IMPLEMENTING A RISK ASSESSMENT WHEN MANAGING CHANGE

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"Don't take your love away from me
Don't you leave my heart in misery
If you go then I'll be blue
Cause breaking up is hard to do"

Breaking up is hard to do
- Neil Sedaka

Institutional investors face some difficult decisions after concluding that an investment manager will need to be terminated. In some situations, the resulting termination has nothing to do with the existing manager. Changes in strategic asset allocation or structure (going to Global Equity from EAFE/US Equity) result in winners and losers of assets. In other situations, a plan sponsor may have lost confidence in the investment manager due to the failure of one or more of the 4P's of investment management research: People, Performance, Process, and/or Philosophy. Breaking up is hard to do...

While the decision to leave a manager is difficult, plan sponsors must find answers to important questions. Do I cut ties quickly or stay with my existing manager until a replacement has been appointed? How long will this take? What are the risks of doing something vs. nothing?

These questions should not cause undue anxiety for a plan sponsor. Although there are many options available, undergoing a risk assessment can help guide plan sponsors to a satisfactory conclusion.

A risk assessment is a straightforward exercise that assesses the key risks involved in making changes to the portfolio. We have worked with various clients to develop a risk assessment to help them decide whether to use a Temporary Assessment Management solution to bridge the gap between termination and a new funding. To reach a decision, we walked clients through the following questions.

What type of change is being made?

Asset allocation or structural change

When the main factor for terminating a manager is related to an asset allocation or structural change, the urgency to make an immediate change is less critical. Even so, it's important to determine whether the new asset class or structure has a tradeable index. For example, if the asset class shift is to Emerging Markets, there are beta solutions to get immediate exposure. However for some alternative asset classes, such as infrastructure or direct real estate, there are no tradeable investments matching the desired investment characteristics.

Failure of one of the 4P's of investment management research

When the main factor for terminating a manager is related to one of the 4Ps, the urgency to make an immediate change is escalated. Three of the four "Ps" are discussed below.

People & Process - If there has been a disruption to the portfolio management team, including key people leaving the firm, an immediate termination is often a foregone conclusion. For plan sponsors invested in a tradeable asset class, a beta solution can be considered as an interim solution.

Performance - Underperformance may be the reason for the manager being terminated but the underperformance may not justify immediate termination. The plan sponsor should evaluate the likelihood of continued below benchmark performance. A historical analysis of the manager's quarterly performance may shed some light on the potential risk for future underperformance. Below is an example of one such performance summary.

Quarterly Excess Returns versus MSCI EAFE Index (Net)

	Since Inception	Last 10 Years	Last 4 Years	Last Year
% of quarters outperforming	57.8%	52.5%	31.3%	0.0%
% of quarters underperforming	42.2%	47.5%	68.7%	100.0%
Mean positive excess return	3.33%	2.09%	0.99%	-
Mean negative excess return	-1.82%	-1.42%	-1.56%	-2.31%
Maximum quarterly excess return	17.89%	8.17%	1.50%	-1.23%
Minimum quarterly excess return	-9.88%	-5.15%	-5.15%	-5.15%

Source: MGR-IQ, Pavilion Advisory Group's investment manager database

By no means is past performance indicative of future returns, but if quarterly under performance is occurring with greater frequency, it may lead to the expectation for near-term underperformance.

How long will it take to select new investments?

Most institutional investors follow a manager selection process that involves a comprehensive search, a due-diligence review and, ultimately, a contract with the new investment manager. Combined, these steps sometimes take a few months. In some cases, institutional investors may follow an abbreviated process that, in turn, shortens the time required to select a new manager.

The frequency of decision-making meetings also will determine how long the manager search process will take.

Depending on the length of the process, plans may be exposed to an opportunity cost risk of either not benefiting from a new allocation or continuing to be invested in an underperforming manager.

What is your tolerance for a short-term benchmark tracking error and underperformance?

Although this would seem like an unusual question given that the plan sponsor hired the legacy manager knowing their active risk, risk is not static nor is an investor's appetite for risk static.

If the investor is determined to eliminate benchmark risk, then exposure to any short-term active risk may require immediate action.

What are my options for an interim solution? What are the costs?

In theory, getting index-like returns during the search process seems simple enough but, in practice, there are several approaches with different factors and results. The more common strategies include: index pooled funds or segregated index management; temporary asset management; exchange traded funds; and index futures. The pros and cons of each are outlined in Appendix A.

Whether making short-term or long-term changes to a portfolio, transaction costs should never be overlooked. Pavilion's team can assist an investor to assess the costs of making interim beta decisions including the use of an ETF, Futures or an index instrument. Furthermore, Pavilion is capable of developing customized, low-cost solutions via a temporary asset management solution. Pavilion uses optimization tools to construct and maintain model portfolios that meet specific tracking error objectives.

The key cost factors* to assess are:

- **Trading costs and related taxes and levies –** The cost of transitioning to an interim solution will vary based on the asset class and the type of interim solution. For example, replicating a full index will be the most costly solution versus a low tracking error solution that seeks to minimize trading costs and maximize in-kind transfers.
- **Custody Costs –** Depending on the index selected and the investable markets, the custody fees can be a significant cost. For example, the MSCI ACWI Index has 2,449 constituents and the MSCI EAFE Index has 901 constituents. (as of September 30, 2014). So a full replication EAFE Index assuming $25/ticket cost and 901 trades could result in fees of $22,525.
- **Management Fees –** Selecting a passive or optimized interim solution should result in significant fee savings over the active management fee. However, depending on the asset class, the savings will vary due to the different costs of passive solutions. In some cases, the active management cost savings will cover all the costs of moving to an interim solution.

