



Transition Manager Search

Texas Municipal Retirement System

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Overview of Transition Management



Transition Management Overview

What is Transition Management?

Transition Management is the movement of assets from a “legacy” portfolio to a “target” portfolio utilizing strategies designed to reduce overall risks and costs.

When is Transition Management used?

- Portfolio/manager shifts due to:
 - Asset allocation changes
 - Investment universe or investment style changes
- Investment manager terminations, replacements, or additions
- Sizable fund flows (significant additions or redemptions)
- Managing exposure during vehicle change (to/from a commingled vehicle to a separate account)

Why is Transition Management important?

- The process and cost of transitioning assets is often overlooked.
- Transitions can be operationally complex and potentially costly to the fund.
- Effective management of transitions is a fiduciary responsibility.
- Without transparency, adverse effects can be misallocated to the performance of the outgoing mandate or the new mandate, unfairly coloring past or future performance.

Current TMRS Transition Management Bench

TMRS Transition Managers under Contract

- BlackRock
- Citi
- Russell

TMRS Transition Management Usage to Date

- Six (6) transition management events (2013-2015) involving Phases I-III of the Equity Restructuring totaling nearly \$2.5 Billion in trading.
 1. U.S. All Cap Portfolio Funding
 2. Non-U.S. Core Portfolio Funding
 3. U.S. Mid Cap Portfolio Funding
 4. Emerging Markets & U.S. Small Cap Portfolio Funding
 5. U.S. Small Cap Portfolio Funding
 6. Non-U.S. Small Cap Portfolio Funding
- Citi was engaged on all but 1 of the events (BlackRock performed event #4 above, the Emerging Markets & Small Cap Portfolio Funding).
- Usage of Russell and BlackRock was less due to a protracted contracting process, but contracts are currently in place with all three transition managers.
- Transition Managers provided project management and transparency, and observed results were within expectations.

TMRS Investment Policy Statement Guidelines

General Transition Management Roles

- Decision on how to transition assets (transition manager, legacy manager, or target manager) is delegated to Executive Director and Chief Investment Officer with advice from Investment Consultant.

Investment Policy Articulates:

- Transition Managers be Registered Investment Advisors, contractually accept fiduciary responsibility, and provide agency-only executions.
- Transition Managers be engaged from a Board pre-approved pool of Transition Managers.
- Post-transition reporting to the Board is required.
- Periodic analysis and reporting to the Board on the quality/status of the pool of Transition Managers is required.

Marketplace Evolution

The Pros & Cons of Competitive Bidding Processes

Pros:

- Potential reduction in commissions/explicit costs due to competition.
- May identify options for trading strategies and risk management during restructuring.
- Provides for a documented process that encourages discussion with and consideration of alternative providers for each restructuring event.

Cons:

- Preparing and soliciting bids (even from a contained pool of bidders) can create delay between decision point to transition portfolio(s) and the actual implementation of the transition event – such delays can create material differences in portfolio performance.
- Additional time and resources are dedicated to preparing and reviewing bids.
- Commission rates, and explicit costs in general, can represent a minor portion of overall costs although they are often the most visible and controllable costs.
- Bidding often relies on estimates and market conditions that may not be present in the actual event results of selected TM and often require substantial qualitative overlay by Consultant and Staff (regarding the reasonability of estimation process rather than the specific estimates).

While competitive bidding for TM assignments remains quite common, RVK notes that there are some meaningful challenges to the practice.

Marketplace Evolution

Optimal Transition Management Bench Commentary

Optimal Size of Transition Management Benches can vary widely

- In RVK's experience, Transition Management relationships range from an evergreen relationship with one or more firms (historically quite commonly implemented using a custodial affiliate or a passive investment manager) to a formal transition management bench with multiple Transition Managers under master contract.
- Transition Management benches most often contain 3-5+ firms, typically with different business models and differentiated strengths (by asset class, transition type, or otherwise).
- With significant instances of provider exits over recent years, there can also be meaningful business value and prudence to having multiple Transition Managers on an established bench to provide for continuity and stability within a pre-selected and vetted pool of TM providers.

Transition Management Industry is Diverse and Crowded – Focus is Key

- Within a universe of a dozen potential transition managers, often providing very similar services and bearing similar messages, RVK believes that focus on large and established providers with revenue model transparency, deep staffing, business model sustainability, and areas of differentiated strength is critical.
- This may either take the form of shorter lists of universally qualified bidders or designated bidders for specific asset categories/event types

RVK has continued our discussion on these topics following the 2016 TMRS Board Education and Transition Management Review Session.

