

Public Fund Uses Custom Core® to Meet Capital Needs, Adhere to Income Rules

CHALLENGE

A state public school fund wanted to expand its asset allocation but was constrained by its legal restrictions.

SOLUTION

We proposed a Custom Core portfolio composed of equity ETFs, using our tax-management processes to avoid realizing a net loss in the portfolio.

RESULTS

The school fund observed its legal restrictions while diversifying into both income and growth assets.

Challenge

A state public school fund was bound by law to generate a fixed level of income but was prohibited from realizing a net capital loss at the total portfolio level. To respect this law, the fund had historically invested only in US Treasuries, held to maturity, which would generate the income needed as well as prevent any realized losses in the portfolio.

The fund was now interested in adding global equities to the portfolio to grow the overall capital base, but it needed to do so without incurring a net capital loss. To do this, they needed the ability to manage gains and losses across the portfolio. To complicate matters, there were additional legal restrictions that prevented the holding of individual stocks but did allow for the fund to invest in ETFs.

Parametric solution

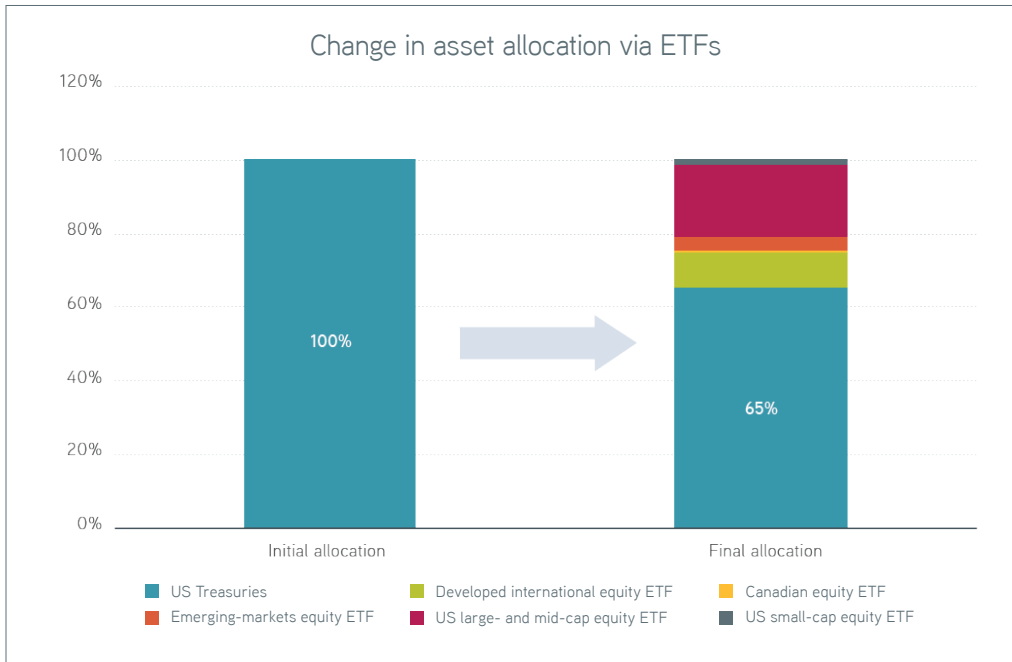
To help the fund realize its new asset-allocation goal, Parametric proposed a Custom Core® mandate of equity ETFs, using Parametric's tax-management solutions to avoid realizing a net loss in the ETF portfolio. We held regional ETFs, since additional securities allowed for more discretion for management of losses—that is, the wider spectrum of distinct securities meant the dispersion in returns of the ETFs allowed for some holdings to be in a gain position, despite the overall equity markets having fallen. In the case where a loss must be realized in the portfolio (due to rebalancing or raising of cash), this dispersion in returns increases the probability of the existence of a realized gain with which to offset the loss.

In addition, ETFs representing global equity benchmarks have suffered from low liquidity, since there appears to be higher investor interest in regional and country-specific ETFs. As a result, the suggested combination of regional ETFs actually proved to be more liquid than simply buying a global-equity ETF.

Parametric also restricted trades in our systems to be gain-loss neutral—in other words, any capital losses incurred must be offset by the realization of a capital gain. In addition, we performed quarterly trades to coordinate gain and loss matching across the bond and equity portions of the school fund's portfolio to ensure that the overall portfolio allocation was kept in place without realizing a gain.

How to add global equities without incurring a net capital loss in the portfolio?

We proposed a Custom Core mandate of equity ETFs, using our tax-management solutions to avoid realizing a loss.

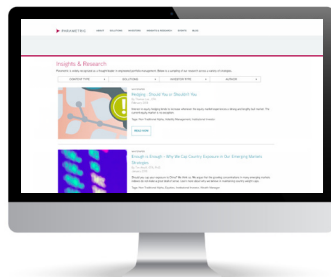


Results

By avoiding realized losses, Parametric helped the client observe its legal restrictions while diversifying into both income and growth assets. This allowed the state school fund to generate the needed income for its obligations while tapping the higher expected growth rates of equities to increase the underlying pool of assets over the long term. In the bigger picture this allowed the state education fund to balance the two competing beneficiaries of their assets: the income to support current educational initiatives and the asset growth to ensure it can continue to generate income for future students.

Parametric helped the client observe its legal restrictions while diversifying into both income and growth assets.

At Parametric, we manage more than \$78 billion in assets in Custom Core accounts alone. Working within institutional constraints while providing the client with its desired asset allocation is a key component of our approach.



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