A tale of two rebalances

Time-tested implementation best practices during market stress

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During the first half of 2020, investors were on a rollercoaster, bracing themselves during the lows of the fastest bull-to-bear market ever, and riding the highs of potentially the most rapid recession recovery in history. To borrow a few words from Charles Dickens, "it was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness…"[1] Our institutional clients managed through the chaos by ensuring that they stayed the course with long term strategic allocations and rebalancing at or near the end of the first quarter. All the while, assuring that there was enough cash on hand for both expected (benefit payments, capital calls, expenses) and unexpected (increased collateral requirements, variation margin payments) outflows. We all questioned the efficacy of each decision as it unfolded in an environment that was unprecedented and at times unsettling. As an implementation solutions provider with both overlay and transition management experts, Russell Investments traded record volumes across asset classes as we partnered with our clients to facilitate significant rebalancing trades during this time. A vast majority of this activity was successfully managed and traded remotely as a result of the ongoing challenges of the COVID-19 pandemic.

The economic recovery and possible virus treatments and vaccines remain uncertain. What we do know with certainty, however, is that getting the low frequency but high impact investment and risk management decisions right during times of stress, is mission critical and the details matter.

Market dynamics

There were several drivers of uncertainty at the start of 2020, which combined to make the first quarter one of the most volatile in history. As the COVID-19 virus spread, governments around the globe were put on alert with many enforcing lockdowns and impacting their economies in the process. This was compounded by the price of oil falling materially given the dispute between Saudi Arabia and Russia. This one-two combination resulted in significant volatility in markets as investors took different views on how the economy would fare in the months ahead. Given the uncertainty, risk-on assets such as global equities, commodities, and credit sold off while safe-haven assets such as sovereign bonds rallied. Volatility, volumes, and transaction costs all sharply increased, but those institutional investors with the right implementation toolkit were able to nimbly reposition their portfolios to meet their strategic objectives and take advantage of market opportunities.

[1] *A Tale of Two Cities*. Charles Dickens (1859).

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At the end of the first quarter, many institutional investors needed to rebalance their portfolios, most commonly by selling fixed income and purchasing public equities. With smaller market movements, many institutional investors relied on synthetic rebalancing with an overlay, however, given the size of the market movement over the quarter, physical rebalances were often required. The ability to utilise an overlay in combination with physical trading allowed many of our clients to nimbly reposition, especially given the lack of liquidity in some asset classes.

After falling to a low of 2,237.40 on March 23rd, the S&P 500 Index rallied nearly 20% during the second quarter of 2020, the largest rise since the fourth quarter of 1998. Monetary policy support, fiscal stimulus, and hopes that stay at home measures would slow the outbreak of the coronavirus outweighed economic fundamentals for investors. April's non-farm payrolls fell by 20,500,000, the largest drop ever recorded, though May's report did show an increase of 2,500,000. The unemployment rate remained high at 13.3%, and GDP contracted 5% quarter-over-quarter. To counter these depression level numbers, the Federal Reserve announced a 2.3 trillion-dollar support package in early April. In mid-June, the Fed also began its 250 billion-dollar corporate bond buying program, which was first announced in March. Markets are forward pricing vehicles and as such market participants drove risk assets significantly higher in second quarter. This resulted in many plans breaching the high end of their equity rebalancing ranges, prompting a rebalance out of equities back into fixed income. Selling high and buying low is a fundamental market principle that defines rebalancing. Enjoying the fruits of this practice requires that investors rebalance and those that missed that opportunity at the end of the first quarter were likely to miss this opportunity later in the second quarter.