Transition Manager Industry Review

Alternative Approaches

Interim Asset Management

- Some Transition Management firms offer services, known as “interim management,” where they can take over interim fiduciary oversight of a terminated manager’s portfolio of securities prior to identification of a replacement manager.
- Taken together with model-driven trading (incremental trims and adds to remove active portfolio skews), interim management can form the basis for effective cost- and risk-management.
- Interim management typically takes the form of portfolio oversight to a model-driven tracking error target for a period of 6 months or under and can represent a superior trading cost to risk reward trade-off than a roundtrip transition from an active portfolio to fully passive management and back.

RVK believes that there is a place for an interim asset management specialist on the TMRS Transition Management Bench to respond to specific circumstances that might require an interim management solution (or at least to facilitate the consideration of such services).

Transition Management Search Process



Transition Manager Search Process

Board Authorization

- Board approved BlackRock, Citi, and Russell as members of transition management panel in 2013.
- RVK provided an educational presentation on Transition Management in 2016. Transition Management Review was added to work plan.
- New search conducted due to time (5 years since the prior search).

Manager Screen

- RVK reviewed the universe of transition managers with demonstrated capabilities in transition management.
- Minimum qualifications and evaluation criteria were established.
- Thirteen (13) managers were identified as potentially qualified.

Questionnaire

- Developed jointly by RVK and TMRS Staff.
- Issued questionnaire to candidate short list.
- Twelve (12) responses were submitted.

Evaluation & Preliminary Due Diligence

- TMRS evaluation team included Director of Equities and Investment Analyst III | RVK evaluation conducted by RVK's Investment Operations Solutions Group.
- Questionnaire Evaluation Performed by RVK and TMRS. Eleven (11) responses met the minimum qualifications.
- Conducted telephone interviews with top six (6) ranking firms.