*Costs are assuming the portfolio is built in a segregated account. Pooled fund costs vary based on the provider and amount invested.

Risk Assessment Matrix

	LOWER RISK	>>>>>>>>>	>>>>>>>>>	HIGHER RISK
What type of change is being made?	Asset allocation shift to a non-tradeable asset class	Asset allocation shift to a tradeable asset class	Performance issues, change in philosphy or process	Major organizational change or departure of key person or people
INVESTMENT MANAGER RISK				
How concerned are you with your current investment and investment manager?	Manager's active risk and recent performance raise no concerns	Manager's active risk is higher than expected and/or performance is moderatly concerning	Manager's active risk or recent performance are concerning and inconsistent	Managers active risk is higher than expected and near term performance has been very poor and volatile
PLAN RISK/TOLERANCE				
What is the plan's current risk appetite	Willing to take short-term fluctuations and/ or under-exposure to desired asset class	Looking to mitigate some of the current risk exposure	Looking to have a beta solution for new asset class and willing to take some benchmark risk	Looking to have immediate beta for new asset class and unwilling to take benchmark risk
OPPORTUNITY COST RISK				
How long will it take to select the new investments?	0 - 1 month	2-3 months	3-6 months	6+ months
TRANSACTION & FEE COST RISK				
What is the cost of an interim solution?	Savings achieved: Management fee savings should cover the cost of the move to the interim solution	Low cost: The cost to move to an interim solution is less than 10	Moderate cost	High cost

After factoring in all these questions, it should become clearer what needs to be done. With the tools available to plan sponsors today, the evolution of the search process provides many low-cost solutions that may eliminate the short-term risk of being in an underperforming asset class or having underweight asset class exposure.

See the following page for Appendix A: investment options to bridge the gap between managers

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Appendix A: Investment options to bridge the gap between managers

Here are the options for plans to obtain index-like returns during the manager search process.

Index Pooled Fund or Segregated Index Management

Passive investment management is commonly available for most benchmark investments (e.g. MSCI EAFE Index, S&P 500 Index). The assets are either held at the plan's custodian (Seg) or commingled with other clients at the manager's custodian (Index Pool).

Benefits:

- Very low tracking error to the benchmark index;
- Low management fees;
- Segregated account format reduces some counter-party risk and provides a high level of transparency;
- Commingled structure spreads the operational costs and keeps the expense ratio down; and
- A broader range of indexes can be replicated.

Limitations:

- Transition costs - Plans transitioning to a full index can expect elevated transition costs and high turn-over. Costs include brokerage commission, exchange fees, custodian costs, and indirect costs.
- Custodial set-up requires account openings. Some markets, especially in emerging markets, can take several months to open and add significant costs to the implementation.
- Requires an investment management agreement or a subscription agreement.

Temporary Asset Management

Temporary asset management (TAM) is a Pavilion investment strategy that uses portfolio optimization to effectively reduce the active risk of a client's legacy manager portfolio until a new target manager is selected and funded. The optimized portfolio is constructed to track, within an agreed tracking error, the performance and risk characteristics of a defined benchmark. TAM seeks to minimize transaction costs throughout the term of the mandate, including the initial investment and the ongoing portfolio management.

Benefits:

- Highly customizable strategies;
- Low tracking error to benchmark, majority of active risk is eliminated;
- Lower management fees vs. active management; and
- Lower transaction costs vs. passive solutions (i.e. index funds).

Limitations:

- TAM solutions are low tracking error (e.g. 25-150bps) vs no tracking-error solutions;
- Solution is only available using a segregated account; and
- Requires an investment management agreement.

Futures

An index Futures contract legally binds the buyer to purchase an asset (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a predetermined future date and price. Index Futures contracts are standardized to facilitate trading on a futures exchange and are settled in cash.

Benefits:

- Does not require an investment manager and can be purchased through a broker;
- The derivative markets are very liquid and, due to index arbitrage, trade at or very close to their fair value; and
- Transaction costs in the futures market are lower than the equity markets.

Limitations:

- Transition costs - Plans transitioning to a Futures portfolio could expect up to 100-per-cent turn-over to realign the holdings;
- Requires a futures account where the trades will clear and margin will be posted. Futures accounts often take several weeks to open and include several agreements;
- Operationally more complex then equities, Futures contracts expire and must be rolled to maintain exposure and margin requirements; and
- The Index Futures trading universe is limited. Some contracts that appeal to Plan Sponsors are not liquid (MSCI EAFE Index) or do not exist (MSCI World Index or Canadian Small Cap Index).

Exchange Traded Funds

An exchange traded fund (ETF) is an exchange-listed security that seeks to track an index[1]. This is achieved by the fund owning and holding most of the underlying index constituents. The fund manager may elect to create a highly correlated portfolio that is more efficient and cost effective than a full replication model. ETFs are traded like a stock and the price tracks the underlying net asset value of the fund holdings.

Benefits:

- Low tracking error to the benchmark index;
- Simple investment structure doesn't require an investment management agreement; and
- Increasing and decreasing positions can be done through a broker.

Limitations:

- Management fees are higher than Institutional Index Pools. Fees also have a wide range from 9-70+ bps;
- Transition costs - Plans transitioning to an ETF should expect up to 100 per cent turn-over to transition the assets;
- Not available for all indexes.

[1]Today, more ETFs are being offered employing leverage or active strategies.