Extreme volatility affects various asset classes in different ways.[2]. In March, global equities experienced higher volumes in both physical and futures trading. Increased volumes allowed traders to execute quickly, however the performance slippage versus order arrival price was much higher as prices were fluctuating rapidly. Conversely, fixed income markets faced liquidity constraints, particularly in credit and corporate bonds, with significantly increased bid offer spreads. U.S. Treasuries experienced similar dynamics to equity markets, as large volumes traded, but at a higher cost than normal. In mid-March, hourly tracking error was 33 basis points in fixed income and over 130 basis points in public equities. To put these numbers in perspective, both represent a solid annual net of fee return expectation for active managers in each broad asset class. Put another way, an hour of cash exposure during this volatile period could have cost a plan a year's worth of excess return from an active manager. The details matter. Markets were moving more than 5% a day for several weeks. While we already discussed how important it was that clients took the opportunity to rebalance at the end of March, the impact of the implementation of those moves should not be underestimated. Russell Investments' exposure management platform allowed clients to not only strategically rebalance but also to maintain market exposures throughout trading. These two actions are not mutually exclusive and should simply be considered best practice.

By the end of the second quarter, market conditions had improved, particularly around the index reconstitutions in June, but liquidity could not be considered back to normal.[3] While market depth increased, volumes declined, creating a dampening effect on overall liquidity and the VIX remained at elevated levels. The end of the second quarter was a welcome reprieve from the first, but the lessons from the first quarter rebalance remained ever-present as clients reversed course in the second quarter.

Two rebalancing approaches

Institutional investors have clear accountability for ensuring assets are invested as agreed upon within their investment policy statements and are well versed at planning for known near-term liabilities, but fast-moving markets can make this task much more challenging. We observed two types of rebalancing approaches during the first and second quarter as follows:

1. Simplistic rebalancing

This type of rebalancing is typically observed when an investor lacks staff or capacity to carefully coordinate rebalancing efforts and does not engage an experienced implementation partner to coordinate and provide oversight on their behalf. Often these investors "insource" the coordination and direct trading across managers, accounts and with their custodian to facilitate changes to asset allocations or to implement plan rebalances. This typically involves rebalancing with physicals, without the use of an overlay. Assets that have rallied are sold to cash, settled, and then reallocated to other asset classes that have fallen during the same time period. This often results in considerable cash exposure; from the point of the assets being traded on the sell side to the point in which they are traded on the buy side, the plan sits with cash exposure and bears the opportunity cost in their long term performance track records. We often find that these investors spend a disproportionate amount of time trying to coordinate all efforts when that time could be spent focused on investment and risk management decisions in times where these decisions can have significant impacts to plan performance.

[2] See Bagley, T (2020, April). "Liquidity in crisis" Russell Investments.

[3] See Bagley, T (2020, June). "Liquidity in crisis revisited" Russell Investments.

2. Coordinated rebalancing

This type of rebalancing is typically observed by investors who engage an experienced overlay provider and have access to an experienced transition manager. The investor remains responsible for making the investment decisions around which managers will ultimately be giving and receiving assets, but the implementation partner then takes the lead in strategy development, coordinating all operational project management and trading. Overlays are often utilised as the first line of exposure management thus allowing for a point in time synthetic rebalance. Once completed, physical trading can commence with careful coordination around unwinding the overlay to maintain appropriate market exposure while implementing the physical rebalance. Investment staff can focus on more important forward-looking investment and risk management decisions while the implementation partner executes the rebalance utilising a breadth of implementation tools with the goal to deliver the lowest cost, lowest risk outcome for the investor.

Why does the approach matter?

The first rebalancing approach seems simple and easier but can result in undesirable outcomes and uncomfortable conversations. Using this approach relies on hope that the market will remain stable, but market volatility ultimately undermines that hope as cash exposure is an undesired asset class when rebalancing between equities and fixed income. In extreme situations, a plan can accidentally fall outside of strategic asset allocation bands for long periods of time as physical assets are in flux between managers and custodial accounts. In summary, our experience shows that coordinated rebalancing is best practice, but in times of stress, the act of rebalancing and managing the details matter even more. Let's look at how these two strategies would have performed during the volatility of the first quarter and the relative calm of the second quarter.

Case study

To illustrate the two approaches discussed above, we analysed a $10 billion plan with an asset allocation mix of 60% MSCI All Country World Index and 40% Barclays US Aggregate at the start of 2020, but by late March, market movements pushed their allocations beyond a simple +/- 5% rebalancing band, to approximately 7% underweight equities, and 7% overweight fixed income.