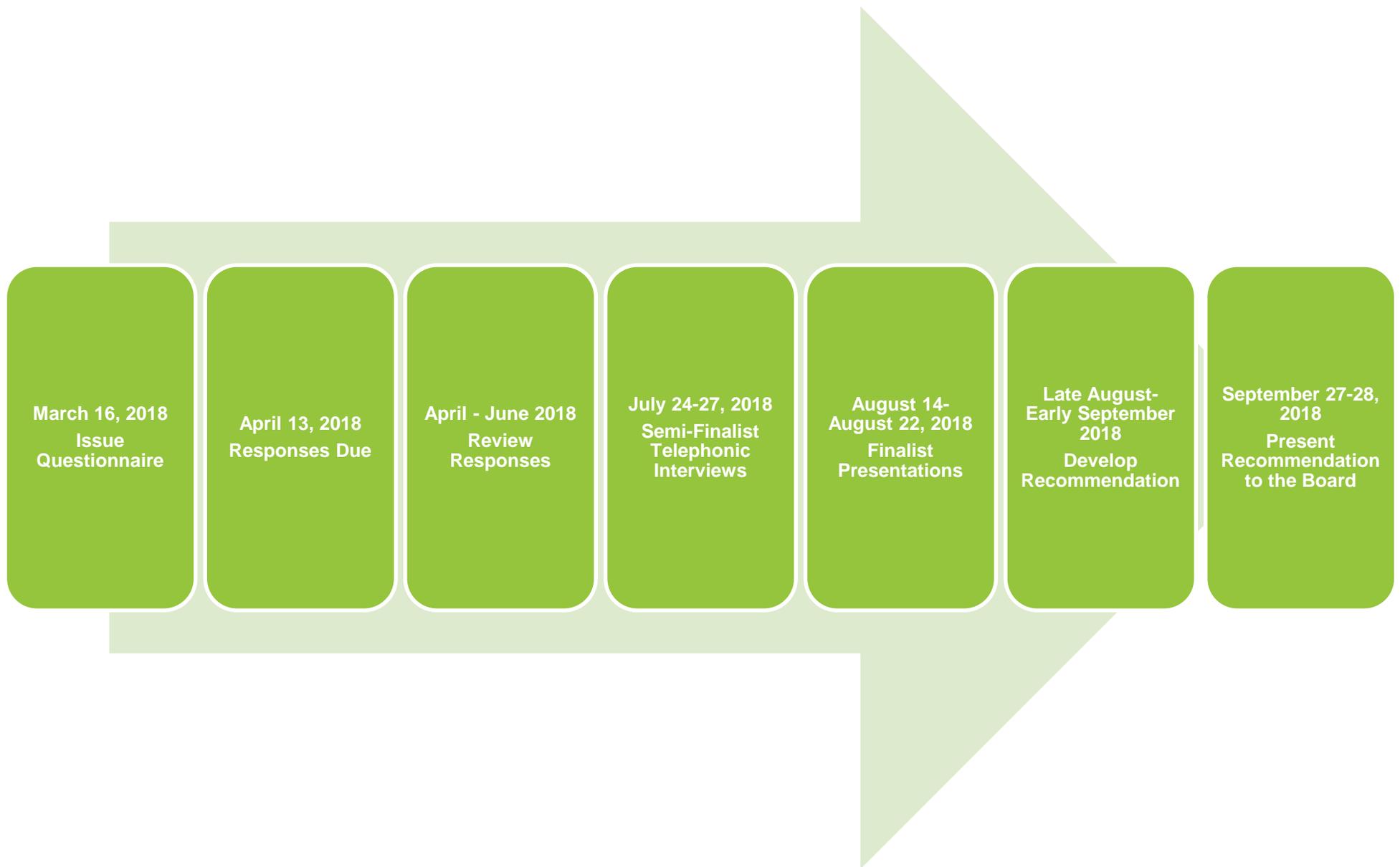
In-Depth Due Diligence

- Highest ranking five (5) firms identified as finalists.
- In-person presentations conducted for more in-depth due diligence review.

Recommend

- Five (5) firms selected for recommendation to the Board as “designated pool” of transition managers with specific asset-classes or transition mandates of focus for approved use by TMRS Staff.

Transition Manager Search Timeline



Minimum Qualifications

As of December 31, 2017, responding firms must satisfy the minimum requirements as outlined below in order to be considered for contract award.

1. Firms offering to provide Transition Management services must have transitioned a minimum aggregate of \$25 billion over the past 5 years ended December 31, 2017.
2. The firm must certify in writing that it will serve as an agency provider of transition management services and act as a fiduciary when performing these services and be bound by Prudent Investor Rule standards.
3. The firm must be a U.S. Securities and Exchange Commission-Registered Investment Advisor or an advisor exempt from registration (Form ADV/ Parts 1 and 2); or otherwise regulated by an appropriate government regulatory oversight organization (unless exempt from such registration requirement) disclosure of the exemption must be submitted.
4. The firm and its personnel must have all authorizations, permits, licenses, and certifications as required under federal, state or local law to perform the services specified.
5. The firm must provide transition management services compliant with the T-Charter/T Standard methodology unless an exemption is explicitly approved by TMRS.
6. The key professionals and/or organization must not have, nor could they potentially have, a material conflict with the Board of Trustees, Staff, Consultant, or Custodial Bank.
7. The firm must have adequate fiduciary insurance coverage. At a minimum, the firm must provide proof of Errors and Omissions/Professional Liability Insurance.
8. Upon selection as a successful candidate, the firm should be willing to enter into a management contract, and the material terms, conditions, and approach to the contract shall be based on the contract terms provided.

Initial Evaluation Criteria

Organization & Experience = 15 points

- Satisfied minimum qualifications
- Organizational structure
- Staffing model and turnover
- Quantitative evidence of transition abilities
- Experienced growth, business structure, financial condition, litigation

Methodology = 15 points

- Clarity of methodology & philosophy
- Core competencies
- Cost management
- Risk management
- Liquidity sources
- Quantitative tools
- Approach to pre-cost estimates

Operations, Execution, & Cybersecurity/PII = 15 points

- Broker execution practices
- Corporate governance operational support
- Internal and external crossing sources
- Special settlement capabilities
- Foreign exchange execution

Reporting = 15 points

- Custom reporting
- Final Pre-Trade reporting
- Interim reporting
- On-line reporting
- Post Trade Reporting

Disclosures / Conflicts of Interest = 10 points

- Fiduciary status
- Transparency
- Agency Status

Revenue Sources = 30 points

- Willingness to provide guaranteed cap on fees.
- Reasonable and competitive fees, assessed in isolation and in comparison to other providers

- Twelve (12) responses were received. Eleven (11) responses met the minimum qualifications.
- Six (6) respondents identified as semi-finalists:

