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Viewpoints

Overlay Strategies

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Overlay strategies represent another tool in the toolkit for institutional investors that may allow them to more efficiently meet their objectives. In broad terms, overlay strategies are carried out separately from the underlying portfolio assets and are constructed to target asset allocation exposures or risk characteristics, or to express tactical views. Whereas most investment managers are measured against their alpha generation, overlay managers are primarily measured against their ability to mitigate risks and efficiently execute their mandate.

Introduction

Overlay managers ("OM") are engaged to provide a variety of derivatives-based investment strategies. Overlays are implemented through purchasing futures or other derivative instruments so that the net characteristics of the underlying assets and the overlays deliver the desired level of risk mitigation and optimization. When an overlay is added to an investment portfolio, the overlay may effectively represent the addition of economic leverage and, in most cases, the total notional portfolio market value will be larger than the underlying portfolio.

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Over the past decade there has been a proliferation of overlay products, and overlay managers are increasingly adept at crafting custom overlay strategies to meet client needs. Our research note offers a brief overview of some of the most common overlay strategies, their benefits, and considerations.

#1. Cash securitization

Cash securitization is an attractive option for institutional investors that prefer to keep capital invested at all times. Most investors keep some level of cash in the portfolio for operational purposes, such as paying benefits and expenses, or meeting private market capital calls. However, in a low rate environment, cash acts as a drag on performance due to the low return nature of the asset class. Cash securitization is the process by which an overlay manager utilizes the cash exposure to stay invested in financial markets through the use of derivatives. For example, an investor may purchase S&P 500 futures to "equitize" the cash portion of their portfolio.

A cash securitization overlay program can be focused on an individual asset class (e.g., equities) or broadly implemented across the entire portfolio. The latter approach requires the OM to have visibility across the investor's cash holdings and cash flow needs. The OM can then use this cash as collateral to purchase futures contracts on liquid indices while being mindful of the timing of plan operation needs. The contracts used are typically long positions in equity and Treasury futures. This eliminates the "cash drag" on performance and keeps the investor fully invested, reducing tracking error versus a policy benchmark.

A risk to the cash securitization strategy occurs when the synthetic asset performs poorly. The cash earmarked as collateral will be used to settle the derivatives contracts, thus creating a need for additional cash. This may result in the need to liquidate physical assets (e.g., stocks or bonds) at adverse prices in order to meet short-term operational obligations.

#2. Exposure maintenance and policy rebalancing

An institutional investor may implement an exposure maintenance overlay to ensure asset classes remain within predetermined ranges. This type of strategy is appealing for the following reasons:

A. **Delegation of asset allocation maintenance** – Ensuring every asset allocation remains within target ranges can be a time consuming and unpredictable exercise. A portfolio can go years without requiring a rebalance trade or, during periods of volatility, can require several trades in a matter of days. Putting an exposure maintenance overlay in place will delegate the monitoring and trade execution to the OM and thereby ensure that the portfolio will maintain its desired target asset allocation exposures.

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B. Efficient transactions – Effective rebalancing often comes down to timing. Executing rebalancing in physical markets may not always be the most efficient approach. The time it takes between recognizing a market dislocation and settling the physical assets can stretch over days or weeks, depending on notification and settlement schedules, potentially missing a window of opportunity. In most cases, the OM will recognize the dislocation at the market close and have the corresponding synthetic investment in place immediately.

C. Cost effective transactions – During periods of extreme market stress (e.g., March 2020), bid-ask spreads for normally liquid assets can widen substantially. An overlay manager can execute the transaction to achieve the desired market exposure using derivatives at a much lower transaction cost, including market impact costs for larger investors. In these instances, it can be beneficial to have a second option for accessing markets and achieving liquidity.

