Bridging the Gap: ETF Solutions for Transition Management

**Issue**

To efficiently navigate portfolio transitions, institutional investors look for solutions that are liquid, transparent and flexible – three qualities often associated with exchange-traded funds (ETFs).

Transition management can help reduce the risks in portfolio transitions such as manager, benchmark and asset allocation changes. Investors can also use transition management to respond to large inflows or outflows, to adjust to a new investment objective, such as liability-driven investing, or to consolidate pension plans or investment portfolios in the wake of a merger or acquisition.

In such times of change, most institutions and their consultants look to maintain market exposure, while retaining a high degree of flexibility and liquidity to allow for redeployment of assets. Others simply elect to remain in cash. All typically seek to mitigate risk and control costs.

Explicit transaction costs resulting from transitions, such as commissions, are easy to quantify. Other costs, such as opportunity cost and market impact, are more difficult to measure but can nonetheless have a significant impact. A key issue for investors and transition managers is to efficiently gain interim market exposure to minimize opportunity cost, without sacrificing the flexibility required to gradually reinvest as opportunities arise or decisions are finalized.

According to a May 2012 Greenwich Associates survey of 80 institutional investors that currently use ETFs, 55% of institutional funds (i.e., corporate funds, public funds, foundations and endowments) and 61% of asset managers are using ETFs in manager transitions, making transitions the most popular application for ETFs among these users.
Education

Understanding transition management and implicit costs

In many cases, institutions hire a transition manager whose role is to help safely navigate between one investment or investment manager and another. For example, the transition manager can take over the assets from the investment manager being terminated, sell the securities that need to be sold and buy securities to build a portfolio based on the new manager’s selection. The transition manager then delivers the portfolio to the new investment manager, ending the transition management mandate. This process is most common for complex transitions involving multiple strategies or managers, or when an RFP (request for proposals) needs to be conducted during the interim period. In other instances, the new manager can assume certain transition duties directly. For example, at PIMCO we typically take delivery of a legacy portfolio at the client’s request; PIMCO then determines which securities, if any, can be transferred to the target portfolio and looks to efficiently liquidate the remaining securities and apply the proceeds to the new investments.

Transition managers, like all investment managers, must constantly balance the need to act swiftly – before prices move away from them – with the risk their own trading will have market impact, or an effect on prices.

Market impact typically results from large transactions, particularly those involving less liquid securities. To minimize market impact, transition managers often spread these trades over more than one day. In doing so, they may avoid allowing opportunistic traders to benefit from the information that large orders are being placed.

Opportunity costs can occur when prices move from their initial levels before the transition manager has had the opportunity to buy or sell. For example: on June 1, 2012, the yield on the 30-year U.S. Treasury bond declined by 12.2 basis points, corresponding to a 2.50% price increase, according to Bloomberg data. Assuming a transition manager waited until the close to purchase 30-year Treasuries, on that one day the opportunity cost would have been 2.50% of the value traded. Of course, “opportunity cost” can also move in the investor’s favor. The effect can be positive or negative. Hence, unlike commissions, opportunity cost is a risk rather than a direct cost; but like market impact, it can be an unintended consequence of portfolio transitions.

The T Standard, developed by Russell Investments in 2003 and updated in 2008 (T Standard 2.0), provides a practical framework to evaluate implementation shortfall, or the combination of market impact and opportunity costs. An outcome-oriented “portfolio performance metric” (Collie, 2009), the T Standard offers a methodology to assess the positive or negative impact of a transition, whereby the actual transition outcome is compared to a hypothetical, instantaneous and cost-free transition executed at closing prices prior to the start of transitional trading. By evaluating the transition outcome in a holistic manner rather than considering trading metrics alone, Collie contends that the T Standard treats transitions management as “full-fledged investment management, albeit a short-term version” rather than as a mere trading function.

Market impact and opportunity costs matter. In a 2006 article, “Implementation Shortfall: From Concept to Practice,” Kritzman, Myrgren and Page show these costs typically explain over 97% of a transition management outcome.

What can investors do when a new manager has not yet been identified?

For pension plans, endowments and other investors, the problem with opportunity cost is particularly acute when the decision to terminate a manager has taken place with urgency – for example, following personnel changes, rules violations or poor performance – or when a sudden shift in views results in a decision to invest in a new asset class. In these situations, if the investor has not yet identified a new manager, opportunity costs can be substantial.

