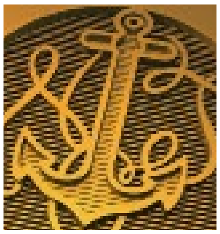
MOVING MOUNTAINS

How to Effectively Manage Risk When Transitioning Assets



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Asset restructuring events involve many details and subtleties. They can be complex and fraught with potential risk. Fortunately, effective planning can help reduce risk. Following the steps outlined here will help you to better plan your next transition event and mitigate much of the risk when restructuring your investment portfolio.

BE PREPARED

Have the necessary pieces in place to facilitate a transition without any delays — even if a transition event isn't imminent. To do this, you need to:

- Establish a relationship with a transition manager by having an on-going legal agreement ready.
- Maintain a transition account ready for trading, including global markets as necessary.
- Ensure that all necessary legal documents are in place before you proceed with the transition.
- Ensure fiduciary oversight is maintained throughout the transition.
- Decide what your target portfolio is before terminating a manager. Agree on new investment manager/fund agreements and have them signed (or close to it).
- Consider interim strategies if you have not yet hired target managers. Potential interim solutions include index funds, exchange traded funds, futures and temporary investment management. These solutions are particularly useful to exit a managed portfolio that is experiencing deteriorating performance or where there is key personnel turnover.

ARTICULATE SCOPE

The next step is to explain your transition goals and objectives to all the parties involved. Without an established destination and clear set of expectations, transition planning may get off to a slow start. In order to achieve this, you can take the following steps:

- Build a "road map." Detail where you are coming from (legacy) and where you want to go (target).
- Describe in detail your ultimate goals from legacy to target.
- Decide between percentage targets or dollar targets if you are funding multiple accounts. With dollar targets, you need to designate one target account as a "plug" that will receive more or fewer dollars, depending on market movement and trading costs.

IDENTIFY POTENTIAL ISSUES

Identify and list the broad issues you might encounter in your transition, and search for any unusual areas of risk you need to consider. Recognize the unknowns or unanswered questions going into the transition event. Consider any post-transition effects such as the effect on reporting or performance. This can help you prepare a strategy to mitigate the risk in advance.

To help identify potential issues, on the following pages are some key questions to pose for different facets in a transition.

SAMPLE ROAD MAP

Legacy Manager Name	Account Type	Asset Type	Action	Sale
Manager A	SMA	US EQ	Termination	($21,000,000)
Manager B	CF	Global EQ	Termination	($161,000,000)
Manager C	MF	US EQ	Termination	($63,000,000)
Manager D	SMA	US FI	Pare back	($72,000,000)
Manager E	CF	US FI	Termination	($12,000,000)
			Total Legacy	**($329,000,000)**

Target Manager Name	Account Type	Asset Type	Action	Purchase
Manager 1	SMA	US EQ	New funding	$125,000,000
Manager 2	SMA	US EQ	Add'l funding	$14,000,000
Manager 3	SMA	Global EQ	New funding	$50,000,000
Manager 4	MF	Global FI	Add'l funding	$20,000,000
Manager 5	MF	US FI	Add'l funding	$35,000,000
Manager 6	CF	US EQ	New funding	$70,000,000
Cash to be raised*	CASH	Cash	In-kind funding	$15,000,000
			Total Target	**$329,000,000**

** Cash is for benefit payments that must be paid at the end of the month.*

QUESTIONS TO ASK WHEN TERMINATING AN INVESTMENT MANAGER

What is the last trade date/ termination date?

- This will help you to understand who will assume fiduciary responsibility at precisely what time. The investment manager's fiduciary responsibility usually includes trading, obtaining good settlement, voting corporate action and proxy activity.
- Confirm any advance notification requirements within the investment management agreement.

Does the account have any unusual types of securities that may influence the transition time line?

- Derivatives (as well as related margin held), swaps, currency forwards or to-be-announced mortgage securities (TBAs) require special planning. Will the outgoing manager close the legacy portfolio's positions in these securities? Or will the new target manager or transition manager assume the positions? These factors will affect the transition's timing.

