

IN TRANSITION

Topics in Transition Management



Mellon Transition Management Services

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TIME TO TRANSITION: *Is There a "Right" Time to Transition Asset Portfolios?*

As the well-known adage goes, "timing is everything." That's no less true when it comes to asset transitions, but determining the "right" time to implement investment decisions has always been a daunting task. Because transition management is an approach to risk management typically offered over a very short-term horizon, implementation shortfall¹ numbers for given transitions are married to the specific market climate in which the transition takes place. If a given transition requires only a single trading session to complete, that does not grant the transition manager much time to allow an underperforming target portfolio to mean-revert. The movement of the market on the day selected for the transition can significantly color the transition results; in other words, timing does seem to matter.

Active managers, hedge funds, and traders may speculate on second-by-second fluctuations in asset prices, but long-term investors (most of the rest of us!) prefer to allocate capital across a diversified pool of investments and let compounding work its magic. Such patience has paid off handsomely in most markets across most decades. Nevertheless, for even the most patient investor, the temptation exists to try to time the market. The recent renewed focus on behavioral economics reminds us how powerful this inclination can be.

Like its cousin index management, transition management has, primarily due to its quantitative nature, evolved within a generally passive framework.



Transition managers, in fact, as short-term risk managers, may be considered in some respects even more passive than conventional indexers. This is because, unlike the index manager, most transition managers do not directly manage on-going investment strategies and many do not take positions in securities. Consequently, transition managers have generally been agnostic when it comes to questions surrounding the timing of a transition trade. If pressed, transition managers have implicitly embraced the oft-cited Brinson, Hood, Beebower principle² that the asset allocation decision is the critical decision that the investor makes. If this is so, then the obligation of the transition manager is simply to implement that decision as quickly and cost-effectively as possible.

This is a rather artificial framework when the investor in question is an asset owner with a formal investment decision making process like a defined benefit plan. For such investors, there may be a significant lag between when a pension consultant makes a recommendation, to when the board approves the change, to when the investment manager is selected, to the point where the mandate is ready to be funded. Unlike the rapid-fire manner of some hedge fund managers who may flip positions in seconds, many long horizon institutional investors may take months before they are ready to trade. At least one US public fund went so far as to designate "Tuesdays" as the day when it would take care of any necessary trading.

¹See *In Transition* Summer 2005 for more details on this methodology for calculating the investment performance of an asset transition.

²Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance," *Financial Analysts Journal*, July/August 1986

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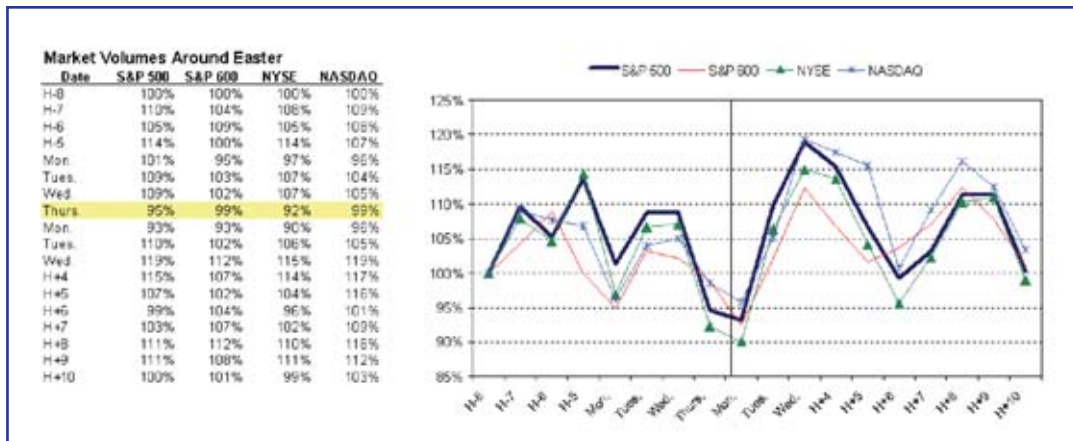
OPERATIONAL CONCERNS WITH GLOBAL TRANSITIONS

If pushed about timing, a transition manager with an investment affiliate that manages index accounts might suggest that a client wait until mid-month or month-end trading sessions in order to maximize the potential for explicit cost reducing crossing opportunities. However, as we described in “Cross-Examination,” the tracking error of most transitions is typically a multiple of explicit costs so delaying may generate opportunity risks that greatly offset any benefit that index crossing offers.³ For liquid markets with low commissions and narrow bid/ask spreads, the rationale of waiting until month-end to transition seems less compelling on a purely economic basis.⁴

A complex optimization problem lies at the heart of the question: “when is the right time to make a change in an asset portfolio?” This question may be framed in terms of the investor’s rebalance policy. Whether a short-term trader or long-term investor, a change should be made to a portfolio when the benefits of holding A exceed the benefits of B net of all implementation costs. This is notoriously difficult to gauge because it involves not only calculating transactions costs (a relatively mundane task) but also correctly forecasting numerous stochastic variables including future volatility and the investor’s utility function (a real knotty problem requiring advanced mathematics).

