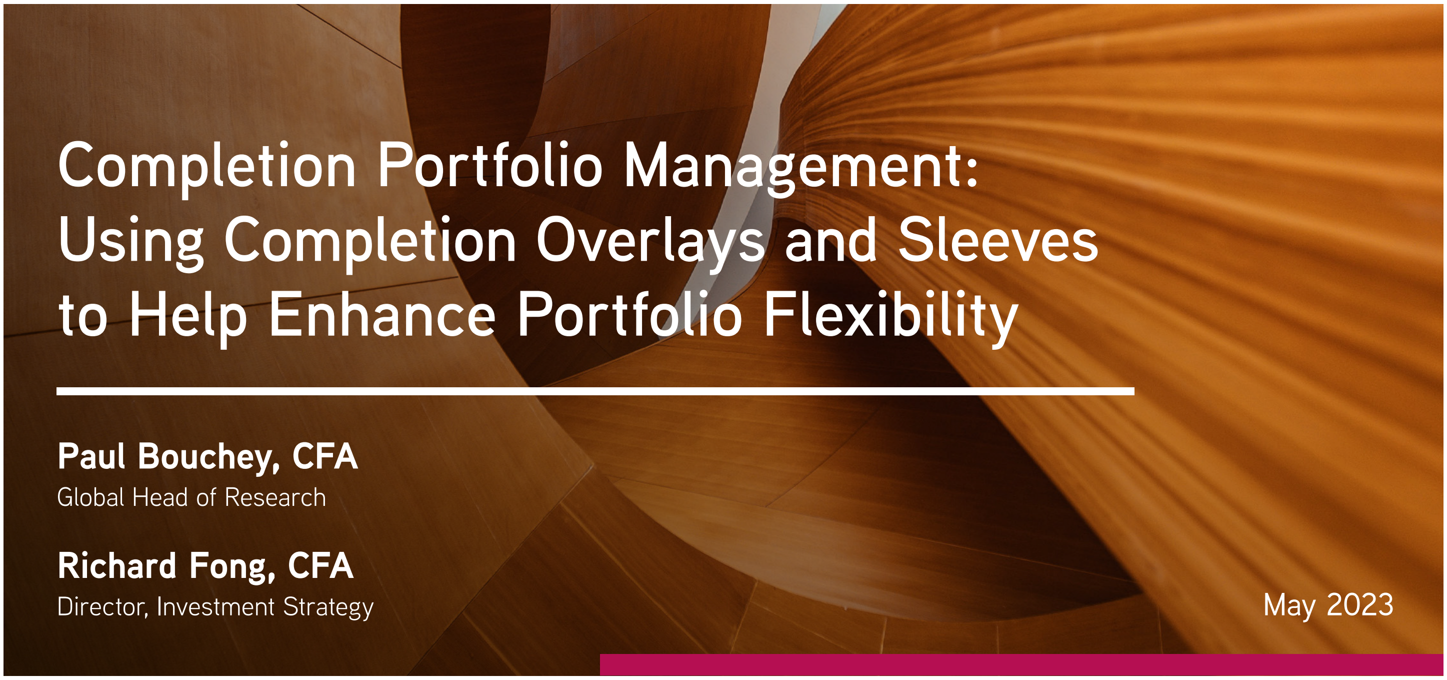

Completion Portfolio Management: Using Completion Overlays and Sleeves to Help Enhance Portfolio Flexibility

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May 2023

Fund sponsors can spend significant resources developing an asset allocation framework to meet their goals and objectives. Typically included in this framework is a governance structure and management process for maintaining the desired asset allocation, selecting investment managers, and regularly monitoring portfolio performance and risks relative to those objectives. However, real-world constraints on capital and resources can make managing these competing interests difficult. A completion manager may help to relieve some of these concerns through improved monitoring, analytics, and exposure management, which can help loosen these constraints and enhance portfolio flexibility.

Key takeaways

» A completion manager can help track and manage risks from exposures that may have otherwise been unmanaged.

» Used as a natural extension to a traditional framework, a completion manager exerts greater control over the portfolio management process, optimizing capital allocation and helping increase potential return.

» Completion portfolio management regularly monitors portfolio exposures against policy targets, generates portfolio analytics and reporting, evaluates exposure management, and manages portfolio exposures to mitigate unintended exposures.

