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Streamlining Liquidity and Exposure Management Within Multimanager Funds

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Multimanager or white-label funds have become more popular for segments of the investment marketplace. Defined contribution (DC) plans have begun to use multimanager funds to increase efficiencies and, where applicable, leverage the relationships formed by companies' defined benefit plans. Outsourced chief investment officer (OCIO) providers have also adopted multimanager funds to bring scalability to smaller institutional investors.

For fund managers, a key challenge of managing these funds is liquidity management. They must ensure that adequate cash is available to absorb participant activity, such as redemptions and contributions, that can occur as frequently as daily. This liquidity management process creates cash drag, reducing expected returns and increasing expected tracking error. This paper will explain why using an overlay manager can tackle this challenge, generating operational efficiencies, improved tracking error, and incremental return for the funds.

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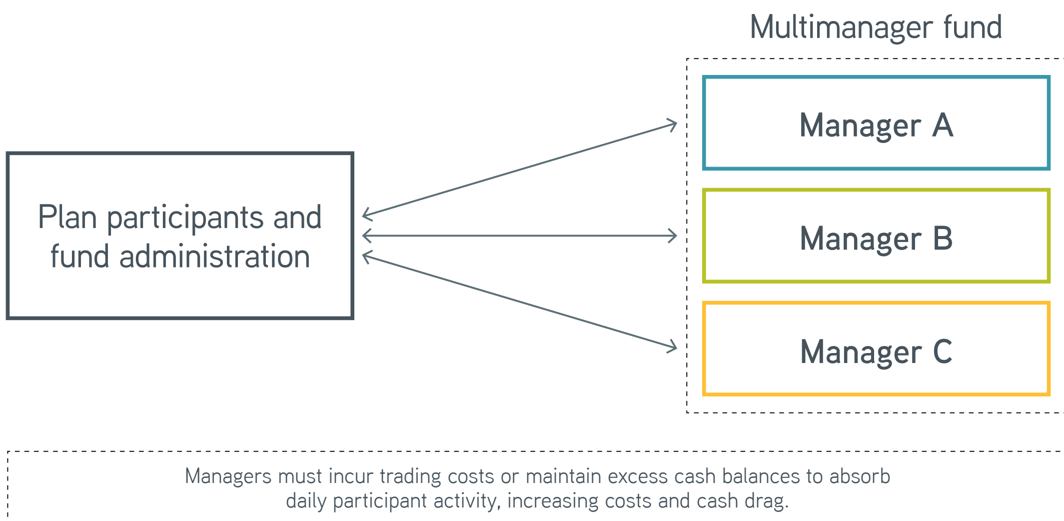
The challenge of liquidity management

All multimanager funds must have a framework to support participant and investment manager activity. In many cases a liquidity sleeve holding cash is used to absorb this activity, serving as the account through which all this activity passes. However, in cases where there's no liquidity sleeve, contribution and redemption activity simply passes through to each investment account directly. If the manager maintains a cash position, they risk introducing cash drag into the fund. Similarly, if contribution and redemption activity is continuously directed to individual manager accounts, investment managers may hold excess cash in order to accommodate unexpected activity.

Figure 1: Liquidity management before centralization



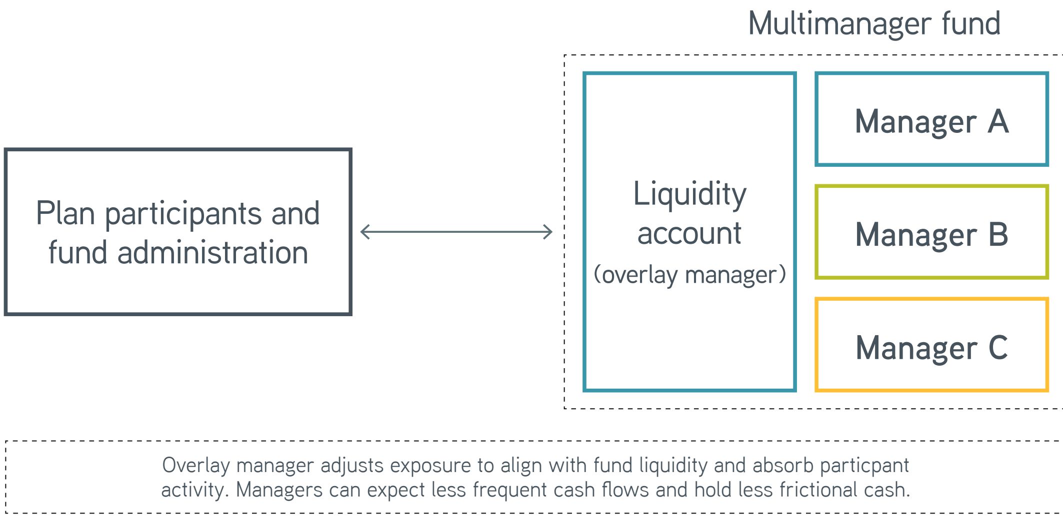
Source: Parametric. For illustrative purposes only.

An overlay mitigates cash drag and provides operational efficiencies in fund liquidity management through two primary functions:

- **Cash overlay.**[1] Overlay exposure is used to add market exposure to align with fund liquidity, reducing the impact of cash drag. The overlay is potentially adjusted each day as contributions and redemptions occur, with lower transaction costs than trading physical securities. Frictional manager cash can also be included in the overlay, reducing cash drag across all accounts in the fund. In this way fund managers have the ability to carry more liquidity—typically amounting to 2% to 5% of the total fund size—in order to reduce the frequency of needing to raise or send cash to managers, reducing trading costs and allowing managers to hold less cash.
- **Centralized coordination of manager activity.** An overlay manager can coordinate directly with the fund's underlying managers to raise or deploy cash as the level of liquidity in the fund drifts from target levels. Overlay exposure is then adjusted to align with manager trading activity, mitigating unnecessary gaps or fluctuations in market exposure during the transition of assets.

[1] For more information, please see Richard Fong and Emily Pechacek, "Cash Securitization: The Challenge of Effective Liquidity Management," Parametric, January 2019.

Figure 2: Streamlining liquidity management mechanics after incorporating an overlay manager



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The benefits of an overlay manager

Using an overlay manager for fund liquidity management offers the following benefits:[2]

- Increased expected return by eliminating cash drag
- Improved fund tracking error by mitigating exposure gaps during investment activity
- Reduced transaction costs and residual cash in underlying managers
- Increased staff efficiency by reducing day-to-day administrative burden
- Decreased disruption to physical managers

An overlay can also improve liquidity management relative to a passive index fund. An overlay only requires a small portion of notional exposure to be held as collateral, leaving the remaining cash available to absorb daily participant activity. An index fund must be fully funded, creating operational challenges related to cash settlement. As well, index funds can only be traded at the market close and may require advance notice, potentially introducing unnecessary gaps in market exposure. On the other hand, futures can be traded intraday to adjust exposures as soon as activity is known. In this way an overlay is a much more efficient vehicle for aligning market exposure in a timely manner and reducing operational concerns surrounding cash settlement.

[2] Investing in an overlay strategy involves risk. All investments are subject to loss. Please refer to the Disclosures for additional information.

Conclusion

Overlay within a multimanager fund increases fund efficiency by centralizing liquidity management. Using this framework, fund managers streamline the management of cash flows due to participant and investment activity. A liquidity sleeve obtains benchmark exposure, mitigating the effects of cash drag. As a result, the fund can generate incremental return and improved tracking error while reducing transaction costs.

Parametric is located at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of the firm's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.