STRATEGY SPOTLIGHT

Using overlays to balance the yin and yang of your Non-profit portfolio

Russell Investments

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 to represent opposing forces, however, this is not quite correct. There are a number of phrases in English that do a better job of representing yin and yang, such as "1 + 1 = 3" or "the whole is greater than the sum of its parts." In essence, yin and yang does not represent opposing forces, but rather complementary forces.

There are two elements of investment management that go hand in hand with yin and yang and those are risk management and return enhancement. Good investors realize you must have both of these elements represented in a portfolio, and if you have too much of one, relative to the other, your portfolio can become unbalanced.

Overlays can be used to balance the yin and yang of your portfolio in a number of different ways (see Exhibit A), and this paper will share three strategies for doing so. The first strategy is using an overlay to implement asset allocation shifts, 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.

Craig Shubin
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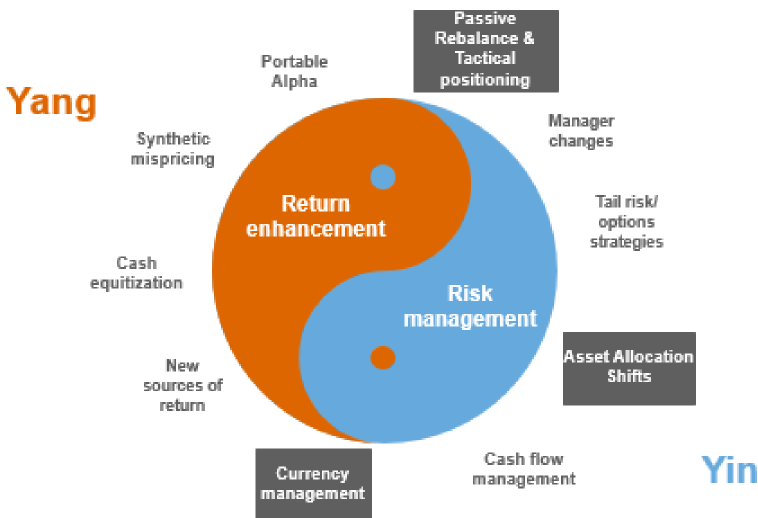
This paper shares three strategies for using overlays to balance the yin and yang of your portfolio: (1) Asset allocation shifts (2) Currency management (3) Passive rebalancing and tactical positioning