Semi-Finalist Evaluation Criteria

Organization & Professional Staff = 20 points	Execution Abilities, Business Model, Philosophy and Methods = 30 points
<ul style="list-style-type: none">• TM Firm Structure and Operational Reporting Lines• Depth of TM team• TM Staffing Assignment Model• Event Management Controls and Process	<ul style="list-style-type: none">• Trading and execution abilities including relevant strength in specific asset classes• Provision of reporting and benchmarking detail• Review of client and event management approaches

- Six (6) semi-finalists were each given an opportunity during a telephonic interview to differentiate themselves, discuss specific questions about organizational structure and capabilities.
- Five (5) respondents were identified as finalists:

Vendor
Russell
Citi
BlackRock
Pavilion
Northern Trust

Finalist Evaluation Criteria

Proposed Team and Supporting Resources = 5 points	Demonstration of Tools, Processes, and Pre- and Post-Trade Execution = 15 points	Demonstration of Operations and Trading Execution Approach and Strategies = 15 points	Compliance and Risk Control Disclosures / Conflicts of interest and Revenue Source = 15 points
<ul style="list-style-type: none"> • Depth of Team • Supporting Resources Present • Organizational Stability and Access 	<ul style="list-style-type: none"> • Effectiveness of demonstration of systems and approaches • Review of checklists and processes leveraged 	<ul style="list-style-type: none"> • Effectiveness of demonstration of operations and supporting resources • Effectiveness of discussion of how such resources would be deployed for case study examples 	<ul style="list-style-type: none"> • Effectiveness of demonstration of compliance and regulatory oversight • Effectiveness of discussion of internal control environment including hiring process

- The five (5) finalists were each given an opportunity during an in-person interview to address questions related to organizational resources, stability, introduce additional team members and operations / trading / compliance resources. Finalists were also asked to review and demonstrate their tools and resources through three case studies.
- All five finalist respondents were identified by TMRS staff and RVK as recommended for selection and designation for asset-class / situation-specific mandates:

Vendor
Northern Trust
Citi
Pavilion
BlackRock
Russell

Transition Manager Recommendation



TMRS Transition Management Bench Structure and Guidelines

TMRS Staff and RVK recommend that the Board approve the retention and designation of a slightly wider pool of transition managers and allow the use of interim asset management where appropriate.

- TMRS Staff and RVK will select transition managers pursuant to the receipt of pre-trade proposals from one or more of the approved providers based on the facts and circumstances of the required restructure event.
- TMRS Staff will review rationale for selection and transition outcome with the Board during the next scheduled meeting.
- Transition Management program, including results of overall program and provider assignments, will be reviewed periodically with a formal search process conducted no less frequently than every 5 years.

TMRS Asset-Type and Transition Situation Bench Structure may utilize one or more providers for each:

- US Small/Large Cap Equity Restructures
- Developed Global Equity Restructures
- Global Equity, including Emerging Restructures
- Global Fixed Income Restructures
- Interim Management and Exposure

Transition Management Bench

RVK and TMRS staff assert that all recommended managers have strengths in more than one asset class or service which can be utilized to produce the best suited proposal for any TMRS transition event.

While not pre-defining any future transition manager selection outcome, RVK and TMRS staff highlight below the following transition managers and their current strengths for potential Asset-Type and Transition Situation usage. Each transition will be evaluated and awarded independently:

Vendor	US Equity Restructure	Non-US Developed Equity Restructure	Non-US Developed + Emerging Equity Restructure	Global Fixed Income Restructure	Interim Management
Northern Trust	✓	✓			●
Citi	✓	●	✓	●	●
Pavilion	●	✓			●
BlackRock	●	✓	✓	✓	●
Russell	●	●		✓	✓

Legend:

- ✓ : Indicates preferred provider to perform transition for asset class
- : Indicates suitable provider to perform transition for asset class

Example: The Potential Value of Interim Management

- RVK and TMRS staff discussed Interim Management (IM) as an alternative approach in the August 2013 and October 2016 Board presentations.
- Should TMRS lose confidence in an active manager's ability to outperform their benchmark, the option to leverage the relationship with an IM can save costs and reduce risk.
 - **Cost Savings** – stop paying active management fees immediately and these savings often outweigh explicit fees of the impending transition.
 - **Risk Reduction** – Based on agreed upon tracking error constraints, the optimization process for the interim portfolio will maximize the retention of existing securities, while minimizing transaction costs.
- This provides TMRS the flexibility to determine if there is a need for interim management based on the specific factors of any given portfolio change.

