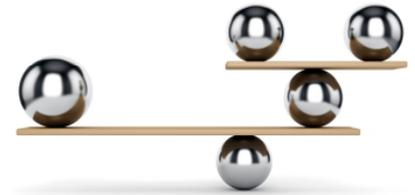




# Using overlays to balance the yin and yang of your portfolio



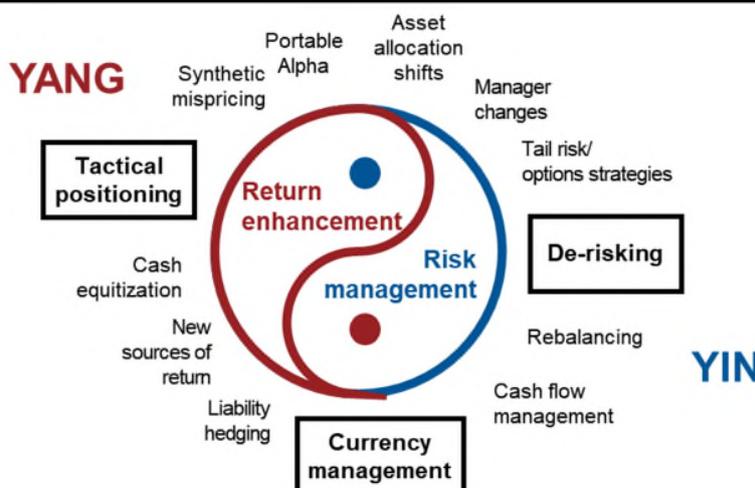
3 strategies to optimise risk management and return enhancement

In the Chinese philosophy of Taoism, there exists a concept called “taijitu,” more commonly known as yin and yang. In Western societies, yin and yang is typically thought of to represent opposing forces, however, this is not quite correct. A more accurate representation would be “the whole is greater than the sum of its parts.” In essence, yin and yang does not stand for opposing forces, but rather complementary forces.

There are two elements of investment management that go hand in hand with yin and yang: risk management and return enhancement. Investors need to balance both elements to optimise their portfolio.

Overlay programs can be used to balance the yin and yang of your portfolio in a few different ways (see Exhibit A), and this paper will share three strategies for doing so. The first strategy is using an Overlay to implement de-risking, which is focused on risk management; the second strategy is using an Overlay for currency management, which has elements of both risk management and return enhancement; and lastly, using an Overlay to implement tactical positioning, which is focused on return enhancement.

Exhibit A: Different ways overlay programs are used to balance the yin and yang of your portfolio