Exhibit A



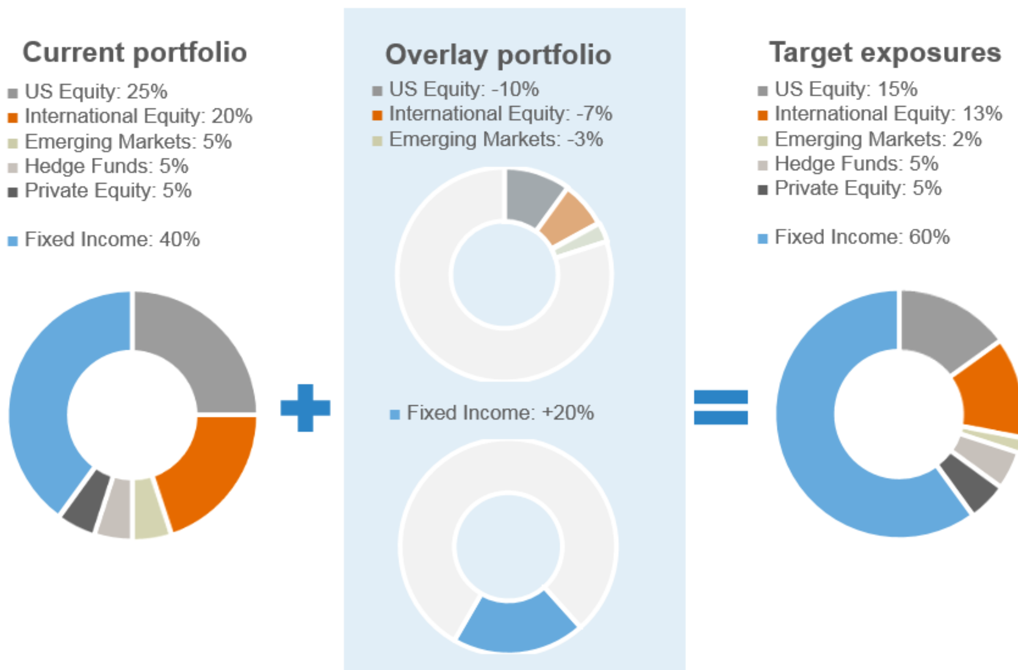
Asset allocation

Volatility of return differentials between asset classes is a given in capital markets. Stocks outperform bonds, bonds outperform stocks, and then stocks outperform bonds – and the cycle continues. These return differentials can be quite large at times and can create opportunities to make asset allocation changes in your portfolio. As capital market assumptions are updated after a period of outperformance of stocks relative to bonds, investors may shift their asset allocation to take assets from equities to fixed income to target opportunities in bonds.

An overlay helps investors move to their new target exposures more quickly by hedging away the exposure they no longer want and providing the exposure they do want. Exhibit B provides an example of an investor that decided to shift 20% of its assets away from equities to fixed income. An overlay accomplishes this by shorting futures contracts representing U.S. equity, international equity and emerging markets – and simultaneously adding additional fixed income exposure via interest-rate futures and swaps. In short, the overlay effectively removes the exposure the investor no longer wants (equities) and provides the exposure it does want (fixed income).

Certainly, asset allocation shifts, 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 investors the ability to implement new target exposures immediately, rather than allowing the operational constraints of a physical shift to dictate the timeframe for implementation. Achieving the beta exposures of the new policy targets through an overlay buys investors 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.

Exhibit B

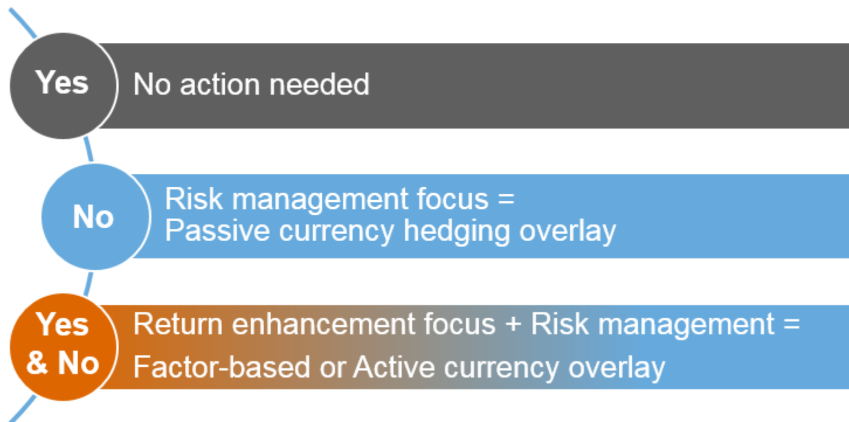


Currency management

Over the past two years, the appreciation of the U.S. dollar (USD) has had a significant impact on international asset risks and returns. Whether you are bullish or bearish on the USD, it can pay for investors to think about how they are managing foreign currency exposure in their international portfolios.

We see a number of different approaches investors can take when thinking about their international currency exposure, which is best characterized in Exhibit C below.

Exhibit C



Investors answering "Yes" tend to believe currency returns are mean-reverting over time and 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.

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 organizations prefer to manage this incremental risk from foreign currency exposure if they don't foresee a compelling return opportunity.

- **Overlay solution:** A passive currency hedging overlay can be a great solution for investors seeking to reduce their foreign currency exposure. A passive currency hedging overlay offsets the currency exposure that exists with holding physical assets, providing the organization a hedged return stream from the international assets. Options include hedging all, or some part of, the foreign-currency exposure.

