Summary
- Some high profile organisational failings and fraudulent behaviour has damaged the reputation of the transition management industry.
- Trustees have been reminded of their requirement to ask questions of their transition managers.
- Independent monitoring can help ensure managers are performing appropriately.
- Ensuring the information supplied to trustees is understandable is a key challenge.

Managing managers

The transition management industry has been in the spotlight for the wrong reasons recently, leading to some scepticism among trustees. But there are a variety of ways to ensure your transition manager is delivering, as Christine Senior reports

The transition management industry has suffered some knocks to its reputation over the last few months with providers found guilty of dubious practices, and subsequent advice from the Financial Conduct Authority that levels of governance and transparency were not always what they should be. Pension schemes must play their part in ensuring that all goes well in a transition. An error or worse – fraud – could entail losses during the transition that cancel out all anticipated outperformance from a change of manager.

The fine imposed on State Street has dented the trust that pension funds had in their transition manager. Earlier this year the firm was fined nearly £22.9 million for overcharging its transition management clients. Six clients were overcharged by $20 million between June 2010 and September 2011. The FCA found that State Street's UK transition management business deliberately misrepresented its earnings from particular transitions in communications with clients. "State Street UK's business line controls and control functions did not ensure that TM documentation, the trading process, or communications with clients were adequately monitored," said the FCA's Final Notice.

Another blow to the industry happened in the US, where ConvergEx, a global brokerage, admitted a scam that involved using an offshore trading operation in Bermuda to manipulate the price of securities. This resulted in clients, including pension plans, being overcharged. After investigations by the Securities and Exchange Commission and the Department of Justice the firm was forced to pay a total of $150 million in penalties and restitution.

Then came a review of the transition management industry by the FCA in February, which drew attention to potential weaknesses in providers and advised that more emphasis was required on controls, governance and oversight. But on a more positive note, its conclusions were that overall firms were performing according to FCA requirements.

While the review reminded transition managers they need to focus their business practices, it has also had an impact on their clients, pension scheme managers and trustees. It has certainly raised awareness of potential pitfalls in a transition and underlined that trustees have a duty to ask more questions of their managers, in what is a complex and potentially risky operation for a pension fund.

Inalytics is a specialist firm which can undertake detailed measurement and analysis of transitions. Graham Dixon, its head of transition management, says: "ConvergEx and State Street have had an effect of undermining confidence in the whole industry. What it has done and because of the FCA review it reminded clients of their duty to scrutinise their transition managers. I sense pension funds are taking their due diligence more seriously, taking monitoring transition managers more seriously, looking to evaluate their transition more seriously than before."

Russell Investments head of transition management EMEA Chris Adolph says it's a question of asking the right questions of the transition manager: "I think what happened at State Street shows how important it is you really understand how your provider works, how they make their money, what they can and can't do."

A certain level of complacency might have crept into long standing relationships between pension funds and their transition managers. Mercer senior consultant Andrew Williams says: "Those clients who have used a provider on more than one occasion in the last few years and been happy with their services perhaps don't always see the need to carry out the level of due diligence that we and the FCA might expect. Clients who have used providers that have been in the news for the wrong reasons in the last few years have almost no option but to look again, seek advice and review own processes internally."

A source of help for trustees is the guide recently published by the NAPF that offers guidance on the whole process of transition management. This outlines eight areas where trustees should be asking questions to prospective transition managers. The guide was produced in association with Russell, and follows advice the firm was already offering its clients, says Adolph. "We try to provide guidelines to clients on the sort of things they should look out for. These are things that are not immediately obvious to most trustees. Unless you have read it you wouldn't know to ask the questions. As investments get more complex, it's very onerous on trustees to know what questions to ask."

"Trustees have a duty to ask more questions of their (transition) managers, in what is a complex and potentially risky operation for a pension fund"

At Inalytics their advice focuses on three areas: due diligence, governance structure, and appointing a person responsible for monitoring.

Dixon says: "Trustees should do more due diligence on a transition manager than on a fund manager. You have to carry out a proper due diligence and satisfy yourself they are the right person for the task. Secondly you should have a good governance structure throughout the transition, and take an interest as the transition is going on. Then you get no surprises at the end. And thirdly have somebody responsible for taking a look at all the material that comes out of the transition for trading to satisfy themselves that everything looks in order. That person will ask questions of the transition manager."

Just having somebody monitoring the event on a day to day basis has the effect of keeping the manager on the straight and narrow, according to Dixon. "Someone from ConvergEx said: 'We only picked on clients that were asleep, clients that were not monitoring, and those we knew were taking a close look we left untouched'. At Inalytics we find transition managers say they work more carefully and thoroughly if they know there's an independent measurer."

One area of particular concern is charges; if funds are charged fees they did not specifically agree to, the fund loses money, the value of assets is affected. Adolph says: "More clients are saying I want some form of compliance sign-off certifying that what you have charged me is what we agreed to. We certainly do that with clients to make sure there is some form of independent review of how much we as a firm have earned relative to what we said we would earn."

Conflicts of interest within a transition management firm also need particular scrutiny. One sensitive area is where a transition manager also has a proprietary dealing arm which trades on its own account as well as for clients. Chinese walls need to be maintained between the trading desk and the transition team. But in all areas where possible conflicts of interest can occur it's important pension fund clients are clear about how they are managed.

Towers Watson senior investment consultant Colin Rainbow says: "Most organisations have some conflicts of interest. It's down to having them documented in a detailed way and ensuring there is a compliance team to manage those conflicts. The conflicts philosophy needs to be embedded in TM team. They must believe in the conflict policy and adhere to it."

Things can go wrong in the transition right through the process, starting with the pre-trade report Rainbow says: "Before every transition starts the transition manager is likely to produce a pre-trade report to define its strategy and how it would transact your assets. It's important to agree the strategy chosen is the best one."

The post trade report also requires particular scrutiny. Williams says: "I never read a transition manager's post transition report that didn't say they didn't do a great job. An element of cynicism is probably healthy in this situation. We have seen an increase in independent parties carrying out reviews of transition managers' performance at a granular level, looking at numbers on a trade by trade basis."

But this requirement for transparency can result in an overload of information being produced, which paradoxically can obfuscate. A few providers respond to the requirement for transparency by providing too much data.

Williams says when the transition is complete, the provider might produce a spreadsheet or disc listing all the transactions. "That can run to tens of thousands of lines. You can't see the wood for the trees. We have been talking to providers for years about not just providing the data but providing commentary, almost writing a report in words that lay trustees can understand."

Written by Christine Senior, a freelance journalist