Talking Transitions *with* Penserra

SERIES 1 | ARTICLE II

Beta Management within a Transition

In its simplest form, beta management helps a client maintain their desired asset class exposure temporarily and reduce the performance slippage relative to their overall asset allocation.

While there are several ways to implement a beta management strategy, the two common tactical approaches used by transition managers are derivatives based and non-derivatives based solutions.

▶ Derivatives Based Solution

Often times, a situation will arise where cash may be held for an unknown period of time. This is usually the result of an unplanned event, such as the immediate termination of a manager, the need for maintaining short-term liquidity needs, ongoing cash equitizations or timing constraints with their target investment managers during an asset allocation shift.

In such instances, by understanding the client's objectives including the desired interim benchmark and timing requirements, using an optimized basket of futures to synthetically obtain your market beta may be desirable. Compared to a non-derivatives based solution, this can be cost-effective and allow a client the flexibility of deploying the underlying cash at any time.

▶ Non-Derivatives Based Solution

For a client who already holds an existing portfolio but needs someone to temporarily manage it (also known as interim management) until a more permanent portfolio management solution is found, a transition manager can offer a solution based on some or all of the current legacy portfolio holdings. The thought behind this solution is to minimize the cost of moving into an eventual target while also managing risk relative to a benchmark. To create an interim solution, the legacy portfolio is evaluated versus the benchmark—the current tracking error is measured as well as the cost to fully transitioning from the current legacy portfolio into the benchmark. These two data points become the end points to form a range of possible solutions. One extreme is a zero-cost solution where the client bears the full risk of tracking error with the existing portfolio to the benchmark. The other end of the spectrum is a zero-risk solution of holding the benchmark but bearing all the trading costs associated with transitioning into that benchmark. With those end points, we would then create multiple solutions along that continuum allowing the client to choose the most appropriate combination of cost to trade and risk to the benchmark.

While there are several ways to implement a beta management strategy, the two more common tactical approaches used by transition managers are derivatives based and non-derivatives based solutions.

▶ Summary

In discussion with the client, the appropriate target portfolio solution is determined based on preferences in the trade-off between costs of trading and risk versus the the benchmark. The transition manager is able to create and hold that target portfolio for a negotiated period of time. Depending upon the duration of the mandate, reports are provided on a periodic basis evaluating the ongoing active risk relative to the benchmark allowing for a periodic rebalance of holdings to a target risk level. This solution allows a client the time to make decisions in terms of final disposition of assets while also preserving the cost savings of potential in-kinds in the event the physical assets are going to a target investment manager within the same asset class.

Turn to Penserra to deliver the investment, trading, and operational expertise you require for a seamless transition.

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