In economics and finance, one of the key debates is how to deal with risk. Business schools teach students that risk should be minimized, or possibly, avoided.

For two millennia, risk minimization has also been a key ingredient in the evolution of business. Historically, a critical point occurred when the concept of a “corporation” came into existence. This allowed entrepreneurs, inventors and capital providers to come together for risky ventures. Prior to this, risk-taking was mainly done by sovereign nations who replenished their coffers through taxation or by aristocratic landlords.

Backed by the protection that limited liability offered, and despite high failure rates for new ventures, innovation thrived and created a myriad of products and services. Today, vivid examples of successful risk-taking come from firms like Apple, Google and Research In Motion.

What drives innovation is competition and the profit motive. And most industries, including the financial services industry, are forever engaged in this activity. Financial services, encompassing banking, insurance, brokerage and asset management, have seen tremendous innovation during the past 35 years. Much of this was focused on helping transfer risk via securitization or derivative products. Experts say that without these products, globalization and world trade could not exist at their current levels.

Nonetheless, the positive benefits of these innovations are being widely denounced. Bankers in general and Wall Street in particular have become convenient scapegoats for the post-crisis weak economy. In truth, (con't pg. 2)

**Trust—Have We Reached a Crossroad?**

By George M. Klar — President, Alternativ Solution Inc.

A transition is defined as a unique or rare trading event whereby a large value of marketable assets, usually spanning multiple securities, must be sold and/or purchased within a very short time period. Due to the nature of such a rapid transaction, there is a significant risk of implicit, although sometimes hard to quantify, market impact costs. Furthermore, there are also explicit costs, such as commissions, that accrue during the transition’s execution.

To reduce both implicit and explicit costs, many institutions employ specialist transition managers to handle trade execution. These managers not only focus on minimizing implementation inefficiencies, they evaluate the risks associated with any transition. Also, as transition management has expanded to multiple asset classes, transition managers can execute increasingly sophisticated portfolios if they have the expertise to find required liquidity sources and to navigate specific market complexities which can cause delays.

A typical transition may require trading the bulk of the portfolio near the market open and within a very limited timeframe. This can achieve the goal limiting market exposure and minimize implementation shortfall costs. Recall, the real objective of each transition is to mitigate risks and costs rather than simply trying to time the markets. Beyond market impact costs, the manager also works to limit explicit costs; commissions and bid-ask spread. (con't pg. 2)
Wall Street seriously tarnished its image by paying bonuses after receiving government bailouts.

However, the reality is bankers didn’t cause the crisis, at least not alone. We should include a cadre of players including regulators, rating agencies, accounting firms, central banks and elected officials. Let’s also blame self-delusion (housing prices only go up), seeking higher yields as interest rates declined, insufficient due diligence by sophisticated investors and simplistic risk models which assumed recent events were good predictors of the future. Add to this list mark-to-market accounting, which was designed to increase transparency and lower systemic risk. It inadvertently fuelled problems by forcing rapid decisions while the financial industry’s solvency deteriorated. Some of those decisions backfired (Lehman).

This brings me back to innovation, risk and economics. Philosophically, a big question today is….who do you trust? Is it the “corporate entity” with its selfish, self-centered, profit motivation…. or government with its long-term focus and its objective of social stability through regulation.

If you selected the “corporation”, you are effectively embracing unpre-
dictable innovation. This is Adam Smith’s world where competition and the invisible hand constantly guide the economy towards equilibrium. It means that you embrace change, or as economist Joseph Schumpeter put it “creative destruction.”

If you selected “government”, you are choosing a centrally managed system where stability is the top priority. But governments don’t innovate (there is no incentive for that). Instead, they create regulations. Those can lead to problems if they are poorly conceived. Success in government hinges on adopting wise policies. That’s hard to achieve in democracies where leaders gain their position by popularity contests or when compromise is the only way they retain their power.

In my view, the tremendous volatility we are seeing today in some parts of the capital market is caused by a tug-of-war between two philosophical forces and how each side views risk. One side favours a free market with minimal government involvement. The other side feels government intervention using Keynesian or Monetarist policies is warranted to achieve an objective.

For much of the 20th century, the Keynesian view dominated and viewed fiscal stimulus via borrowing as appropriate to prevent a slowdown. Alternatively, control of the money supply could achieve a similar goal. Currently, the capital markets are sceptical of both. Ultimately, society must pay for any stimulus measure regardless of how it is introduced. Recently, sovereign debt risk has escalated significantly in some areas.

Governments are not always wise or just, but neither are corporations! And to some extent, the financial crisis has caused many to question the role and behaviour of each side.

Are investors becoming disillusioned with both? In my view — yes. Prolonged use of fiscal (and monetary) tools explain why capital market volatility is oscillating so wildly. Concern is emerging as to whether global stimulus can permanently renew growth and innovation.

Philosophically, we’re at a crossroad; innovation versus intervention. Finding the right balance will determine our economic vitality going forward. So….who do you trust?

Is Transition Management Important? (continued)

In the 1980s, technological advances led to the ability to trade baskets of equities. Use of transition management grew as the value of assets in pooled funds increased and the need arose to efficiently trade a wider array of securities. Global custodians entered the transition management business in the 1990s, mainly to accommodate their customers. Custodial banks used their inherent ability to leverage their large volume of internal trade flow to “cross” transition customers’ assets whenever possible. This minimized both implicit and explicit trading costs and gave the larger custodial banks a distinct competitive advantage.

A key component of any transition management program is the quantification of the transition’s costs and best execution monitoring by both the transition manager and by an independent consultant that deals with such analysis. Poorly handled transitions have high implicit and/or explicit costs. Even worse, slippage is both permanent and non-recoverable. Often, these can range from a low value to double-digit basis points.

Since the explicit cost savings generated in a well-orchestrated transition can be more than lost to high market impact costs, new pre-transition analytical tools are available to sophisticated pension plans, endowments and other users of transition management services. These tools allow an independent assessment, prior to execution, of the potential market impact costs. More importantly, it allows the transition manager and their clients to discuss potential trading challenges before any action takes place. Using the new analytical tools gives each side the ability to discuss strategies on how to execute particularly complex trades. In so doing, plan sponsors discharge their fiduciary duty better and sleep well in the knowledge that professionals have reviewed, assessed and worked in concert with the sponsor to keep all key costs under control.