» Completion programs may be implemented through a partially funded overlay or a fully funded completion sleeve, both of which are complementary to an existing manager lineup.

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Why consider a completion manager?

We believe real-world considerations in asset allocation and manager selection often lead to unintended deviations, both persistent and transitional. For example, fund sponsors may see greater alpha-generating opportunities in Europe relative to other regions and allocate capital accordingly. These tilts and concentrations in some cases introduce the potential for meaningful divergence from desired portfolio characteristics and ultimately from performance objectives. Figure 1 illustrates the ongoing performance impact that a 10% tilt to Europe and away from Japan created relative to the benchmark. For example, this tilt led to underperformance of more than 4% in 1999 followed by outperformance of 2% in 2000.

Fund sponsors might instead want to introduce tactical tilts intentionally. However, a traditional framework may lack the transparency to monitor these deviations, and capital constraints may limit the ability to manage the associated risks. A completion manager can serve as a natural extension to a traditional framework, allowing for greater control over the portfolio management process and helping increase potential return through optimized capital allocation.

While the types of exposures covered vary widely, the role of a completion approach to portfolio management is essentially composed of four components:

- Regularly monitor portfolio exposures relative to the policy target.
- Generate portfolio analytics and reporting.
- Evaluate exposure management alternatives, risks, and costs.
- Manage portfolio exposures to mitigate unintended exposures (or provide flexibility to introduce active tilts).

Completion programs may be implemented through a partially funded overlay or a fully funded completion sleeve, summarized in figure 2. These choices aren't mutually exclusive; we believe both are complementary to an existing manager lineup.

FIGURE 1: IMPACT OF EXPOSURE TILTS (10% OVERWEIGHT EUROPE, UNDERWEIGHT JAPAN; YEARLY RETURN DIFFERENCE VS. MSCI EAFE)

Source: Parametric, 2022. Impact calculated as the calendar year difference between the MSCI EAFE and a tilted portfolio. The tilted portfolio is approximated as MSCI EAFE + 10% MSCI Europe – 10% MSCI Japan, rebalanced monthly. For illustration purposes only and should not be considered as an investment advice or a recommendation to invest in a particular strategy. Past performance is no guarantee of future results. An investor cannot invest directly in an index. Actual results may vary.

FIGURE 2: COMPLETION IMPLEMENTATION PROGRAMS

Implementation	Completion overlay	Completion sleeve
Funded/unfunded	Partially funded	Fully funded
Instruments used	Derivatives	Cash equities
Common exposures covered	› Broad styles › Countries or regions › Sectors	› Styles › Factors (earnings quality, dividend yield) › Sectors
Considerations	› Relative financing costs › Tracking error › Margin	› Sleeve sizing › Tracking error

Source: Parametric, 2023. For illustration purposes only. This is specific to equity, but completion programs may be expanded to include other asset classes. For example, completion programs may be used to implement a desired duration or key rate profile. OTC instruments may allow for the ability to manage more precise or esoteric exposures and may introduce additional risk.

Completion overlays

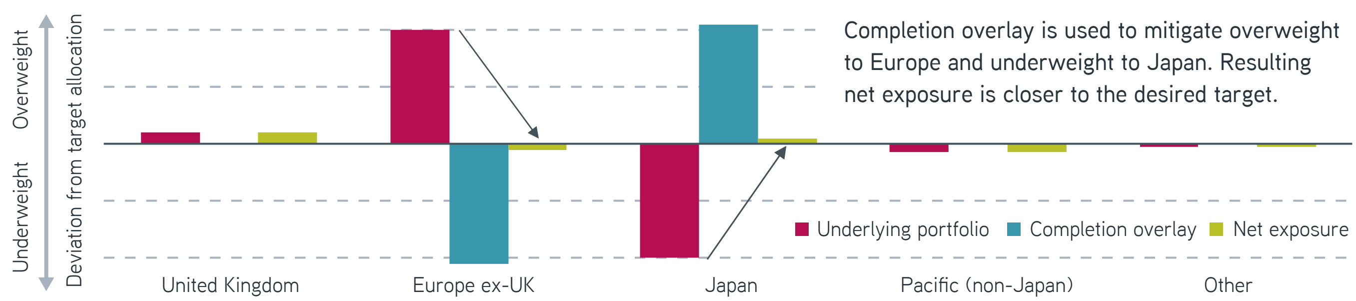
We can think of overlay completion as an extension of traditional overlay management to include a more granular focus on characteristics such as countries, regions, sectors, and styles. For example, an investor may find their portfolio overweighted to developed Europe because of a preference for high-conviction managers in that region. While traditional analysis may show developed international equity as on target, a significant tilt toward Europe may introduce unintended risks relative to the benchmark. Figure 3 illustrates how a completion overlay would seek to reduce this bias by removing exposure to developed Europe and adding exposure to a corresponding underweight region, Japan, often through futures. This structure is intended to loosen capital constraints, allowing for allocation of capital to preferred managers, while using an overlay to complete the policy asset allocation, which can potentially mitigate unintended risks, retain expected alpha, and improve portfolio flexibility.

