORT works on a portfolio level unlike most other algorithms. It optimises the buy portfolio and the sell portfolio taking into account the correlation between assets. It eliminates stock and sector specific risks by trading out of high-risk positions early on in the trading period and then passively executing the remaining portfolio in line with volumes traded while keeping the trade cash balanced at all times.

Managing cash flow

Cash flow management in this transition was a key element, particularly because we were transitioning across multiple accounts and the liquidity profile of buys and sells in each account varied. As much as the overall trade was cash balanced in each region after each trading day, we suffered from cash flow imbalances within the accounts driven by the liquidity imbalance of the buys and sells. This resulted in one account being significantly over-bought while the other two accounts were oversold. This imbalance required us to adjust the standard settlement cycles of the trades to match the liquidity needs in the accounts (*ie* extend settlement of purchases in the overbought account and shorten settlement of the sells and *vice versa* in the other accounts).

Part of cash flow management involved the execution of foreign exchange transactions. These trades were executed ▶▶

simultaneously to the underlying securities to minimize currency risk. This also helps to ensure that the exchange rate prevailing at the time of each trade is locked in so that the settlement value of the underlying security does not fluctuate with exchange rate volatility or price drift.

During the implementation period, LD Pension was updated on the progress of the transactions and the costs on a regular basis during the day. We also reported on cash flow movements, so that the currency overlay could be adjusted accordingly, which was a process managed in this transition by the client.

Karin Russell, executive director, transition management at Morgan Stanley. Photograph kindly supplied by Morgan Stanley, June 2011.

Evaluation and settlement

During this final stage of this transition, we took care of instructing and settling the transactions as well as the reconciliation of positions and handover to the new managers.

Managing operational risks in a transition is as important as managing the investment risks since failed settlement and mismatch in cash flows can result in significant interest charges in some markets as well as the risk of being "bought-in" in other markets. A "buy-in" means that an investor will have to repurchase shares of stock because the seller either failed to deliver the shares or did not deliver them in a timely fashion. The buyer notifies exchange officials who, in turn notify the seller of the delivery failure. The exchange assists the buyer in purchasing the stock again, with the original seller having to make up the price difference if the new shares are more expensive than originally agreed to. We instructed the trades in the name of LD Pension to its custodian via SWIFT, which eliminated some of the operational risks and ensured timely settlement of the underlying transactions.

During this part of the transition, we also produced a post-transition report, which provided objective attributing performance results and a qualitative commentary on the transition. These results were presented to LD Pension during a meeting following completion of the restructure. Both pre and post-transition cost reporting followed the T-Charter principles. ■

LD PENSION'S ANALYSIS OF THE DEAL

THE TRANSITION OF assets with a total transaction volume of more than $3bn is not to be taken lightly. At LD Pension we quickly realised that we did not possess the necessary skills to carry out this speciality within investment management. This was an easy conclusion. The tough job was finding the right transition manager with both the necessary integrity, skill set, and a thorough understanding of our way of doing business. After a thorough evaluation of multiple transition managers, we found what we were looking for, explain Claus Buchwald Christjansen, chief investment officer and Lars Wallberg, chief financial officer at LD Pension.

We have a number of observations on the transition management service offering. In our view, the quality of services provided by the world's top transition managers is extremely high. Thus, when it came down to choosing a transition manager, choosing the right people to interact with during the transition event became one of the most important selection criteria. Moreover, we found during the transition event that these selection criteria proved to be very important.

Minor or major problems will always arise during a transition event. A good example in our transition event would be the changes in the standard settlement cycles which created some minor challenges during the transition itself. These changes challenged the custodian in a number of ways. However, we felt that the transition team correctly weighted the trade-off between the operational risk and the investment risk associated with managing the cash flows during the transition event. We were kept up to date about the challenges with managing the cash flows during the transition, and the post-transition analysis was totally transparent about this particular facet of the transition.

The one-point-of-entry model which characterised the transition team's approach worked very well for us. We felt at all times during the transition event, that we had 100% access to a key person in the team, who was integral to managing the transition event. Even though a larger team was working behind the scenes, we benefited greatly from having to communicate with one person only.

Before the transition we had some rather fierce discussions with the transition managers about the business model of a transition. We felt that it was very important to have a mutual understanding on how revenue is created, and which parties in a transition profits from it. These discussions underlined to us that the transition management team was acting as our agent. It also created an environment during and after the transition itself in which we did not have to discuss costs associated with the transition. As a matter of fact, costs came in within the estimate outlined in the pre-transition analysis.