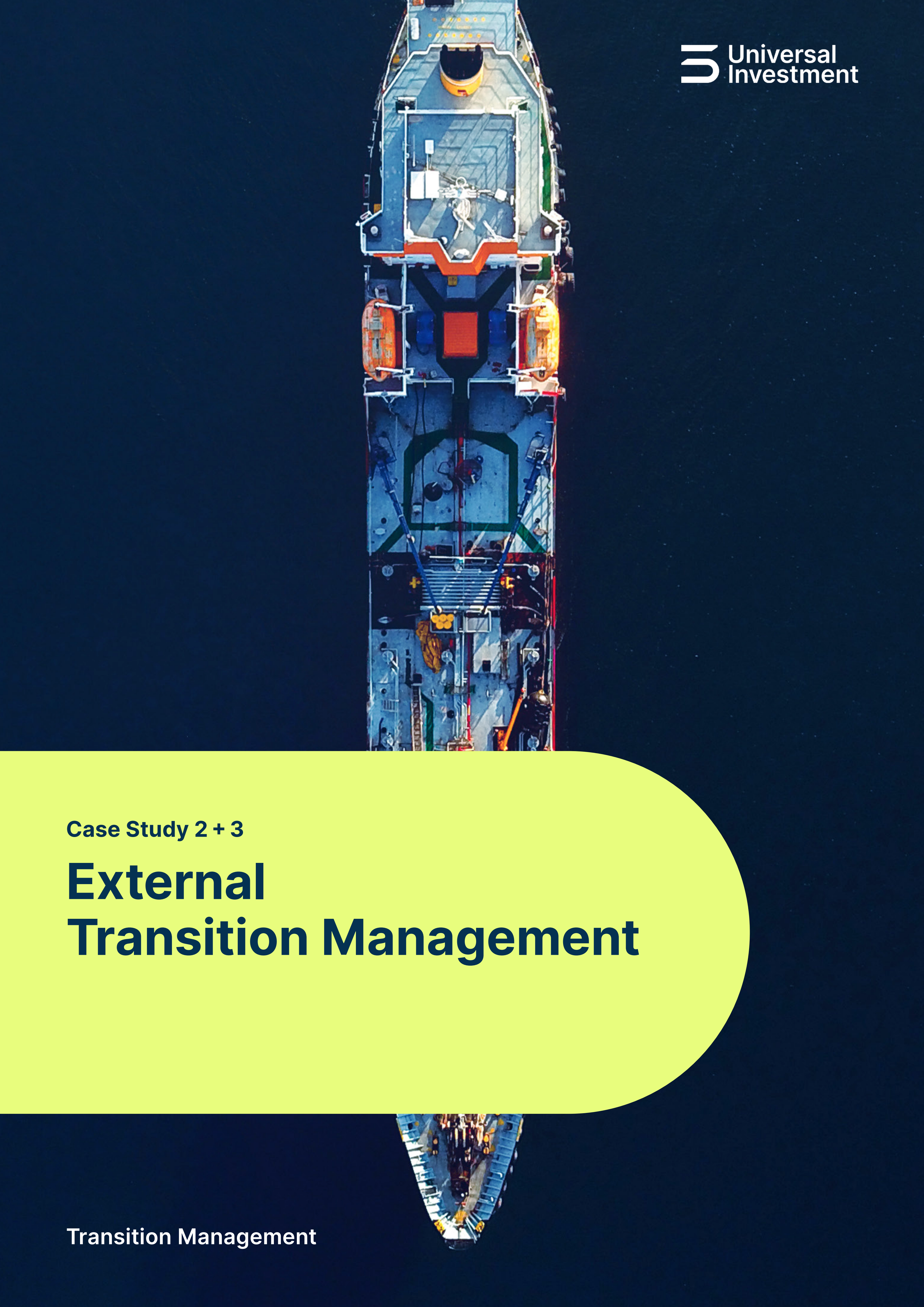


Universal Investment

Case Study 2 + 3

External Transition Management

Transition Management

Case Study 2

External Transition Management

Key elements of the transition

- US corporate portfolio (volume 500 million euros)
- Switch of asset manager
- Restructuring of the portfolio

Brief

The investor planned to restructure a US corporate portfolio to form a passive US equity portfolio. At first glance the transition appeared to be a straight-forward switch from bonds to equities with a simultaneous change of asset manager. A closer look, however, revealed complex structures with diverse risk factors that could impact both portfolios.

Key points identified in the pre-trade analysis

- US dollars: currency risk
- Sector risk in individual industries
- Corporate risks
- Liquidity
- Integration of overlay management

Calculations by the transition management team at the time showed that without transition management, a classical restructuring with an uncoordinated, simultaneous sale of bonds by Asset Manager A and building-up of equities by Asset Manager B would lead to a tracking error of 14.06 % p.a. or 3.7 million euros in the transition period. By using a transition manager during the transition, the tracking error was reduced to 2.79% p.a. or 0.8 million euros in the transition period. Trading of equities is more liquid than that of bonds. For this reason, the equity exposure was established right at the start of the transition using an S&P-500 future. Opportunity costs could therefore be greatly reduced. The duration risks of the bonds could furthermore be hedged using US interest rate futures.

