

In Transition

Topics In Transition Management

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Little more than one year since Lehman’s implosion, global capital markets have sizzled with risk-taking by investors once again apparently in vogue. As the year-to-date returns imply, the riskier the asset class the better. The market seems to have no doubts about the shape of the economic recovery: raise both arms for an emphatic “V”! Hard to believe and makes one wonder: isn’t this the kind of ebullience that got us into trouble in the first place?

As the third quarter drew to a close, most major indices had gone Rocky Balboa on us. For example, down for the count fewer than 200 days ago, the S&P 500® index has leapt from the canvas catapulting nearly 60% from its March 9th market bottom. Non-US stock markets, as measured by the MSCI World ex-US index, also rose dramatically across the period registering gains of more than 30% so far in 2009. Not to be outdone, Emerging Markets equities rocketed a breath-taking 9% for September, a jaw-dropping 21% for the quarter, and an eye-popping 65% year-to-date as measured by the MSCI Emerging Markets Index. A “decoupling” far different than one might ever have imagined.

The capital markets recovery has not been limited to equity. Indeed, credit markets also uncorked the champagne. In some circles there has been a stampede to investment-grade credit as an “equity substitute.” It seems there has been an even more frantic rush to non-investment grade debt with high yield bonds up almost 6% during September, close to 15% for the third quarter and a remarkable 49.0% year-to-date.¹

Our summary of factors contributing to transition costs, based on aggregate amount traded, as shown below:

Component Costs (in bps) of US Large Cap Equity Transitions

	30-Jun-09	30-Sep-09	Q/Q△	Directional
commissions*	6.85	5.93	-0.92	↓ decrease in component cost
bid/ask spreads**	7.02	5.64	-1.38	↓ decrease in component cost
volatility***	321	206	-115	↓ decrease in component cost

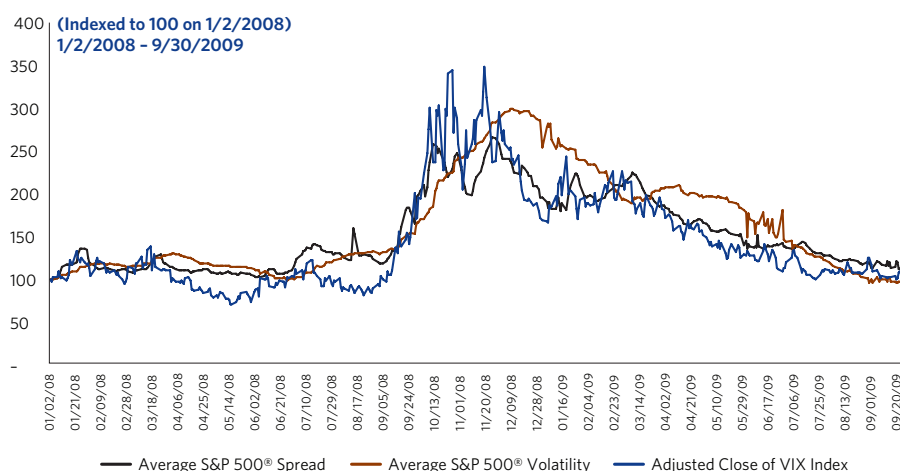
* Average commission in basis points for a U.S. large cap liquidation, based on S&P 500® constituents, at 2 cents per share commission

** Average daily spread of the S&P 500® constituents

*** Average daily volatility of the S&P 500® constituents

Source: ITG, 2009

Average Spread and Average Volatility of S&P 500® Constituents and VIX Index



Source: ITG, 2009

Forward looking volatility declined nearly linearly from the end of June to the end of September with the VIX® resting around 25 as the quarter drew to a close. Estimated transactions costs as modeled by our specialist team were down across the board as depicted in the following table.

¹ According to the Barclays Capital High Yield Index

Estimated Average Trading Costs (In BPS) For Various Global Benchmarks, as of September 2009

INDEX	COMMISSION	ESTIMATED BID/ASK SPREAD AND MARKET IMPACT	TAXES AND FEES	TOTAL TRANSACTION COSTS
MSCI ACWI ex US	7	19	9	35
MSCI EAFE	7	16	10	33
Emerging Markets	25	44	7	76
S&P 500®	6	8	0	14
Russell 2000	17	40	0	57
Russell 3000	8	12	0	20
Wilshire 5000	9	9	0	18
Barclays Aggregate	0	68	0	68

Hypothetical commission charges, for analytical purposes, are based on purchasing a \$100 million benchmark portfolio from cash. Any results presented based on simulated or hypothetical results have certain inherent limitations. Unlike actual results, any simulated or hypothetical results do not represent actual trading.

Taxes and fees vary depending on the specific equity securities being purchased.

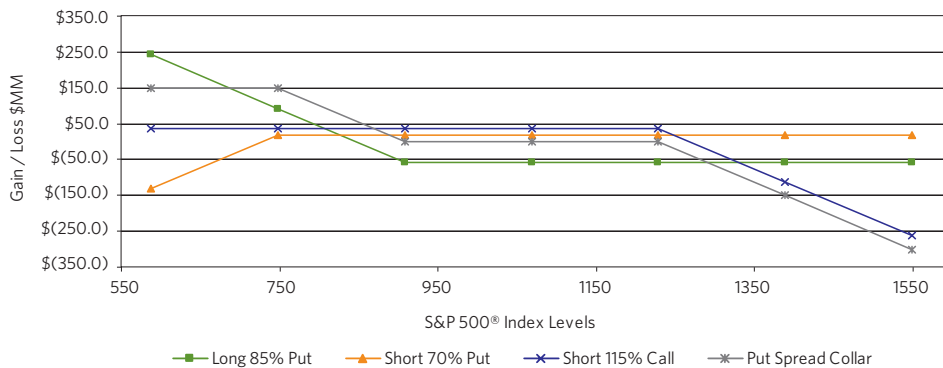
Estimated spreads and market impact figures are generally based on specific transition events performed in the second quarter.

Please see disclosures at right.

Source: MTM, 2009

Given the parabolic move in the six months since the end of the first quarter, even the most doctrinaire “long-termists” must be wondering out loud whether it wouldn’t be prudent to take some risk off the table. For those looking at insurance, some type of a portfolio collar may be worth considering. Consider the following hypothetical example:

Hypothetical Put Spread Collar (S&P 500®, 12/19/10 expiry)



Based on a \$250mm portfolio with the index at 1070.

Hypothetical illustration results have certain inherent limitations. Unlike actual results, any hypothetical results do not represent actual trading.

Source: BNY Mellon Beta Management, 2009

With deep out-of-the-money (OTM) puts still reasonably well bid because of their “crash insurance” properties and performance chasers buying upside calls, the “put/spread collar” which buys insurance and helps finance it with OTM puts and calls may be a sensible consideration.

In 2008, an investor with a 60/40 equity/bond asset allocation was down about 28%. As we head into the home stretch of 2009, that same investor with a static allocation would have recouped much all of last year’s losses. Underfunded plans may have no choice but to continue to sit at the casino, but for those with flexibility, protecting this year’s winnings may be of paramount importance as this remarkable year winds down.

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