To illustrate this point, Figure 1 shows the probability of 2%, 5% and 10% opportunity costs that arise from being invested in cash instead of a 60% stock/40% bond portfolio. For the 5% threshold, this probability increases from 11% at the end of one month to 44% at the end of six months. Unlike market impact and transaction costs, opportunity cost tends to increase with time and accordingly takes on greater significance over longer periods of time. While many transitions are short-term and last no more than a few days, medium-term transitions of one to six months are not uncommon, and can even last longer in the event of a protracted RFP process.
The risk of opportunity cost for assets with high risk premia – such as equities – is relatively well understood. But bonds also are subject to this risk. While investors sometimes lump cash and bonds into the same asset class, bonds have a different set of risk factors from cash, most notably duration and credit. Lack of exposure to these factors can cause significant opportunity costs – a risk that rises over time.

Over the course of a one- to six-month fixed income transition, it would be prudent not to ignore this risk because the probability of a positive return over such a period of time historically has been higher for fixed income than for equities. For example, when comparing three-month total returns for the Barclays U.S. Aggregate Index and the Standard and Poor’s 500 Index, rolled monthly from December 31, 1975 through September 30, 2012 (a total of 439 three-month periods), the historical probability of a positive return was 80.4% for the Barclay’s bond index vs. 69.2% for the S&P 500. Accordingly, the probability that an implementation shortfall from a lack of fixed income exposure would have resulted in a loss to the client was greater.

To illustrate this point, Figure 2 shows the probability of a 1% opportunity cost from being in cash instead of the Barclays U.S. Aggregate for periods ranging from one day to one year. For medium-term horizons of one to six months, this probability ranges between 34% and 55%.

Transitions to destinations known and unknown

The term “transition” is used generically, but when the time comes to evaluate solutions a further distinction can be made. Short-term transitions to a pre-selected manager or to a chosen investment can be measured in days while longer-term transitions requiring an RFP, board approval or other potentially lengthy steps can take weeks or months. For both, the explicit or known costs, consisting of fees and commissions from trading out of one asset class and into a new one, can be the same. However, in a short-term transition, explicit costs take on greater significance against the lesser return opportunity compared to a longer-term transition; conversely, implementation shortfalls can be more limited. For a longer-term transition, implementation shortfalls can be substantial, and therefore getting a close match to the desired exposure is paramount. In both cases, cost sensitivity must be weighed against the need for liquidity and flexibility.

Using ETFs to manage transition risk

Investors and their managers have a wide array of investment options when implementing a transition, including futures, swaps, commingled trust funds (CTFs), separate accounts and ETFs. Each has advantages and disadvantages. For instance, futures are a fairly popular choice when the desired exposure can be achieved in that manner, but outside of major benchmarks few contracts are available; in addition, operational aspects of futures investing – from account opening to margin requirements – can be cumbersome. Swaps also
are used for transitions; however, often, the length of the documentation process, as well as the counterparty risk, can cause concern. CTFs and ETFs offer more choices when it comes to obtaining targeted exposures, including actively managed strategies in some cases, which can make them more efficient tools. While CTFs are often a few basis points cheaper than comparable ETFs, this difference should be evaluated within the broader context of their respective flexibility and liquidity. ETFs have the advantages of tradability, transparency and intra-day pricing.

To reduce the risk of opportunity cost, investors who would otherwise be on the sidelines for weeks or months may consider using ETFs to gain interim exposure to desired segments of the market. As Greenwich Associates’ May 2012 survey showed, more than half of institutional ETF investors use them this way. Their goal is so-called cash “equitization” or “bondization” as a way to gain or maintain exposure to the target allocation. Put simply, during portfolio transitions, instead of just holding cash, institutions can invest in ETFs to gain market exposure and reduce potential opportunity costs. This solution may be particularly attractive when an institution has terminated an investment mandate but is still weeks or months away from selecting a replacement.

Figure 3 provides an illustration of the historical distribution of the returns of the Barclays U.S. Aggregate Bond Index in excess of cash returns over successive monthly periods. The magnitude and frequency of these return differences over time reinforces the fact that cash is not an adequate substitute for a core bond allocation and the need to carefully evaluate the risks associated with a deviation from the portfolio’s target allocation.

**A PIMCO Solution**

**The solution: an ETF bridge**

Certain key characteristics should make ETFs attractive tools for transition management.

**Tradability:**

ETFs trade on an exchange, providing real-time market prices, unlike most bonds which trade over the counter with more limited price transparency. Also, when trading ETFs, investors can use limit orders or stop-loss orders with the intent to mitigate execution risk.

**Transparency:**

The daily disclosure of portfolio holdings allows transition managers, investment officers and consultants to see the portfolio composition during the transition period and to run their own analyses.
Liquidity:
ETFs benefit from two sources of liquidity. In the secondary market, existing shares can be traded on the exchange, which can help reduce market impact in the securities held by the ETF. In the primary market, the creation/redemption process – which necessarily involves an Authorized Participant (AP) – provides a mechanism to adjust the supply of ETF shares based on current demand and offers additional liquidity, typically commensurate with the liquidity of the underlying securities. To further improve the implementation process, investors have several execution options: secondary market execution, in-kind creations/redemptions and, in some cases, cash creations/redemptions. Even for ETFs with low average daily volume (ADV), investors can often complete large trades representing multiples of ADV due to the available liquidity in the ETF’s underlying securities.

