

# The Parallel Evolution of Fixed-Income and Equity Transition Management

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**H**iring transition managers in the equity market has long been a popular option for asset owners seeking to reduce risk and effectively manage complex rebalancing events. Retaining transition managers for fixed-income transitions, however, is still a relatively new option for many plan sponsors. Traditionally, plans have relied on the legacy manager or the target manager (or, less politely, the fired and hired manager) to transition bond portfolios. Although the structure of the bond market is different from the equity market, asset owners are increasingly comfortable with the idea that transition management adds as much value in fixed-income transitions as it does in equity.

In order to understand this evolution, we need first to understand the evolution of equity transition management. During the decades of the 1980s and 1990s, when transition management was an unfamiliar term to many, the bulk of manager changes were handled by the legacy or target manager. While these options were the clear paths of least resistance, both created unique sets of problems.

Legacy managers, having just been terminated, felt little inclination to deliver quality executions or competitive commission rates. Even if sponsors trusted that the fired managers' spiteful compliance would not yield high explicit and implicit costs, this approach had many other shortcomings. The fact remained that allowing the legacy manager to liquidate

its own account meant that the sponsor would most likely miss out on in-kind transfer opportunities and would almost certainly lose market exposure for several days during the transition period.

The latter option, allowing the target manager to effect the transition, had its own set of considerable drawbacks. It created undue opportunity cost by delaying the implementation of the plan's asset allocation decision. It also necessitated a "performance holiday"—the performance benchmark date of the manager, who had been saddled with the responsibility of liquidating the legacy manager's portfolio, was often unclear. Poorly defined (or undefined) start dates could even be used as an excuse for poor performance several years later. This lack of accountability was understandably troubling to asset owners.

Beyond these serious concerns, there remained the fact that transition management was not the core competency of the investment managers. Plan sponsors required comprehensive project management, as well as thorough pre- and post-trade reporting.

So, to meet the demands of the market, the role of the transition manager grew. Choosing a transition manager allowed sponsors to avoid lapses in market exposure, add accountability and transparency to the process, and move from their legacy allocations to their target allocations in a more efficient way. Furthermore, hiring a transition manager

allowed asset owners to engage an experienced party to plan for and manage the operational steps, thus reducing market risk and relieving the administrative burden of the sponsor.

By 2000, transition management was a ubiquitous choice in the equity space, and it remains so today. In contrast, the choices asset owners make regarding fixed-income transitions still look very much like the choices made two decades ago with regard to equity transitions. The status quo is changing, however, as plan sponsors understand that, despite the perceived advantages, using a legacy or target manager to transition fixed-income portfolios comes with the same issues and conflicts of interest that gave rise to the prevalence of transition managers in the equity markets. Clients face the same costs and risks, and therefore, the benefits of transition management are the same.

Furthermore, transparency in the fixed-income space has become more robust, as advances driven by customer demand and regulatory changes have resulted in better price discovery. Specifically, the TRACE reporting system and TradeWeb have forced brokers to publish the details of their trades in a timely fashion. This development has provided the context for execu-

tions and enabled clients to know whether or not they have received a fair price. This increased transparency has enabled transition managers to offer sponsors the sort of comprehensive and accurate pre-trade analysis, intra-day trade execution monitoring, and post-trade analysis that has been lacking to date.

While there is little doubt that transition management traces its roots back to equity markets, many of the client-driven developments in that space have clear application to other asset classes. And while it is certainly important to understand the factors that make fixed-income transitions different from equity transitions, it is equally important to understand their similarities. Fundamentally, the goals and the challenges are the same. Similarly, the benefits of transition management apply to both.

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