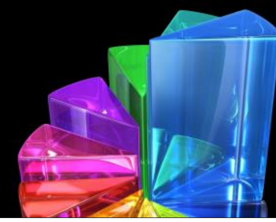
What's new in overlay services?

5 evolutionary trends



Tom Fletcher, CFA, Managing Director, Overlay Services

1. How is the use of overlays evolving?

The most interesting aspect is movement toward allowing overlay managers discretion to pursue enhanced returns by taking on active risk. We have all heard of passive beta overlay, but in today's capital-constrained world, programs that can be expected to generate reliable excess returns, with commitment of very little incremental capital, are very valuable in respect to the fund-level risk budget. The most common uses of such programs are tactical asset class and/or currency tilting. Such programs are delivered via overlays within Russell Investments' funds, or available on a standalone basis for larger clients wanting a more bespoke program.

2. What are some cutting-edge, expanded overlay uses of the past few years?

We are seeing the early signs of evolution into risk-based overlay programs. In these cases, clients are looking for a platform to assess risks and potential for losses under stress scenarios and at the same time looking more deeply into factor alignments and sensitivities at the total portfolio level. With visibility into these dimensions, overlay relationships are naturally extending into broader exposure management relationships, also including factor completion with bespoke long equity portfolios tailored to each client's needs. The combination of capital efficient derivatives overlay, and alignment of economical factor exposures is particularly powerful when coupled with an ongoing monitoring framework that can quantify and manage absolute risks in addition to the focus on excess return generation.

3. What are clients talking about?

While clients have a short list of major projects they can commit to over the scope of a year, it is notable that discussions about mitigating equity drawdown risk are increasing in frequency. Clients are thinking ahead about how they might manage this undue risk before the expansion in the currently extended business cycle ends. Even in the U.S., where there has historically been a long-term focus on expected return maximization, clients are considering what the damage could be if a particularly challenging correction hits the global equity markets. They are acknowledging that conventional portfolio diversification works over the long-term, but does not necessarily provide protection under market stress. While we see a little bit of action in this space currently, we expect the pace of that action to pick up as formative conversations eventually bear out actionable plans. Governance structures and ensuring disciplined decisions under stress are critical aspects to discuss while markets are relatively calm. For the same reasons, it is also a good time to revisit the commitment to rebalancing and making sure equity exposures don't drift to the high end of the policy range this late in the economic cycle.

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4. Does global post-crisis derivatives regulation complicate the overlays, and does an overlay still make sense for clients?

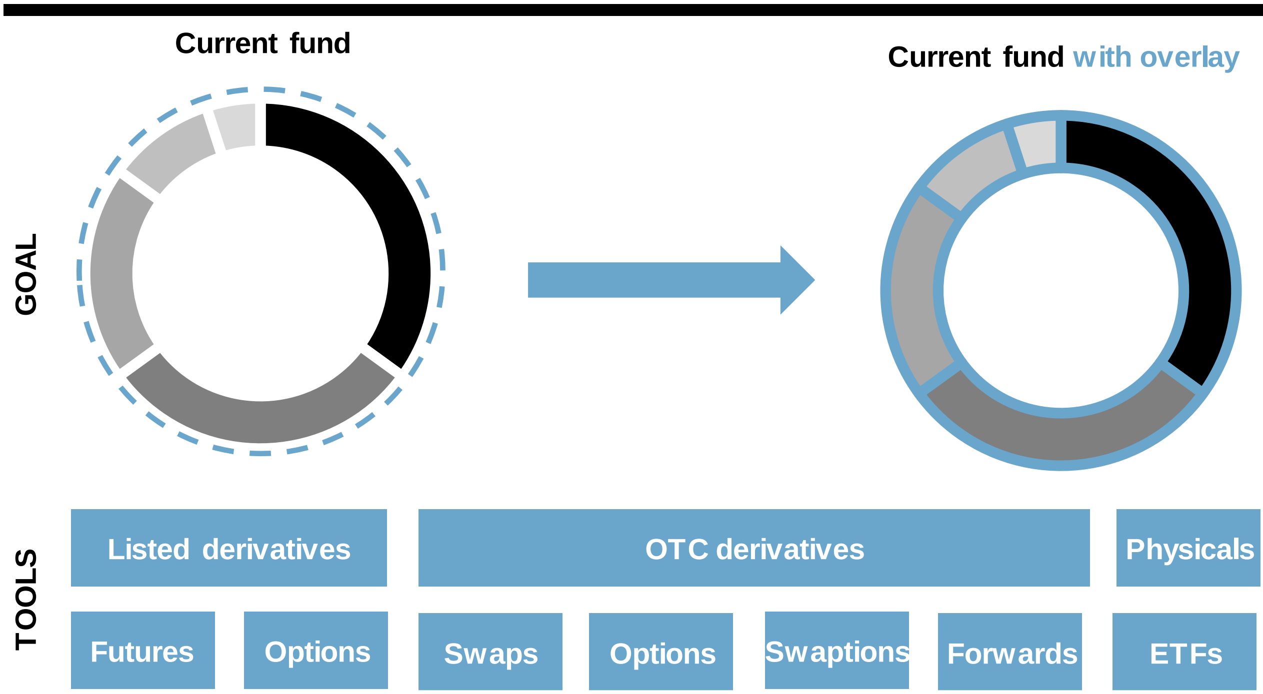
There is now a higher burden of regulatory reporting for brokers and managers involved in this business. The most prevalent overlays we see are implemented with currency forwards and listed futures, where changes in market structure have been less pronounced. Aside from some very subtle changes in required documentation, client access to these overlays has been minimally impacted, and the core overlay benefits of reduced risk and return enhancement have never been more important.

> *Overlays are very capital-efficient tools, particularly in assets where liquid listed futures are available.*

5. How have new regulations impacted broker business models, and why does it matter?

Bank balance sheets have shrunk considerably as risk-weighted capital requirements have increased. As a result, cost of capital has increased for brokers, and they pass on the increased cost of accessing their balance sheets to clients. Institutional clients have the benefit of their own well-funded balance sheet. It is critical for institutions to use their assets efficiently—for instance, by pledging collateral where possible, instead of requiring additional cash for use as collateral. In some cases, holding physical assets, rather than looking to a broker for an exposure in total return swap form, can improve economics. Overlays are very capital-efficient tools, particularly in assets where liquid listed futures are available, as they can deliver incremental returns while only encumbering a small fraction of capital in relation to positions they control. Currency overlays are typically even more capital-efficient than multi-asset derivative overlays, since daily collateralization is not the market norm.

Exhibit 1: What is an overlay



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