Summary

- DB pension schemes have used transition management for three decades primarily to reduce the drop off in performance when switching fund managers.
- Transition management has been noticeably gaining momentum during the last few years, thanks to a tough market environment in which every basis point counts and due to an increased preoccupation with transparency.
- Transition management can be valuable if a fund is heavily into esoteric assets like liability-driven investment (LDI) or infrastructure funds that could involve higher than normal transaction costs and potentially longer delays.
- Transition management has had little impact on DC schemes to date. Industry figures believe current DC schemes are not large enough to make the process worthwhile in contrast to the US. However, this may change in the coming years as a result of auto-enrolment and freedom and choice increasing DC saving.
- Some commentators muddy the waters by referring to transition management in DC schemes when they are technically referring to project management. Further confusion also occurs from the fact that most mainstream DC platform providers offer a degree of transition management.
- In practice, the little usage of independent transition managers in the UK in conjunction with DC schemes occurs when people are actually changing platforms and, very occasionally, for big changes within platforms.

A transition to DC?

Transition management is continually gaining momentum in the defined benefit pension space but limited demand still remains in the defined contribution field. Edmund Tirbutt explores why this is the case and how the market could change further

There is certainly nothing new about transition management, which has been used by UK defined benefit (DB) pension schemes for three decades, primarily to reduce drop off in performance when switching fund managers.

"Research during the 1990s suggested that nearly 3 per cent of annual performance on average was lost during a transition because no one was accountable for performance," Inalytics director Graham Dixon says. "The new fund managers would negotiate a performance holiday from the clients and part of the process of building their new portfolios might involve spending time heavily exposed to cash. But using an independent team of transition managers typically reduced the costs to 0.5 per cent."

Independent transition managers align the interests of the outgoing and incoming teams and will take greater care to minimise costs than would a new manager who is not yet being monitored for performance. They can provide transparency on costs and a greater range of contacts, and can minimise out of market risk by using methods like re-registering assets or conducting in-specie transfers.

Recent momentum

Nevertheless, the approach has been noticeably gaining momentum during the last few years, thanks to a tough market environment in which every basis point counts and due to an increased preoccupation with transparency. This mounting interest was highlighted by the Financial Conduct Authority's (FCA) February 2014 publication of its transition management review, which stressed the importance of the industry for asset owners and emphasised the need for more rigorous governance on transition management from investors.

"In the UK it is likely that almost all large DB schemes will have at some point had exposure to transition management," State Street head of portfolio solutions group for EMEA John Minderides comments. "Typically a DB scheme's requirement for it stems from the large segregated fund reallocations often made as part of their triannual evaluations."

But many smaller DB schemes have also used it because the types of assets being invested in can be just as important as size. Transition management might, for example, be valuable if a fund is heavily into more esoteric assets like liability-driven investment (LDI) or infrastructure funds that could involve higher than normal transaction costs and potentially longer delays, or even if it just holds individual conventional stocks.

Russell Investments head of transmission management for EMEA Chris Adolph states: "A fund could be only £100 million in size but could need transmission management because it's all invested in individual stocks and bonds, whereas a £500 million fund all in pooled funds may have less likelihood of needing it."

Little used for DC

However, even though most of the skills involved are easily transferable to the defined contribution (DC) world, the approach has made relatively little impact on DC schemes to date. Adolph estimates that DC schemes account for less than 5 per cent of Russell Investments' UK transition management activity.

LCP DC team partner Laura Myers, Willis Towers Watson head of DC investments Nico Aspinall and Zurich head of corporate funds proposition Martin Palmer are amongst those who have never come across independent transition management being used in a UK DC scheme.

Furthermore, some other commentators muddy the waters by referring to transition management in DC schemes when they are technically referring to project management. Although project managers can advise on how to do the transition, and maybe even help with pre-funding, they do not actually physically hold any assets. An actual transition manager will have both a transition account in which to hold assets and a bank account in which to process cash.

Further confusion also occurs from the fact that most mainstream DC platform providers offer a degree of transition management. Legal & General, for example, provides analysis and movement of assets free of charge, although members will bear costs like bid/offer spreads and, in rare cases, exit charges.

Legal & General head of DC distribution Emma Douglas says: "The vast majority of funds on our platform are indexed and quite a lot of DC transfers are from BlackRock to us or vice versa, so they are very straightforward. We would avoid dealing charges and out of market risk by doing them in specie as the stocks the funds hold are approximately the same."

In practice, the little usage of independent transition managers in the UK in conjunction with DC schemes occurs when people are actually changing platforms and, very occasionally, for big changes within platforms. They typically involve DC schemes with assets of £500 million to £1 billion.

Reasons for limited demand

One of the main reasons that the appeal of transition management has been so limited for DC schemes in the UK to date has been that they commonly lack the size to make it worthwhile. This contrasts noticeably with the US, where DC funds are much larger and the approach is much more popular. But this situation could of course change after the recent introductions of both auto-enrolment and the new DC pension freedoms, with a number of market commentators forecasting that UK DC schemes will surpass UK DB schemes in size by 2020.

"Until we get scale for DC there is no real need. If I'm dealing with £100 million of assets and want to sell £50 million of them then adding in a transition manager's fee of around £100,000 is unlikely to be worth it as you would be incurring more cost than you would be saving. In the future when we have £10 billion DC schemes we will need transmission management services but we are unlikely to see this for a good five years," Aspinall states.

Transition management is also far more complex for DC schemes, even though they typically invest in pooled funds rather than individual securities. This is because, unlike with DB, the interests of the individual members have to be taken into account. This means having to maintain administrative records of each individual and to treat them differently if they are in lifestyling programmes or indulging in any other form of individualistic investment strategy.

PTL client director Melanie Cusack says: "If out of market exposure arises or the transition is messy it is members' DC accounts that are directly affected as the members bear all the investment risk, so trustees may have some difficult questions from members to answer. Given that the trustees are ultimately responsible for strategic investment decisions such as changing investment defaults and options, irrespective of who they appoint to implement their decisions, there will be less tolerance for bumpy transactions than with DB schemes, where it is the overall funding level that is impacted."

"You must make sure DC members are not suffering an investment hit and that they know their options and when they can and can't deal with their investments," Sackers partner Faith Dickson emphasised. "The general area where people go wrong is poor communication as it's a complicated concept to communicate in a way that people understand, so it's important to find out which methods of communication work best with members. Putting on roadshows in canteens when people can receive face-to-face guidance can be very effective."

There are also other parties, like pricing agents and transfer agents, to satisfy with DC schemes, and there are greater restrictions regarding when you can do transmission management and how long you can do it for. Additionally, it is hard to consolidate assets in a single account, and if the transition manager ends up managing multiple accounts it all adds to the complexity.

However, the economies of scale that should start being achieved by the UK DC market a few years down the line should counteract the types of fees that transition managers have to charge to deal with this greater layer of complexity. So it seems more a question of 'when' rather than 'if' transition management starts to become a standard feature in our DC world.

Written by Edmund Tirbutt, a freelance journalist