Creations and redemptions:
Investors looking to execute larger orders can work with an authorized participant (AP) to access the primary market for ETF shares via the creation or redemption process. The investment size must be a multiple of the size of the creation unit (typically 50,000 to 100,000 shares) and an AP must intermediate the transaction as APs are authorized to transact directly with the ETF.

In-kind creations and redemptions are more common than cash in the ETF marketplace. To facilitate an in-kind creation, the AP assembles the creation basket (an agreed-upon basket of securities underlying the ETF) and exchanges it for newly-created shares of the ETF. The reverse takes place for an in-kind redemption.

To provide additional flexibility, PIMCO and other ETF managers may facilitate cash creations and redemptions at a moderate transaction cost. This solution may be attractive when ETFs have a large number of holdings or underlying securities that are difficult to access without execution capabilities similar to PIMCO’s.

Small investment increments (typically one share):
When transacting in the secondary market as an alternative or a complement to a creation/redemption, small investment increments support dynamic and precise position adjustments. ETF shares are typically priced from $25 to $100, allowing an investor to gradually increase exposure as legacy securities are liquidated or gradually decrease exposure as target investments are identified and purchased.

Transaction costs:
While generally regarded as moderate, transaction costs typically make ETFs more suited to medium-term transitions (two to 12 months) than short-term transitions that span a few days. Potential investors should evaluate transaction costs in the context of the opportunity cost they are attempting to mitigate.

Initiating and exiting an ETF transition
Sourcing the desired securities when entering a new mandate – or disposing of legacy positions when terminating one – can be challenging. One benefit of utilizing ETFs in transition management is the option, for investors who meet size requirements, to exchange shares of the ETF for the portfolio of securities that comprise the creation and redemption basket.

Investors and their transition managers can create or redeem in-kind through an authorized participant to reduce transaction costs if the underlying portfolio of securities closely matches the portfolio they are transitioning from or to. For example, if an ETF's holdings and the target portfolio present a significant overlap, an in-kind redemption of the ETF may be an attractive solution for constructing the new target portfolio.

Once an institution selects a new manager, they can together decide which redemption type (in-kind or cash) would be preferable, depending on whether the new manager can utilize the underlying securities or would rather receive cash to invest.

Building blocks
1. Broad fixed income exposure
Given the breadth and complexity of fixed income markets, exposure to this asset class as a whole varies greatly in quality. Since the arrival of actively managed strategies on the ETF stage, investors seeking the
liquidity and transparency of ETFs during transitions can also look to benefit from the skills of experienced investment teams and the convenience of a listed, easily transferable format.

- **BOND** (PIMCO Total Return Exchange-Traded Fund) offers a unique approach to core fixed income, delivering the results of PIMCO’s time-tested investment process in the convenient ETF format. For institutions in need of a medium-term bridge to, or from, a core fixed income mandate, **BOND** should be considered to provide passage by combining a skilled total return approach with the intra-day pricing and transparency of an ETF.

2. Targeted fixed income exposure
At PIMCO, we typically view the world in terms of risk factors, as opposed to asset classes. Risk factor analysis provides a framework for investors seeking to optimally select ETFs in order to mimic the beta exposures of the target asset mix.

- **ZROZ** (PIMCO 25+ Year Zero Coupon U.S. Treasury Index Fund) should be considered as a solution for those investors looking to temporarily add ultra-long duration to their portfolio in efforts to better match their assets with their obligations in a liability-driven investing framework.

If no single ETF is a match, two or more ETFs can be combined when seeking to achieve the desired duration or credit mix.

- **CORP** (PIMCO Investment Grade Corporate Bond Index Fund) and **HYS** (PIMCO 0-5 Year High Yield Corporate Bond Index Fund) should be considered and can be paired in varying proportions to help attain the desired corporate credit blend.

An ETF-based transition solution takes advantage of the attractive liquidity profile of ETFs and the transparency of their holdings, and also offers the possibility of making dynamic adjustments when needed. As the range of fixed income ETFs continues to grow, so does the relevance of ETFs in various transition scenarios. In addition to institutional investors, financial advisors may find this solution useful in managing clients’ portfolios in times of change.

*Thanks to Sébastien Page, CFA for significant contributions to this article.*
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The value of most bond funds and fixed income securities are impacted by changes in interest rates. Bonds and bond funds with longer durations tend to be more sensitive and more volatile than securities with shorter durations; bond prices generally fall as interest rates rise.

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References:

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