**3 popular ways for balancing the yin and yang of a portfolio**

1. De-risking
2. Currency management
3. Tactical positioning

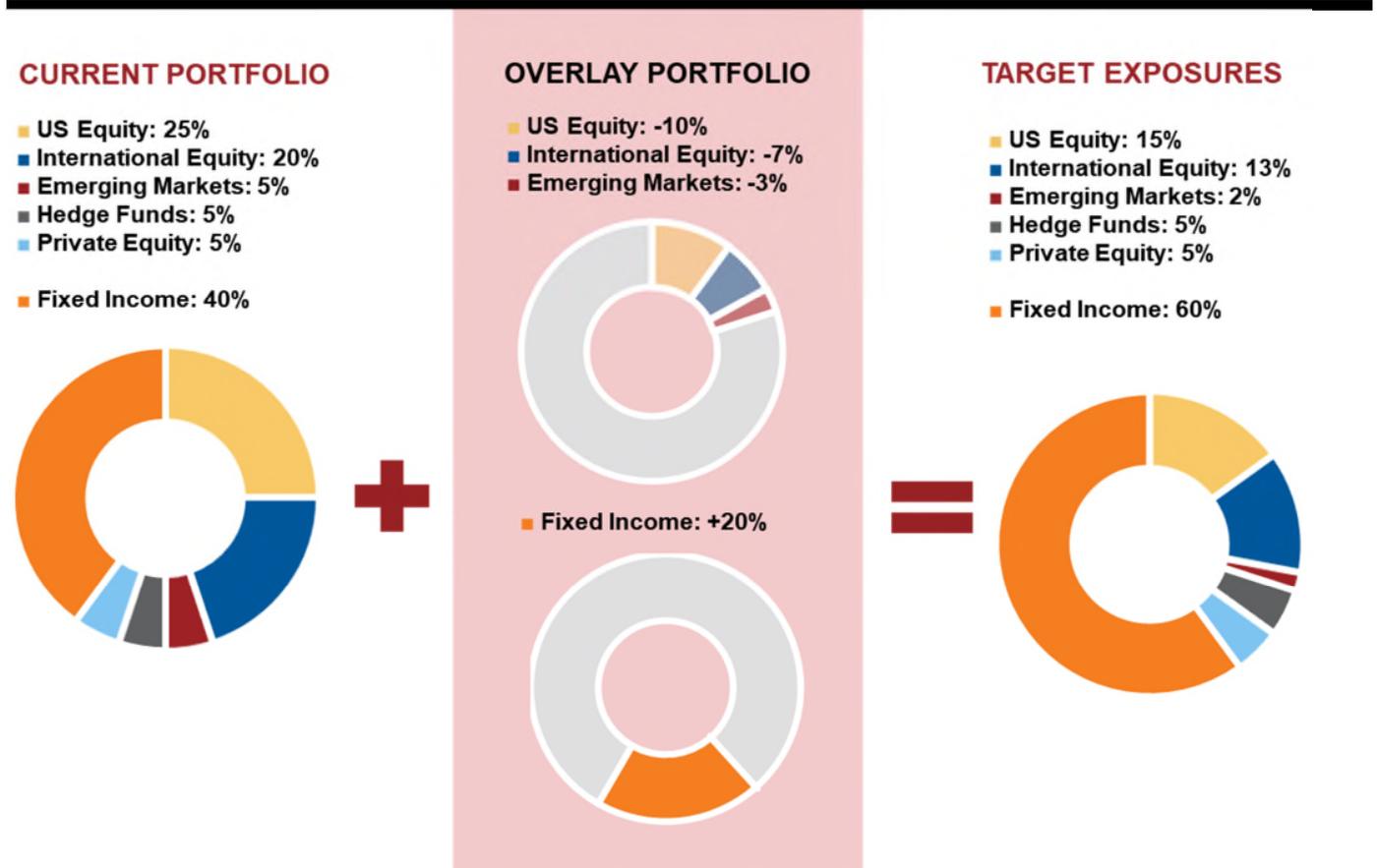
# 1. De-risking



Volatility of return differentials between asset classes is a given in capital markets. Stocks outperform bonds, then bonds outperform stocks—and the cycle continues. These return differentials can be quite large at times and create opportunities for asset allocation changes in your portfolio, such as a de-risking shift. An increase in the funded ratio caused by the outperformance of stocks relative to bonds may cause pension plans to move down their glide path and lower their equity allocation in favour of additional liability hedging assets, such as bonds.

An Overlay helps institutional investors move to their new target weights by hedging away the exposure they no longer want and replacing it with the exposure they do want. Exhibit B provides an example of a pension plan that decides to shift 20% of its assets away from return-seeking (equities) to fixed income. An Overlay accomplishes this by shorting futures contracts representing U.S. equity, international equity, and emerging markets—and simultaneously adding fixed income exposure via interest-rate futures and swaps.

**Exhibit B: An example of a pension plan that decides to shift 20% of its assets away from return-seeking (equities) to fixed income**



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Certainly, asset allocation shifts, such as de-risking, can be accomplished by transitioning physical assets (liquidating/redeeming equity managers and funding fixed-income managers). However, physical asset shifts can take a considerable amount of time. From search and selection to contracting to cash raising and funding, physical shifts can take weeks, if not months, to implement. An Overlay provides the ability to implement new target exposures immediately, rather than being forced by the operational constraints of a physical shift to dictate the timeframe. Achieving the beta exposures of the new policy targets through an Overlay allows sponsors to take time to complete the physical asset shift without having to worry about market returns taking away the opportunity to make the shift in the first place.