Who assumes the investment fiduciary duty once the legacy manager is terminated?

- Custody or trust agreements usually determine who the "default" investment fiduciary is. To avoid any gaps during the transition, you need to clearly define when the transition manager and target manager will assume investment fiduciary responsibility for the assets and determine any gaps you may be responsible for.

Have we notified our custodian of the coming transition?

- The custodian needs to complete a reconciliation with the terminated manager before handing off the portfolio to the next investment fiduciary.

QUESTIONS TO ASK WHEN THE LEGACY OR TARGET PORTFOLIO CONTAINS A COMMINGLED FUND

What are our funding/redemption options?

- Funding and redemption of funds can be completed with cash or securities. Certain fund managers may give the option for either in-kind with securities or cash settlement. If you have a preference for an in-kind versus cash delivery, this is the time to express that request to the fund manager. Ultimately, the decision is at the fund manager's discretion.

Will we incur any charges or costs related to our purchase or sale of the commingled fund?

- Some commingled funds charge trading costs back to their clients.

Should we be aware of any timelines or deadlines?

- Commingled funds often have notification deadlines.
- Some funds are only valued monthly or quarterly, which provides fewer options for funding or redemption.

What is the fund settlement date?

- Commingled funds often settle on T+1. This means that cash or securities must be provided the day after purchase/sale. This can present a liquidity crunch because most equities and bonds settle T+3.
- Some funds require prefunding. In these instances, the cash must be presented before purchase.

What will the security list look like for in-kind funding or redemption?

- Fund managers generally have discretion over how to receive or deliver assets to or from their funds. The in-kind asset list could either be pro rata or adjusted manually by the portfolio manager.

QUESTIONS TO IDENTIFY RISK WHEN PARING BACK OR DRAWING DOWN ASSET MANAGERS

How will we arrive at the exact value for the pareback?

- The intended reduction amount either can be based on a market value or percent, which determines the methodology used to determine the legacy/target mapping.

Will we grant the investment manager discretion over the asset selection process?

- The investment manager can use either a pro rata or optimized approach in the asset selection process.

How can we prevent the pareback from having a detrimental effect on the manager's daily trading?

- Determine a valuation date and communicate it to the manager, custodian and transition manager.
- Similar to a manager termination, a change in investment fiduciary requires the custodian to complete a reconciliation. The custodian and the manager will have to work closely to expedite the reconciliation so as not to disrupt trading while assets are being moved from the account.

QUESTIONS TO CONSIDER WHEN DEALING WITH NON-U.S. SECURITIES

Does our custodian have the necessary global accounts open?

- Foreign markets require local accounts to be opened in advance of trading and settlement. The process can be lengthy in certain countries.
- Local sub-custody accounts are necessary for:
  - — Settlement of an in-kind redemption from a global fund
  - — Trading initiated by a transition manager
  - — Trading initiated by a target manager
- When the necessary local accounts cannot be opened in time for the transition, other options such as American Depository Receipts (ADRs), exchange traded funds or cash in lieu, should be considered to facilitate initial trading.

Do we need to address any tax consequences?

- A change in legal ownership of securities may result in a change in beneficial ownership (CBO). A CBO is a legal description of when the ownership of a security has changed and generally has taxation and stamp duty implications in the United Kingdom, Ireland and Hong Kong.
- The applicability of stamp tax is specifically related to the interpretation of the HM Revenue & Custom (HMRC). It's important to consult a subject matter expert on this topic to thoroughly understand your options.
- The stamp tax in the United Kingdom, at 50 basis points of market value, typically has the most significant effect.

QUESTIONS TO HELP SPOT POTENTIAL CHALLENGES THAT MAY EXIST WITH FIXED INCOME SECURITIES THAT DO NOT EXIST WITH EQUITIES

Do we face any unusual circumstances with our fixed income securities that need to be considered?