Completion overlays introduce several considerations. Derivatives may price rich or cheap, resulting in net headwinds or tailwinds to a completion program. Tracking error may exist between the instruments available and the benchmark. A margin pool must be created to support the program. For investors already using an overlay manager for cash securitization or rebalancing, this facility is already in place. However, completion positions may add incrementally to the margin required.

Growth and value styles are a basic example of a completion sleeve application. Factors such as earnings quality, dividend yield, volatility, momentum, and profitability can be managed in isolation or in conjunction with other factors, all within the same sleeve. These factors can be maintained as part of a benchmark completion or as active tilts based on fund sponsor decisions. For organizations with a focus on environmental, social, and governance (ESG) concerns, completion sleeves may be used to help tilt a portfolio into alignment with particular missions or beliefs.

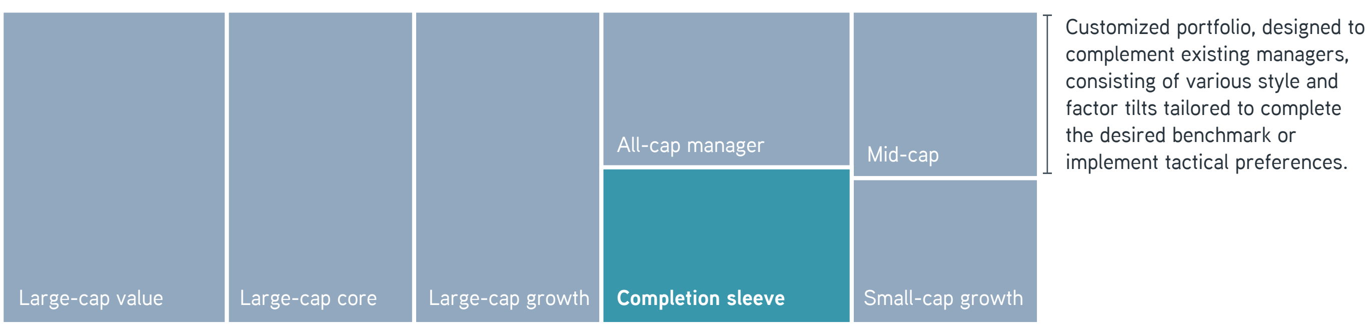
Investors considering a completion sleeve should balance sleeve sizing within the context of tracking-error tolerance and capital constraints. Although this implementation is somewhat simpler than an overlay approach, it's still important to understand the trade-offs involved given the absence of margin. Funding of a completion sleeve increases exposure to index-based management or systematic approaches, limiting the capital available to more actively managed opportunities.

FIGURE 3: COMPLETION OVERLAY ILLUSTRATION



Source: Parametric, 2023. For illustration purposes only and should not be considered as an investment advice or a recommendation to invest in a particular strategy.

FIGURE 4: COMPLETION SLEEVE ILLUSTRATION



Source: Parametric, 2023. For illustration purposes only. Actual portfolio allocation and sizing of completion sleeve may vary.

Conclusion

It's helpful to consider completion management as an action-based extension of the risk-monitoring framework already in place for many investors. Fund sponsors can engage a completion manager to track and manage risk from exposures that may have otherwise been unmanaged. Armed with this ability, investors can implement completion overlays or sleeves to mitigate or actively manage portfolio risks and tilts. In addition to risk management, this structure may help increase return expectations through an optimal allocation of capital. By loosening constraints and unlocking previously untapped potential, this complementary tool helps create efficiencies and enhance portfolio flexibility.

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