## 2. Currency management

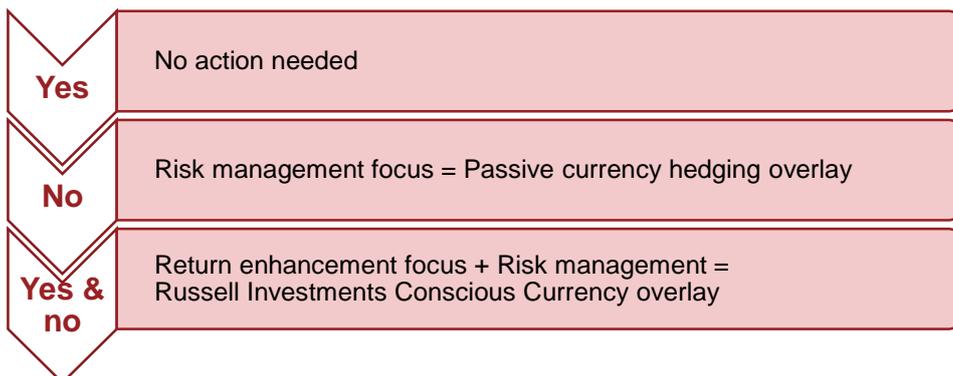
Over the past few years, volatility in currencies has had a significant impact on international asset risks and returns. Whether you are bullish or bearish on USD, it can pay to think about how investors are managing foreign currency exposure in their international portfolios.

Institutional investors can take a number of different approaches when thinking about their international currency exposure, characterised in Exhibit C below.



### Exhibit C: Different approaches

**You own international assets, do you want to own the currency?**



#### Answer = Yes

Institutional investors answering “Yes” tend to believe currency returns are mean-reverting over time. Thus, adjusting currency exposure has no meaningful long-term return impact, or, their foreign currency exposure is de minimis and has little impact on their total portfolio risk/return.

#### Answer = No

Investors answering “No” tend to have a risk management focus on currencies. Since unhedged international exposure tends to have higher levels of volatility relative to hedged exposure, many plans prefer to manage this incremental risk from foreign currency exposure if they don’t foresee a compelling return opportunity.

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### Overlay solution

A passive currency hedge can be a great solution for institutional investors seeking to reduce their foreign currency exposure. The Overlay offsets the currency exposure embedded in the physical assets, providing the plan a hedged return stream from the international assets. The implementation can include hedging all, or a portion of, the foreign-currency exposure.

### Answer = Yes & no

Investors answering “Yes & No” tend to seek both risk management and return enhancement from their currency exposure. They don’t mind owning currency exposure but prefer to hold exposures that are based on factors that influence currency returns rather than the naïve currency exposures embedded in their international assets.

### Overlay solution

A factor-based or active management approach towards currencies may be warranted for institutional investors seeking risk-and-return benefits. Specific to factor-based currency Overlays, strategies can be implemented to hedge the naïve currency exposures in their international portfolios (risk management) and then take long positions in attractive currencies and short positions in unattractive currencies (return enhancement). Tilts are often determined through a quantitative approach looking at the drivers of currency returns including value, carry, and trend.

No matter the view on the future performance of the U.S. dollar or the plan’s investment beliefs regarding foreign currency exposure, a flexible Overlay program can help manage the risks associated with currency or use it to enhance returns.