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 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.

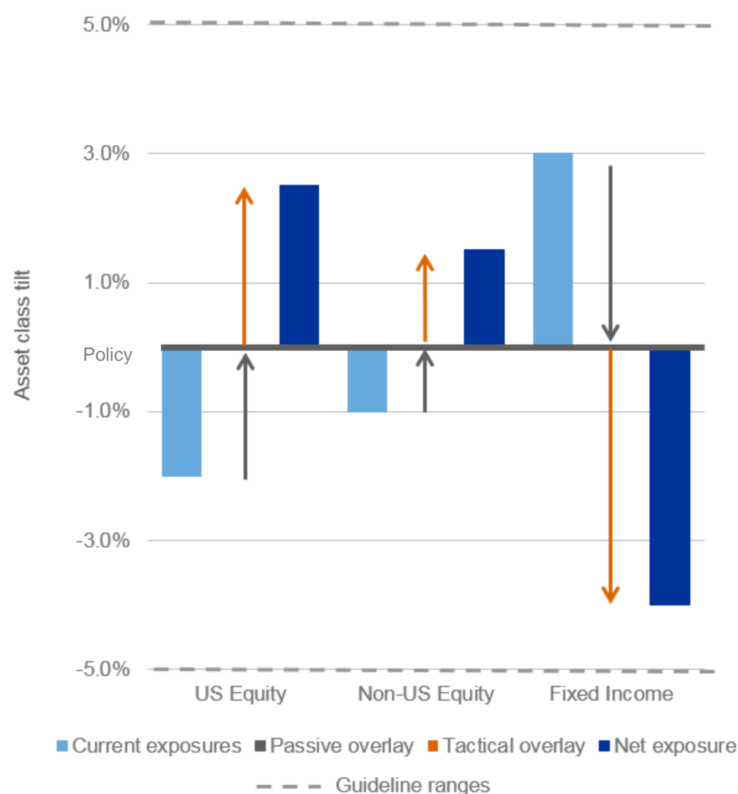
No matter the view on the future performance of the U.S. dollar or the organization's investment beliefs regarding foreign currency exposure, a flexible overlay program can help investors manage the risks associated with currency or use it to the organization's advantage to enhance returns.

Passive rebalancing and tactical positioning

Over time, portfolios can drift from their policy targets. Effects on portfolios such as market movement, manager out/underperformance, payments to cover grants or other spending priorities from the investment program, etc. all cause unintentional drift away from policy. We view this unintentional drift as an uncompensated form of risk. It's uncompensated in that it has 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. Fortunately, there is a great tool to solve the problem of unintentional drift, which is a passive rebalancing overlay. A passive rebalancing overlay can minimize the unintended drift, bringing the portfolio back to policy, utilizing the overlay as a risk-management tool.

Additionally, for investors who desire to balance risk management with a bit 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, giving the portfolio net exposures, which are designed to take advantage of market opportunities.

Exhibit D



While tactical positioning can be implemented by adjusting a portfolio's physical manager allocations, we believe an overlay is a superior vehicle for implementation for three important reasons. First, an overlay allows investors to quickly implement a tactical view; instead of having to line up asset movements, organizations can express their view today. Second, an overlay utilizes low-cost tools such as derivatives to implement the overweights and underweights. Every penny counts in tactical positioning and utilizing low-cost tools helps preserve alpha. And lastly, an overlay easily allows organizations to express a negative view on a wide array of asset classes.

Concluding thoughts

The growing complexity of the investment world can make it difficult for 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 asset allocation shifts, currency management, passive rebalancing and tactical positioning in a cost-effective and efficient manner. Perhaps most important though, an overlay not only allows organizations to implement the strategies discussed here, but also a host of other risk-management and return-enhancement strategies, all on a single investment platform.

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