Trading, Monitoring, and Rebalancing

Because the investment process is not complete until securities are bought or sold, the quality of trade execution is an important determinant of investment results. The methods by which managers and traders interact with markets, choose appropriate trading strategies and tactics, and measure success in execution are key topics in the first reading.

The second reading discusses the ongoing monitoring and rebalancing of the investment portfolio, which are integral parts of the portfolio management process. Portfolio managers must understand the reasons for monitoring portfolios and be able to formulate appropriate portfolio rebalancing policies.

READING ASSIGNMENTS

Reading 29	Execution of Portfolio Decisions by Ananth Madhavan, PhD, Jack L. Treynor, MBA, and Wayne H. Wagner
Reading 30	Monitoring and Rebalancing by Robert D. Arnott, Terence E. Burns, CFA, Lisa Plaxco, CFA, and Philip Moore

LEARNING OUTCOMES

READING 29. EXECUTION OF PORTFOLIO DECISIONS

The candidate should be able to:

a compare market orders with limit orders, including the price and execution uncertainty of each;

b calculate and interpret the effective spread of a market order and contrast it to the quoted bid–ask spread as a measure of trading cost;

c compare alternative market structures and their relative advantages;

d compare the roles of brokers and dealers;

e explain the criteria of market quality and evaluate the quality of a market when given a description of its characteristics;

f explain the components of execution costs, including explicit and implicit costs, and evaluate a trade in terms of these costs;

g calculate and discuss implementation shortfall as a measure of transaction costs;

h contrast volume weighted average price (VWAP) and implementation shortfall as measures of transaction costs;

i explain the use of econometric methods in pretrade analysis to estimate implicit transaction costs;

j discuss the major types of traders, based on their motivation to trade, time versus price preferences, and preferred order types;

k describe the suitable uses of major trading tactics, evaluate their relative costs, advantages, and weaknesses, and recommend a trading tactic when given a description of the investor's motivation to trade, the size of the trade, and key market characteristics;

l explain the motivation for algorithmic trading and discuss the basic classes of algorithmic trading strategies;

m discuss the factors that typically determine the selection of a specific algorithmic trading strategy, including order size, average daily trading volume, bid–ask spread, and the urgency of the order;

n explain the meaning and criteria of best execution;

o evaluate a firm's investment and trading procedures, including processes, disclosures, and record keeping, with respect to best execution;

p discuss the role of ethics in trading.

READING 30. MONITORING AND REBALANCING

The candidate should be able to:

a discuss a fiduciary's responsibilities in monitoring an investment portfolio;

b discuss the monitoring of investor circumstances, market/economic conditions, and portfolio holdings and explain the effects that changes in each of these areas can have on the investor's portfolio;

c recommend and justify revisions to an investor's investment policy statement and strategic asset allocation, given a change in investor circumstances;

d discuss the benefits and costs of rebalancing a portfolio to the investor's strategic asset allocation;

e contrast calendar rebalancing to percentage-of-portfolio rebalancing;

f discuss the key determinants of the optimal corridor width of an asset class in a percentage-of-portfolio rebalancing program;

g compare the benefits of rebalancing an asset class to its target portfolio weight versus rebalancing the asset class to stay within its allowed range;

h explain the performance consequences in up, down, and flat markets of 1) rebalancing to a constant mix of equities and bills, 2) buying and holding equities, and 3) constant proportion portfolio insurance (CPPI);

i distinguish among linear, concave, and convex rebalancing strategies;

j judge the appropriateness of constant mix, buy-and-hold, and CPPI rebalancing strategies when given an investor's risk tolerance and asset return expectations.