Given how complex a problem this type of cost-benefit analysis presents, the more efficacious question to ask may not be: “when is the right time to transition” but “when is the wrong time?” One way to answer this question empirically is through the observation of seasonal patterns in trading volumes. By identifying trading sessions when volumes are markedly weak, the transition manager can help counsel the client on transition periods to consider avoiding by pointing out the higher explicit costs associated with illiquid markets. Some of these observations may seem self-evident. On the afternoon before a market holiday, it seems reasonable to expect that more and more trading participants will be heading to the sidelines as the trading session goes on. But how can a client quantify this effect, and how long does it persist?

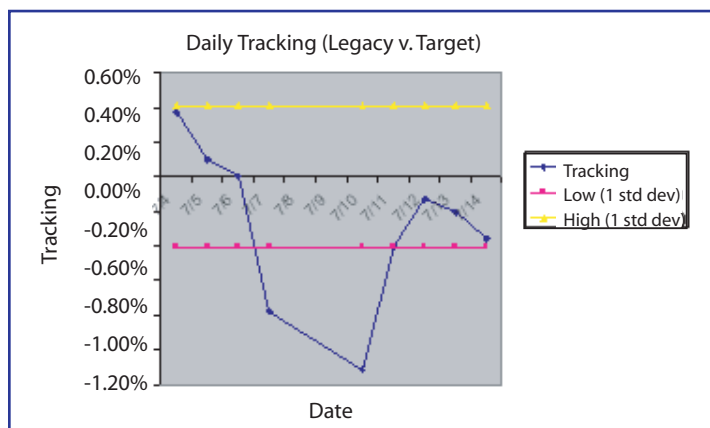
For example, consider the Easter/Passover period which varies from late March to mid-April. Good Friday is a New York Stock Exchange holiday. Even the casual investor can guess that many market participants will



Source: Lehman Brothers 2006

consider taking off on Holy Thursday (the day preceding the market holiday) as well. As expected, according to one study cited above, on average liquidity drops by 5% to 10% immediately prior to the holiday. This weakness persists through the trading session immediately following the holiday before mean-reverting for the remainder of the week. Interestingly, large capitalization stocks seem to suffer more from this trading vacuum than small capitalization stocks.

This effect can be seen in particular portfolios as spreads are observed to widen and market impact is felt more acutely in transitions taking place in the periods immediately preceding or following market holidays. Market volatility during such sessions may be particularly unpredictable as charted below for two transition portfolios examined this past July.



Source: MTMS 2006

In the above instance, realized tracking error between a target and legacy portfolio fluctuated wildly beyond ex-ante forecasts requiring the transition management team to make adjustments to the trading strategy.

³ See *In Transition* Spring 2006

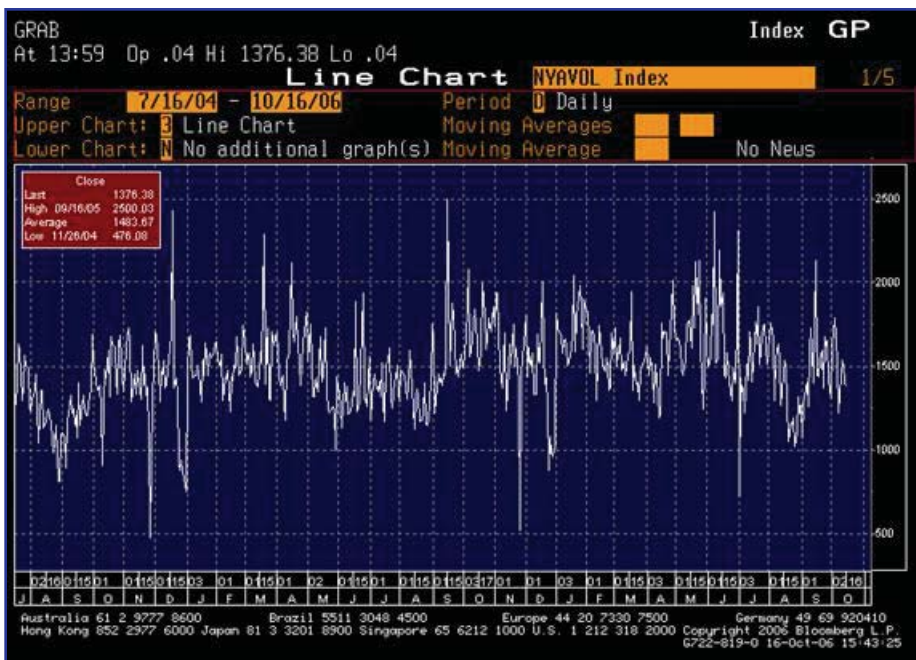
⁴ There often, however, are performance measurement advantages to striking a transition at the end of a month, quarter, or year. Clearly, the tasks of attribution and comparison are much easier when a discrete period of time exists to be measured.