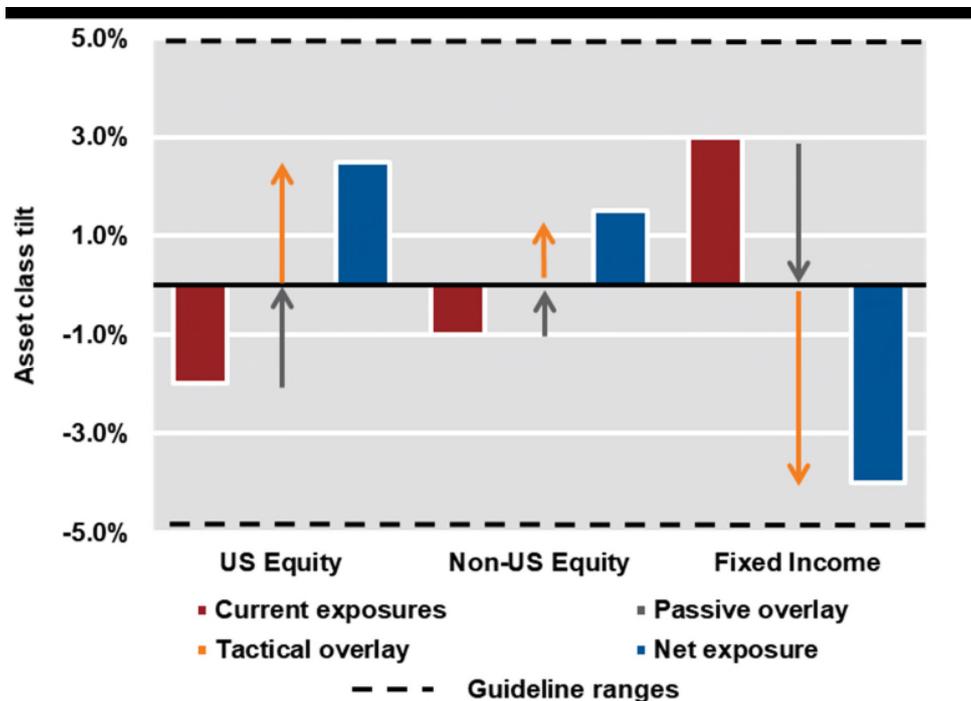
## 3. Tactical positioning

Over time, portfolios can drift away from their policy targets, driven by market movement, manager out/underperformance, operational cash flows, etc. We view this unintentional drift as an uncompensated form of risk with an expected return of 0% since there wasn’t an intentional decision to be positioned in that manner. This form of risk drives tracking error of the portfolio versus the policy benchmark. In short, unintended drift equals uncompensated risk. Fortunately, a passive rebalancing Overlay can minimise the unintended drift, bringing the portfolio back to policy, and is an excellent risk-management tool.

However, for institutional investors who desire to balance risk management with more return enhancement in their portfolios, tactical positioning can play an important role. Tactical positioning is the process of taking “intentional” tilts away from policy with the goal of enhancing returns. As seen in Exhibit D, a passive rebalancing Overlay offsets the unintentional portfolio tilts while the Tactical Overlay provides intentional tilts. The resulting net exposures are designed to take advantage of market opportunities.



**Exhibit D: A passive rebalancing Overlay offsets the unintentional portfolio tilts while the Tactical Overlay provides intentional tilts**



Provided for illustrative purposes only.

While tactical positioning can be implemented by adjusting a portfolio's physical manager allocations, we believe an Overlay is a superior implementation vehicle for three important reasons. First, an Overlay allows investors to quickly implement a tactical view. Second, an Overlay utilises low-cost tools such as derivatives to implement the overweights and underweights. Every penny counts in tactical positioning—utilising low-cost tools helps preserve alpha. And lastly, an Overlay easily allows plans to go both long and short exposures, thus expressing a view on a wide array of asset classes.

### Concluding thoughts

The growing complexity of the investment world can make it difficult for institutional investors to balance risk management and return enhancement in their portfolios. An Overlay can be used to help balance the yin and yang of a portfolio through implementing de-risking, currency management, and tactical positioning in a cost-effective and efficient manner. Perhaps most important though, an Overlay is not limited to the few strategies discussed here but allows plans to implement a host of other risk-management and return-enhancement strategies, all on a single investment platform.

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