Investors will want to weigh the advantages of an exposure maintenance strategy against the costs of implementation and maintenance of the program. During periods of low volatility, transacting in the physical markets are typically more effective than absorbing the cost of a derivative exposure maintenance program. In addition, while certain responsibilities are delegated to the OM, the investor and their service providers will continue to be responsible for communicating operations with the OM (e.g., when to replace synthetic exposure with physical assets). Derivatives provide exposure with pledged collateral that are marked to market on a daily basis, where losses entail greater administrative complexities that may prove unpalatable. As such, communication of these risks – before and ongoing – are extremely important to a successful program.

#3. Transition management

Transition management is the process by which one portfolio (with a specified mandate) transitions to another portfolio (with the same or different mandate). Even where the mandate remains the same, the investment manager responsible for the new portfolio's mandate may not want to inherit or be responsible for adjusting the securities in the legacy portfolio. Depending on the timing, liquidity, and depth of the asset market, transitioning assets from one manager to another can incur additional trading costs and delays.

The outmoded model for handling this type of transition was to instruct the legacy manager to sell all the securities and give the new manager the resulting cash to invest. The main shortcomings of this method are that costs (commissions, opportunity costs, trade execution) may be high, as a firm with no incentive to maximize receipts is responsible for executing the trades, and the investor may be left underexposed to the market during the transition period.

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Using a third-party transition manager ("TM") can reduce or eliminate these costs. For example, the TM typically transfers as many assets "in-kind" as possible. Assets in the legacy portfolio, which are needed by the new manager, can be transferred directly to the new portfolio. Because they are not traded on the open market, commission costs are eliminated. Further, the TM seeks to maintain market exposure throughout the transition, often via the use of derivatives, thus ensuring that opportunity costs are minimized. Finally, a TM is measured on their performance and, therefore, is more likely to search for the best execution. Given that the TM usually has substantial capabilities in a wide array of derivatives markets, achieving the desired market exposure(s) during a transition should prove highly feasible and cost effective.

Any institutional investor should consider utilizing transition management expertise. The benefit of this engagement will depend on the size of the transaction and the type of assets being transitioned. For example, a transition of $50m in highly liquid assets will not benefit from using a TM nearly as much as transitions of larger, less liquid portfolios.

#4. Currency exposure

Investing in foreign assets can improve the diversification profile of US investors, but this comes at the expense of introducing currency risk to a portfolio. Given that currency returns are volatile and difficult to predict, many investors consider implementing currency-hedging programs to reduce or eliminate the volatility that results from foreign currency exposures.

A currency overlay program is meant to synthetically offset the currency risk present with a globally diversified portfolio. An OM can build a currency overlay program for a particular investment, an asset class, or the entire portfolio's currency exposure. Within the program, the OM will use currency futures or forwards to hedge currency risk so that losses in terms of the home currency (e.g., US Dollar) are minimized. A currency overlay program can be active or passive (i.e., rules-based).

While the promise of reducing currency volatility may sound attractive, currency overlays have several disadvantages. The most obvious disadvantage is that some currencies, particularly those for many emerging markets, are typically quite expensive to hedge (the interest rate differential between the US and the country in question is the key determinant of hedging costs). Hence investors may have to be selective in choosing which currencies they wish to hedge.

There are also administrative and governance challenges that deserve mention. Since currency hedging programs may incur losses beyond the investment losses of the portfolio, the decision to hedge currencies could prove difficult to justify in periods of underperformance. The additional administrative burden of maintaining a currency overlay may also be a consideration as frequent rebalancing and data sharing with the OM is required.

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#5. Portable alpha

Portable alpha is an investment strategy where investors combine an independent source of manager skill ("alpha") with an underlying asset class investment ("beta"). By combining two uncorrelated return streams and utilizing a wider opportunity set for alpha generation, portable alpha represents an efficient approach to adding excess return. Practically speaking, investors may also view it as a way to add leverage to their portfolio.

Investors access the beta though derivatives, most often futures contracts, but potentially also via swaps. Hence, portable alpha can be implemented within any asset class with an established derivatives market, such as high quality bonds or public equities.