The chart at right, shows recent 15 month volume in the US and tracks the ebbs and flows of market activity with distinct troughs occurring around holiday periods.

These issues are exacerbated by the end of year holiday schedule particularly in trading markets outside of North America, where markets may be closed for successive days leaving the investor only a narrow window within which to transact. (See the sample calendar below for an example).

Important to note, however, is that during the second half of December, it is often the character of trading volume that changes, not the actual number of shares traded. Calendar year-end idiosyncrasies like tax-loss trading mask the actual liquidity available. While volume numbers look deeper than one might anticipate given the number of holidays, many market participants seem to be trading for other than economic reasons which can cause individual securities to move rather erratically. The same effect is evident during quarterly expiration sessions (the “quadruple witching” effect⁵) or during index rebalance periods like the annual Russell reconstitution.⁶ During such trading sessions, market volumes may be unusually high, but liquidity may not necessarily be better as these events may cause securities or entire sectors to behave in unpredictable ways.

Of course, the potential pitfall of decisions based on historical observations is that the present does not perfectly replicate the past.



Source: Bloomberg, L.P. 2006

DECEMBER 2006

Sun	Mon	Tues	Wed	Thur	Fri	Sat
					1 Mexico	2
3	4 Sri Lanka	5 Thailand	6 Finland	7	8 Argentina Austria Chile Colombia Peru	9
10	11 Thailand Venezuela	12 Mexico	13	14	15	16 South Africa
17	18	19	20	21	22	23 Japan
24 Bulgaria Chile (E-H) Czech Republic Estonia	25 Argentina Australia Austria Bulgaria Brazil Canada Chile Colombia Croatia Czech Republic Egypt Estonia Greece Hong Kong Hungary India Indonesia Ireland Italy	26 Latvia Lithuania Luxembourg Malaysia Mauritius Mexico Peru Philippines Poland Singapore Slovak Republic South Africa South Korea Spain Sri Lanka Sweden Switzerland United States	27 Australia Austria Belgium Bulgaria Canada Croatia Czech Republic Estonia Finland Germany Greece Italy Latvia Lithuania Luxembourg New Zealand Norway Poland Portugal Slovak Republic South Africa Spain Sweden	28	29 Australia (H) Brazil Columbia Japan (E-H) South Korea (E)	30 Philippines
31				4	5	6

⁵ “Quadruple witching” refers to the quarterly expiration of both index and single stock futures and options and the resultant increase in often unpredictable trading flows driven by those looking to close out or adjust positions related to these expirations.

⁶ Russell rebalances its eponymous indices annually to adjust for changes in the marketplace. This reconstitution is generally accompanied by increased volumes (and often volatilities) for the companies that are being re-weighted in the indices as investment managers scramble to reposition their portfolios.

In an Uncertain Summer of Fed Policy, Trading Activity Heats Up

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So much for the summer doldrums when trading supposedly slows to anemic volumes. This year, uncertainty surrounding the outlook for interest-rate policy has led to a boom in trading volumes — in Treasury bonds and corporate-debt products — compared with previous summers.

While there are clearly no mechanical rules that investors can adopt when consider the timing of their next asset transition, the issue is worth examining. While there may not be a single “right” time to transition, there do seem to be particular periods on the calendar — particularly around market holidays — where transition managers should consider calibrating their analytical models to account for possible aberrations in market activity.

MTMS offers global transition management services designed to assist clients rebalance asset allocations, enter new investment strategies, or liquidate existing portfolios. Mellon has provided transition services to clients since 1983. Headquartered in San Francisco and with a global presence, MTMS offers a proven process designed to mitigate operational risks, lower transaction costs and reduce the administrative burden for client sponsors.

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