1. Simplistic approach

The plan instructed their fixed income managers to liquidate roughly $625 million, or about 7% of current plan value at the close on March 25th. That cash remained uninvested for three trading days until the trades settled, proceeds were transferred to the operating cash account, and sent to the target equity managers to invest at the close on March 30th.

Result

The opportunity cost of sitting in cash vs. being invested in equities as the cash was raised accounted for a loss of ~$26 million, or -2.1%. (The ~$26 million loss does not account for the unknown spread and impact costs on both sides of the trade.)

2. Coordinated approach

The plan contacted their overlay manager on March 25th to synthetically rebalance to the desired target exposures immediately. From there, the plan and overlay manager communicated with the manager's transition management team to discuss the desired physical manager movements. The plan's investment staff prioritised their objectives for the transition, which allowed the transition team to instruct the trading desk to patiently liquidate the fixed income assets in a challenging market environment while coordinating the corresponding equity purchases with the fixed income sells. The unwinding of overlay exposures was carefully coordinated in conjunction with the physical reallocation.

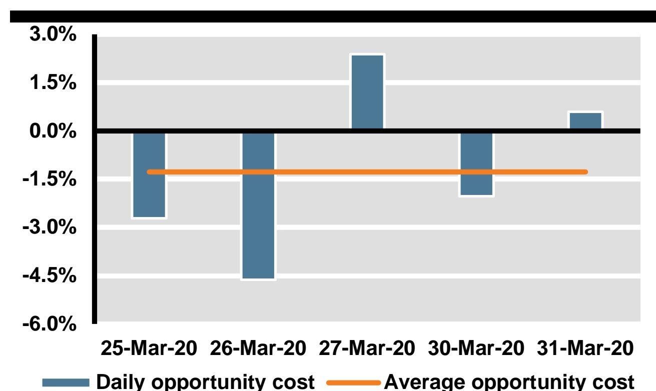
Result

Exposures were managed to the strategy and objectives throughout the process and cash was not introduced into the trade. The transition management team measured the costs throughout the event according to the industry best practice T Standard performance measurement so the plan could easily quantify the results of their investment decisions. The loss of ~$26 million as referenced above for the simplistic approach was avoided.

In the first case study above, cash was uninvested from the close of March 25th until the close of the 30th. However, as shown in Exhibit 1, if an investor held unintended cash exposure during the five days leading into quarter end, there was an average opportunity cost of -1.25%.

Exhibit 1: Unintended cash exposure

MSCI ACWI Cash Drag - End of Q1 2020



Source: Bloomberg, March 31, 2020.

We can rely on time-tested implementation best practices and lean into these practices in times of stress.

By June many investors were back at the rebalancing table as equities significantly rebounded causing an overweight to risk assets and a corresponding underweight to fixed income. Looking at the same two rebalancing approaches above, and a similar time horizon (last week of June), a plan using the simplistic approach would have realised an additional loss of approximately $1.3 million, or -0.36% relative to a plan using a coordinated approach. Whether we find ourselves in a period of higher or lower volatility, there are benefits to rebalancing with seamless exposure management. Every dollar saved is an additional dollar of benefit security for participants.

A Tale of Two Cities, by Charles Dickens, regularly cited as the best-selling novel of all time, is told from the omniscient, or all knowing, point of view. We don't claim to be all knowing and we certainly can't predict the future trajectory of markets, volatility, COVID-19, politics and a whole host of other things to come. However, we can rely on time-tested implementation best practices and lean into these practices in times of stress. Russell Investments saw record levels of fixed income, equity and FX volumes traded across our agency desk in the first half of 2020. We managed a vast majority of this trading remotely and did so seamlessly. While markets have rebounded sharply, we live in uncertain times. Know that Russell Investments is prepared to help our clients navigate the months ahead and stand ready to educate and execute on your behalf in-line with the best practices we describe here.

About Russell Investments

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