Interim portfolio management for fixed income portfolios

Interim portfolio management makes prompt manager changes possible while buying time for new manager selection. There are many different reasons why the investment case for a particular money manager can change: staff departures, significant organizational shifts, whiffs of impropriety, or simply because of a change in the investor's investment policy. Whatever the reason, plan sponsors need to be prepared to change their manager lineup on short notice.

However, what if the search for a replacement manager is still in progress? Liquidating the legacy mandate before the new manager is engaged can be expensive and results in unwanted cash exposure. Quickly changing your investment managers is not always possible. Additionally, your own governance process can delay your terminate or hire decisions, thereby increasing opportunity costs.

One way to manage the risk in this scenario is through interim portfolio management. Of particular interest to fixed income investors, interim portfolio management makes rapid asset redeployment possible while maintaining desired market exposures. This note provides an overview on how it is done.

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An interim portfolio manager who maintains the desired exposure at the lowest cost, can significantly mitigate the impact of a transition portfolio value.

Interim portfolio management fixed income strategies

Maintain benchmark exposure. Minimize risks. Minimize transaction costs. These standards of fiduciary care can be a challenge to adhere to when pressed to exit a manager relationship quickly. This is especially true in the fixed income markets, where a specialized portfolio may take months to trade.

An interim portfolio manager can help the plan by assuming responsibility for the portfolio's exposure and performance upon manager termination. Trading strategies and risk management techniques exercised throughout the assignment can significantly reduce the toll the transition might have on portfolio value.

Interim portfolio management fees are typically lower than active management fees. These savings are immediate. Identification of an appropriate benchmark, and trading in physicals and derivatives to match the benchmark duration, has at times lead to a performance boost. Use of futures can often lower transaction costs over physicals, and use of swaps may lower the tracking error to the benchmark.

Practical applications of interim strategies

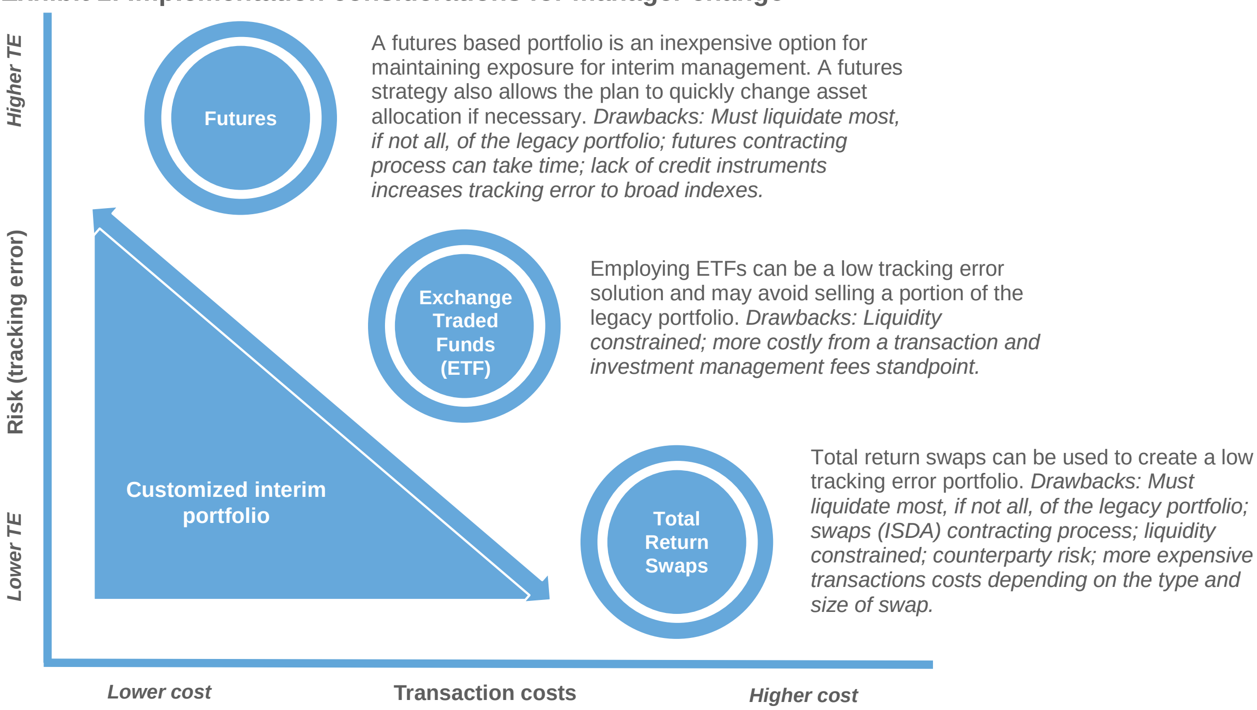
Scenario: The investment committee and staff have made the decision to terminate a fixed income manager. There is no replacement manager identified at the time of the decision. What are their options regarding transition and interim portfolio management of the assets during this period of change?

The following are considerations in this scenario:

- Liquidate the assets in the legacy portfolio and overlay the liquidation proceeds with futures.
- Liquidate the assets in the legacy portfolio and overlay the liquidation proceeds with swaps.
- Transition the assets into an ETF product.
- Optimize the existing legacy portfolio to reduce tracking error for an interim period

In reality, there is no single "best" interim management solution for all events. When the need for a transition hits, the plan sponsor's goals and constraints are all factors in determining the best course. Aligning the needs of the plan with the options available will produce the most successful result.

Exhibit 1: Implementation considerations for manager change



Customized interim portfolio strategies create a portfolio using the legacy assets, balancing reduced risk with low transaction costs to meet portfolio risk objectives for an interim period. *Drawbacks: Most interim portfolios retain some of the legacy portfolio risk characteristics.*

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