To gain beta exposure greater than the cash invested, investors pay a financing cost which is typically tied to a short-term interest rate. The excess funds can then be invested in an independent alpha strategy, resulting in a combined exposure greater than the initial investment. The combined portfolio should generate returns in excess of the beta component as long as the alpha source produces returns which are greater than the cost of financing the beta exposure (and any other fees incurred).

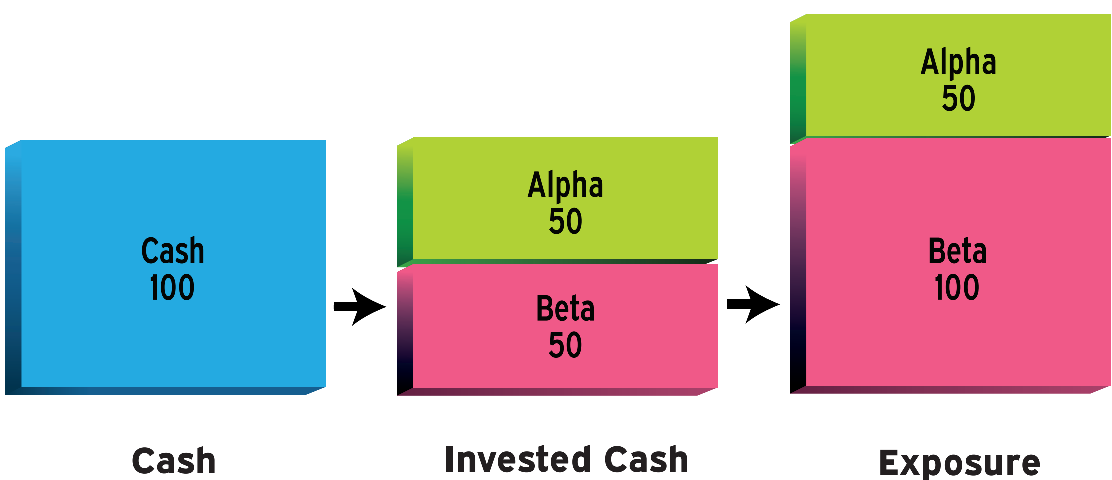

FIGURE 1

Implementation Example

The operational aspect of managing the market exposure (beta) is complex. The process of "rolling" futures contracts or executing a swap requires sophisticated investment and legal review. Investors may employ the services of an OM to manage all of the complexities that are inherent in the strategy.

The strategy, however, does not come without its challenges. These include increased risk, costs and complexity, the potential misuse of leverage, and understanding the nature of the strategy. In addition, sourcing positive and durable alpha is often expensive, difficult to acquire, and challenging to identify.

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#6. LDI interest rate hedge management

Beyond the scope of portfolio construction, overlays can also be used to harmonize a portfolio's liability-driven investment strategy with the variable discounted liabilities of corporate retirement plans. When the interest rate Hedge Ratio ("HR")[1] is 100%, assets and liabilities will move in tandem, in theory, with interest rate changes. Alternatively, when the HR is 0%, liabilities and assets move independently. An investor's desired HR is heavily dependent on their approach to interest rate risk management.

[1] In general terms, the HR equals the funded ratio multiplied by the duration of assets divided by the duration of liabilities.

In many cases, a pension plan can achieve a specific HR target by using physical fixed income instruments. However, there are benefits to using an overlay manager. Specifically, 1) a portfolio may not be able to achieve its long-term return objectives with a large allocation to (long-duration) fixed income; and 2) the physical fixed income duration profile might be significantly different than the duration profile of the liability.

The figure below illustrates, the potential mismatch of assets and liabilities in a hypothetical 60/40 portfolio with an expected long-term return assumption ("EROA") of 6.0%.