One caveat is interim management serves as an additional option when considering the termination of a manager or asset class change but may not be the best solution depending on other factors and investment decisions related to a change in a portfolio.

Example: Managers on Watch List & Why Interim Management May Provide a Solution

- The public equity team recently placed three managers on TMRS's Watch List for varying reasons.
 - Loss of assets
 - Performance issues
 - Firm structure changes
- Interim Management provides TMRS an additional option to transition the above mentioned portfolios based on the multitude of investment decisions present.
- The Public Equity team is responsible for determining what the best solution is when changes are warranted. This can include:
 - Finding the most cost efficient way to transition assets based on a solid risk management framework
 - Moving assets to a passive portfolio and/or another TMRS manager
 - Using an interim manager to manage the portfolio against pre-determined tracking error targets while staff conducts a manager search.

Example: Why Russell Interim Management?

- The August 2013 presentation to the Board identified Russell as a recommendation for the approved bench of transition managers TMRS currently employs.
- One of the pros detailed in the 2013 presentation for the Russell recommendation was *“very strong interim asset management and overlay capabilities.”*
- Russell also demonstrated that interim management was a core competency of their transition management business.

Russell Implementation Services Inc. — helping to solve your investment challenges

Using all instruments to transform what you have and don't want into what you want and don't yet have - with persistence

- **Passive**
 - › Policy implementation
 - › Currency hedging
 - › Liability-driven investing (LDI)
- **Active**
 - › Informed rebalancing
 - › Synthetic mispricings
- **Multi-Venue Pure Agency**
 - › Equity
 - › Fixed Income
 - › Foreign exchange
 - › Derivatives

Increasing returns by reducing structural and frictional costs associated with implementation

Actively, quantitatively or passively managing return seeking asset level portfolios

1. Russell Implementation Services was ranked as a top-tier broker in Pensions & Investments March 2013 Tradewatch report, based on the quality of its trade execution. Russell placed among the top ten brokers in large cap trades and trades representing 50% of daily volume.

2. For the tenth consecutive year, Russell received "Top Marks" in every category of Global Investor magazine's 2013 transition management survey. Global Investor magazine's survey results reveal the top transition managers across the EMEA, Americas and Asia Pacific regions. Global Investor "Top Marks" categories include: accuracy of pre-trade estimate, operational efficiency, post-trade analysis, pre-trade analysis, project management, relationship management, reporting during transition, risk management, trading / execution, transparency of fees and costs.

3. For the fourth year in a row, Russell was a recipient of the UK Pensions award for work in the UK. In 2012, Russell won the "Outstanding Investment Provider of the Year 2012" (includes delegated consulting providers, fiduciary managers, and advisory managers) at the UK Pensions awards organized by Professional Pensions. Russell Investments won two UK pensions awards in 2011: Multi Manager, a category disbanded this year, and Transition Manager of the year. Russell also won the Multi Manager category in 2010 and the Transition Management category in 2009.

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Russell Investments

Example: Why Russell for Interim Management?

- Other transition managers within this recommendation do not rely on interim management as a core piece of their business.
- Instead of providing an optimized strategy for an interim portfolio other transition managers would rather use ETFs, index funds, futures, or synthetic ETFs to maintain exposures but this can be costly.
- Oversight of the interim portfolio is limited.
- Timeframe allowed by a manager to oversee the interim portfolio is also limited. Some choose to take a more conservative legal and compliance perspective and prefer not to take on the responsibility to manage the portfolio while it is in transition.
- TMRS would be required to be more hands on in monitoring the portfolio since oversight is limited.
- Russell believes interim management as a service is becoming more important to public funds.

Russell provides interim management as a core business, provides an optimization strategy for the portfolio, portfolio is reviewed more timely, interim periods are more flexible and can range between 1 to 12 months, and will provide periodic reporting on portfolio characteristics and performance.

Requested Board Action



Approval of Recommendation

- TMRS Staff and RVK recommend that the Board of Trustees approve the selection of the following transition managers as detailed in the Board Communication Memo for the transition manager bench and potential interim management if appropriate:

Recommendations:

- BlackRock Institutional Trust Company, N.A.
- Citigroup Global Markets Inc.
- Northern Trust Investments, Inc.
- Pavilion Global Markets Ltd.
- Russell Investments Implementation Services, LLC