- Many fixed income securities have variable payment options such as principal pre-payments or delinquencies on mortgage- and asset-backed securities.

How can securities with paydown activity affect our transition?

- Free movement (transferring assets between accounts) requires original and current face values. Custodians adjust current face value on receipt of the paydown; investment managers adjust current face value once pre-payment activity is calculated and pre-payment factors are posted. It's important that the manager who is responsible for the reconciliation with the custodian understands this difference.
- Timing around paydown dates can cause reconciliation challenges between the custodian and the investment managers.
- Trades may need to be adjusted when new pre-payment factors come out later in the month.

QUESTIONS TO CONSIDER WHEN PLANNING FOR LIQUIDITY DURING A TRANSITION

What are our liquidity needs as part of the transition?

- Identify cash needs. These could be target funding requirements or future cash flows, including benefit payments or cash disbursements.

Could there be any mismatches in the settlement dates between legacy funding sources and target portfolios?

- It is critical to verify settlement cycle with fund vehicles and if derivatives are involved.
- Settlement cycles vary among different countries and security types.

Is there any potential leverage when employing cash?

- If trade dates on the legacy portfolio and target portfolio are the same, the initial trade amount will be an estimate and a subsequent true up will be required.
- Some fund managers will require pre-funding (i.e., settlement is on or before trade date) and will need additional planning.

QUESTIONS TO ASK WHEN TRANSITIONING ASSETS IN A DEFINED CONTRIBUTION PLAN

Do we anticipate any participant activity during the transition?

- Careful liquidity planning and a well-designed transition management strategy can eliminate the need for a blackout period.

Will the transition affect a single participant option and/or a unitized pool?

- Changes facilitated in-kind may require a transition manager. The transition management account(s) will become part of the participant option/unitized pool(s) until target has been completed.
- Close coordination between the transition manager and the custodian/valuation agent is required for the timely capture of trade details.

How will the final trade/termination be communicated?

- The normal process to facilitate participant-directed daily trade/flow information may not apply. Confirm protocol with the legacy fund/manager.

Will this change affect the recordkeeper?

- If participant flows are to be redirected to a different source, the recordkeeper will be required to make changes accordingly. This may influence the decision for a blackout period.

DEFINE RESPONSIBILITY

A transition is a complex event that involves many parties and has many steps and moving parts. No single party can be fully responsible for the entire transition event, which can cause ambiguity about exactly who is responsible for certain tasks. Careful coordination among all the involved parties, from the custodian to the consultant to the recordkeeper, must be carefully orchestrated. Hiring a transition manager can greatly assist in this process. Work with your transition manager to create a detailed timeline and an action plan outlining ownership for each step along the timeline in the transition.

The most ambiguous responsibilities in a transition are:

- Deciding which party (or parties) is responsible for determining trade date, settlement date and settlement type for each incoming and outgoing manager.
- Coordinating the timing of commingled fund or mutual fund redemptions and purchases in either (or both) the legacy and target portfolios.
- Distinguishing and managing potential gaps in operational risk (process) versus market risk (investment responsibility).
- Assigning responsibility for movements, transfers and payments of cash.
- Deciding when you need a transition manager and what role it will play.

DIRECT ALL PARTIES ACCORDING TO PLAN

Once a plan and a timeline are developed, communicate the plan and timeline to all the parties involved and direct them to execute according to the plan. The communication and direction should be clear, concise and complete, with specific actions and timeline required for each party. It is also a good practice to follow up before the start of the transition to make sure that each party receives and understands the plan and actions needed, and answer any questions and clarify any issues that might exist.

CONCLUSION

Taking the time to create a plan for your transition and ensuring that all parties involved clearly understand their roles and responsibilities can go a long way toward minimizing the potential for problems. The best time to start this planning is before you are considering a transition event.

FOR MORE INFORMATION

To learn more about how our Transition Management services may help you control costs, reduce risk, and preserve value, please call 312-557-5173 or email NTTM@ntrs.com.