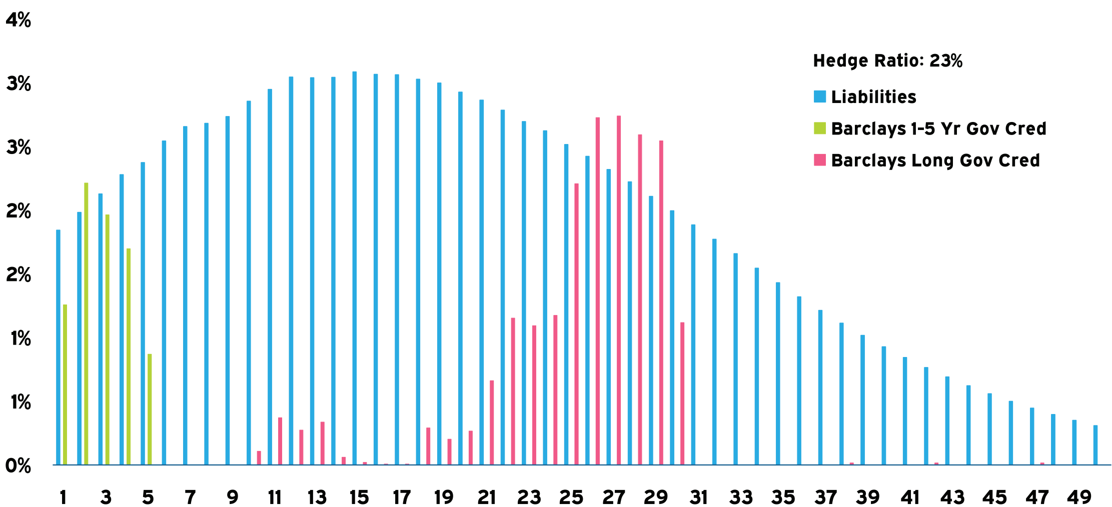

FIGURE 2

Comparison of Benefit Profile to Asset Allocation

Source: Meketa Sample Benefit Profile, Bloomberg.

If the investor would like to hedge 100% of the interest rate risk, they could transition all of their assets to a long-duration fixed income portfolio. Unfortunately, there are two drawbacks of this move: the EROA would drop from 6.0% to 2.5%, and the shape of the expected cash flows from the assets are not the same as the liabilities and, in fact, are even worse.

By implementing an interest-rate overlay, the investor can achieve their interest rate hedging goal, improve the potential to meet their return goal, and better align the interest rate exposure along the yield curve by purchasing futures at specific maturities.

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Considerations for implementing an overlay strategy

Each investor has a unique administrative and asset allocation structure. Therefore, the decision to implement an overlay strategy will also have unique considerations.

There are variety of considerations that warrant additional attention in the cost-benefit analysis of desirability of overlays. For example, there are implementation costs of carry, which may incur losses in normal markets. The introduction of leverage can also exacerbate losses or transpose cross-asset characteristics (e.g., equitizing cash will impart equity-like volatility to a cash allocation). There are also implicit costs, such as time. An overlay strategy may increase the required frequency and scope of communication between portfolio fiduciaries, portfolio service providers, and overlay managers.

Overlay strategies typically charge a management fee based on the notional exposure. In some cases, a minimum fee may apply. Careful consideration of all costs should be evaluated prior to any OM engagement. In addition to financing costs, there are two primary trading costs investors should consider:

- → **Implicit trading costs:** This includes bid/offer spreads that differ by strategy. For example, broad-based exposures, such as S&P500 futures or Treasury futures, have very narrow spreads.
- → **Explicit trading costs:** These include commissions for futures contracts and typically cover exchange, execution and clearing fees. Standardized pre-negotiated futures agreements by the OM keep these costs de-minimus (less than one basis point).

Summary

Investors may find that some portfolio inefficiencies are best addressed through overlay managers. Overlay strategies can be constructed to target asset allocation exposures or risk characteristics, to express tactical views, or to achieve specific interest rate exposures. Overlay managers are increasingly willing and able to customize overlay solutions to meet specific investors' needs.

While overlays can offer portfolio solutions, they are administratively and operationally complex. Their introduction of leverage (in some cases) amplifies the risk of portfolios and hence the need for greater oversight and risk controls.

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