In Transition

Topics In Transition Management

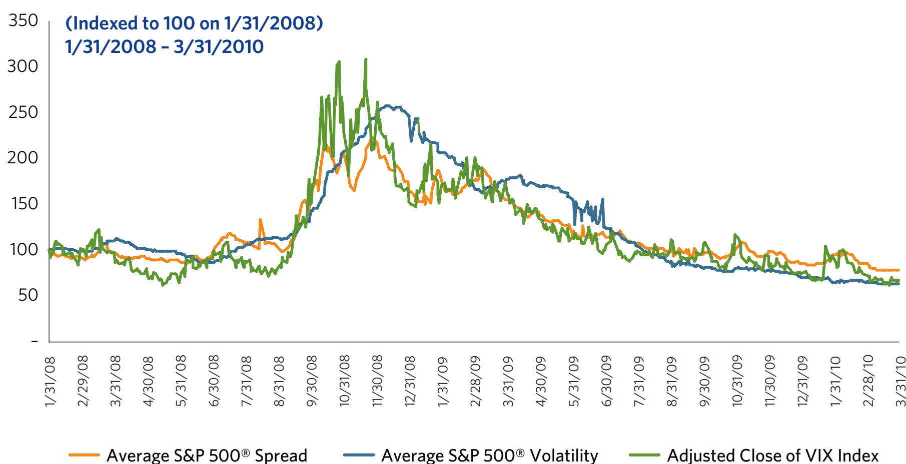
MELLON TRANSITION MANAGEMENT

Volume 21 – Spring 2010

With the close of the first quarter of 2010, the remarkable reinvigoration of investor risk appetite resumed. While few individual investors would admit to forgetting the near financial calamity of late 2008 and early 2009, capital markets in aggregate seem to have an acute case of amnesia.

For the 4th quarter in a row, broad asset class benchmarks rose, and for the 4th quarter in row, transactions costs for implementing investment decisions (as tracked by Mellon Transition Management) declined. The correlation between returns and implementation costs should come as no surprise. It has been widely observed that asset volatility peaks in times of crisis and ebbs as markets recover. Since volatility levels have both a direct and indirect impact on transactions costs, changes in volatility levels will tend to induce a corresponding directional change in transactions costs.[1] This can clearly be seen in the chart above where the average bid/offer spread and the average volatility of S&P 500® Index components have tended to undulate in conjunction with one another.

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



VIX is the Chicago Board Options Exchange Volatility Index

Data Source: ITG, 2010

Our summary of factors contributing to transition costs for Q1 2010 follows below:

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

	31-Dec-09	31-Mar-10	Q/Q△	Directional
commissions*	5.59	5.31	-0.28	↓ decrease in component cost
bid/ask spreads**	5.03	4.63	-0.4	↓ decrease in component cost
volatility***	179	162	-17	↓ 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

Data Source: MTM, 2010

1 For more on this phenomenon, turn to *In Transition, Volume I: "How to Evaluate Transition Management Proposals;" Spring 2005;* available upon request.

Estimated transactions costs as modeled by our specialist team were down across the board as depicted in the below table:

Estimated Average Trading Costs (in BPS) For Various Global Benchmarks, as of March 2010

INDEX	COMMISSION	ESTIMATED BID/ASK SPREAD AND MARKET IMPACT	TAXES AND FEES	TOTAL TRANSACTION COSTS
MSCI ACWI ex US	7	11	9	27
MSCI EAFE	7	8	10	25
Emerging Markets	25	31	7	63
S&P 500®	6	5	0	11
Russell 2000	14	20	0	34
Russell 3000	7	6	0	13
Wilshire 5000	9	7	0	16
Barclays Aggregate	0	30	0	30

Hypothetical commission charges shown above are for analytical purposes only, 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 the end of this publication.

Source: MTM, 2010

Forward looking volatility continued to moderate in the opening quarter of 2010 as the VIX® traded consistently in the mid-teens to low twenties. Cautious investors may remark that the current climate exhibits striking parallels to the pre-crisis calm.

Regular readers of this series will note that we generally reserve the latter section of this quarterly for more thematic analysis. The last couple of issues have focused on hedging ideas. As the calendar flips to Spring, our thoughts turn to rebirth. With the change in the seasons, we consider the recent rebirth of an idea originally credited to Dr. Edward Qian[2] – the so-called "Risk parity" paradigm. While it may be that this framework for investing never actually went away, early indications in 2010 suggest it is an idea so in vogue as to merit a reference in a front-page article claiming "Public Pension Funds Are Adding Risk to Raise Returns" featured in *The New York Times*.[3] In short, risk parity programs recognize that true diversification stems from diversifying risks and that this cannot simply be done by diversifying asset classes. As the risk parity research points out, in a 60/40 asset allocation, the 60% equity position accounts for roughly 95% of the total portfolio risk. Risk parity aims to correct this imbalance by, as the name would suggest, spreading allocations across asset classes in equivalent risk buckets. Because the resultant portfolio typically has a lower expected return, many risk parity approaches require an overlay program to lever the portfolio in order to potentially achieve a higher rate of return.

While many different variations of this framework exist, common to each version is the utilization of derivatives. For institutional investors considering employing this approach, integrating a beta manager into the traditional manager line up may be one of the first considerations.

2 First in "Risk Parity Portfolios: Efficient Portfolios through True Diversification." PanAgora Asset Management, September 2005 and more recently in "Risk Parity Portfolios: The Next Generation;" 2010.

3 Walsh, Mary Williams; "Public Pension Funds Are Adding Risk to Raise Returns;" *The New York Times*; March 8, 2010.

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