What essentially remained was the credit risk of the bonds. The derivative exposure was reduced accordingly during the cash-neutral and optimal liquidity-based trading of the physical securities. The advantage of this approach was that trading could be spread over the day in order to keep market impact costs as low as possible. Risks were managed with derivatives and trading of the securities basket took sector and corporate risks into account. Trading in sectors that were under- or overvalued was given precedence. The risk profile of the target portfolio was thus quickly established.

Further advantages

- The use of transition management avoided converion of US-dollar cash into the fund currency euro (cross).
- The overlay manager was able to make adjustments in consultation with the transition manger. Therefore, there was no time lapse between trading and the regular adjustment period.

Result

The estimated trading costs were reduced. Total costs (the implementation shortfall) of the overall restructuring came to about 700,000 euros and thus corresponded almost exactly to the estimates for an optimised implementation with transition management. The use of transition management saved the investor approx. 3 million euros.

External Transition Management

Universal Investment

Key elements of the planned transition

- Restructuring of an existing passive equity portfolio
- Shift of the regional focus (from EuroStoxx to global equities/excl. Europe)
- No asset manager switch

Brief

An institutional investor is mainly invested in Europe and plans to reallocate a 200-million-euro segment of his master fund from a passively-managed EuroStoxx manadate to a passive global mandate excluding Europe. A switch of asset managers is not planned. The investor therefore has the choice of either carrying out the transition through the asset manager or involving a transition manager.

The advantage of using the asset manager would be that apart from changing investment guidelines, no further steps would be required. A performance break is often agreed for the restructuring phase. An asset manager usually trades using the benchmark closing prices of the relevant markets. This makes sense for the asset manager as liquidity is particularly high at this point because he/she is trading close to benchmark prices and thereby generating as low a tracking error as is possible.

However, this approach, carried out by an asset manager who is not incentivised during the transition phase, raises questions that can be identified and analysed by an objective transition manager. For example: How does the intraday risk profile look?

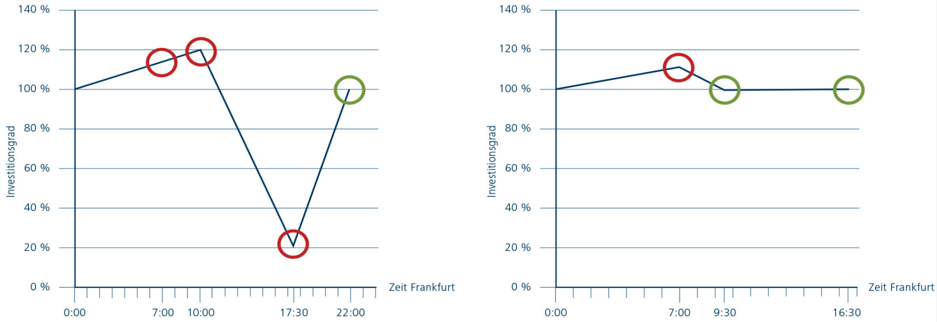
Different global trading times zones need to be taken into account:

- Asia-Pacific: Trading in Japan and Australia closes before European exchanges open, at about 7:00 and 6:00 (German time), respectively. Singapore and Hong Kong coincide with the opening until 10:00 and 9:00, respectively.
- Europe: Trading on the key European exchanges closes at 17:30.
- North America: The US and Canada trade until 22:00 German time.

The intraday profile of trades at closing prices (see Chart 1) is as follows: 120% over-investment after trading closes in Asia and Australia as the Asian-Pacific trade has been executed while the European equities have not yet been sold. By 17:30 the European equities have been sold and the fund is 20% invested. Stock bought in the US and Canada is traded at 22:00 and the fund is now invested at the 100% target. The trading was well executed from the point of view of benchmark pricing, but it carried substantial intraday risks given the volatility.

Abb 1:
Closing-Lösung führt zu Intraday-Risiken

Abb 2:
Transition Management optimiert Investionsquote



Transition management has the potential to reduce risks considerably by improving the intraday profile (see Chart 2) and guaranteeing consistent risk optimisation. Australia and Japan are also bought at the close of trading. This results in overinvestment of 110% at the opening of trade in Europe. 20% of European stock is sold after taking sector risks into account, while at the same time, buy orders are executed in the remaining Asian markets of Hong Kong and Singapore. About half an hour after the opening of trade in Europe, the fund is once again 100% invested. Parallel to this, transition managers keep an eye on possible risks to the remaining European equities in order to ensure the smallest possible risk deviation from the target portfolio. American stock is bought at the start of US trading, while the remaining European stock is sold in tandem. The fund is 100% invested throughout.

Result

Optimisation by the transition management ensures that there are only very slight fluctuations in the investment quota. The liquidity and risks involved in the stock traded are taken into account. Comprehensive transition management that has been planned well in advance substantially reduces risks and is vital to ensure a smooth and secure restructuring of both equity and bond-based portfolios.

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