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March 2022

Rebalancing Through an Overlay Strategy During Periods of Volatility

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Periods of high volatility create opportunities for investors to add value through portfolio rebalancing, yet many institutional investors face challenges in implementing a portfolio-rebalancing strategy that provides for discipline and responsiveness during volatile markets. A lack of consolidated current portfolio values and onerous formal decision-making and approval processes—coupled with determining the right time to trade—often delay identifying and acting on rebalance triggers. Once approval is obtained, coordinating with many managers to buy and sell physical securities and/or funds can be time-consuming and expensive. Responding in a timely and efficient manner to unanticipated market moves under this scenario can be very challenging.
How to address this challenge?

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Potential solution

Rebalancing through an overlay introduces daily monitoring, real-time portfolio rebalancing, and the potential for reduced transaction costs—all while improving policy benchmark tracking. Daily monitoring by the overlay manager allows for immediate identification of and response to portfolio imbalances. When rebalancing is necessary, the overlay manager brings asset classes back to the policy target by using long or short positions of exchange-traded futures, exchange-traded funds, and swaps rather than directing purchases and sales of the investor's individual holdings.

After portfolio imbalances exceed predetermined thresholds, the overlay manager buys policy benchmark exposure to fill underweight classes and sells policy benchmark exposure to reduce overweight classes, thereby bringing the entire portfolio back to policy in a disciplined, timely, and cost-effective manner. Using an overlay program to implement a disciplined rebalancing program reduces behavioral biases and forces the discipline of buying low and selling high.

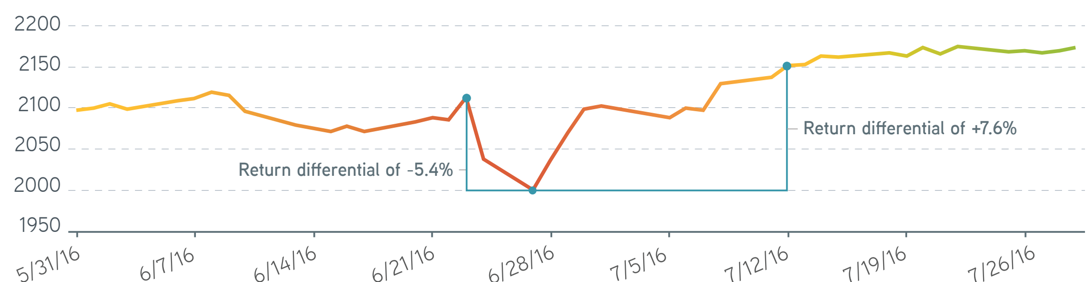
Advantages

- Timely and efficient reallocation of portfolio exposure
- Minimization of exposure gaps during the rebalancing process
- Tracking-error reduction through policy-exposure management
- Reduced behavioral biases
- Potential reduction in transaction costs compared with more traditional rebalancing

Example 1: Brexit

The United Kingdom's vote to leave the European Union in June 2016 is a prime example of how short-term volatility can produce a rebalancing opportunity. This unexpected event, popularly known as Brexit, pushed equity prices sharply lower and caused bond prices to rise around the world. In the two US trading days following the June 23 vote, the S&P 500® Index closed 5.4% lower (see figure 1). However, the drop in equity prices proved to be temporary, and in the following days and weeks the S&P 500® recovered all losses, rising further to establish new all-time highs.

Figure 1: S&P 500® Index total return, 5/31/2016–7/31/2016



Source: Bloomberg, 2016. For illustrative purposes only. It is not possible to invest directly in an index.

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Given the short-term nature of the equity sell-off and subsequent recovery, rebalancing via traditional methods would have limited an investor's ability to benefit from the temporary volatility created by Brexit. Institutional investors who use an overlay manager to rebalance their entire portfolio back to target allocations once preestablished trading bands are surpassed can capitalize on unexpected and often temporary volatility in the marketplace caused by events such as Brexit.

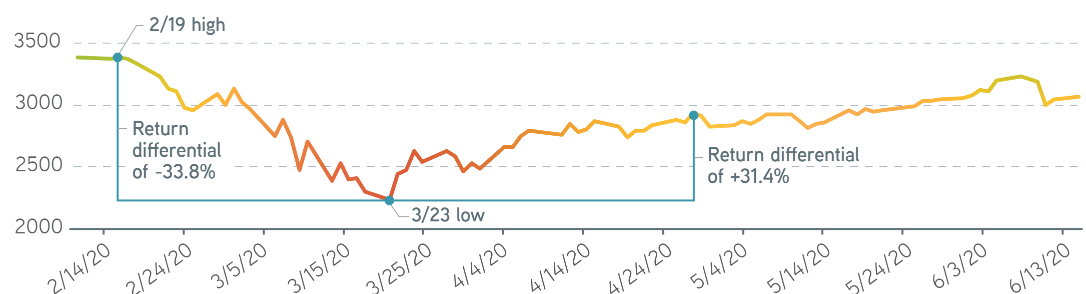
Indeed, on June 28, 2016, as equity prices plummeted, Parametric purchased equity exposure and sold fixed income exposure to bring all asset classes back to policy for our institutional clients who triggered a rebalance, enabling them to add equity exposure near the lows of this period. That July, as clients triggered a rebalance following the run-up in equity prices (again, see figure 1), Parametric sold equity exposure and purchased fixed income exposure to bring all asset classes back to policy targets.

During this two-week period, the S&P 500® rose almost 8%. Automatic rebalancing through an overlay strategy allowed institutional investors to benefit from this short-term market move without the need to move any physical assets in their portfolio. Declining markets may continue to decline, of course; however, rebalancing is a policy-based exercise that tends to add return over multiple market cycles.

Example 2: COVID-19

February and March 2020 brought new volatility to the markets as realization that the coronavirus would permeate the US took hold. By March 23, the S&P 500® had fallen approximately 34% from its peak in February in only 23 trading days. In addition, most markets experienced a significant decline in liquidity, which made physical rebalancing difficult and costly. While market participants debated whether the economic recovery would be V-shaped or prolonged, March 23 proved to be the low point for the S&P 500® in 2020 as the index advanced 30% over the next 27 trading days, later hitting new highs by late August.

Figure 2: S&P 500® Index total return, 2/15/2020–6/13/2020



Source: Bloomberg, 5/14/20. For illustrative purposes only. It is not possible to invest directly in an index.

The heightened volatility during this period resulted in an increased opportunity for investors to benefit from a disciplined and responsive rebalancing program through an overlay strategy. By using an overlay program to rebalance portfolio exposures, investors were able to realign exposures to benefit from the sharp drawdown and quick recovery and to utilize instruments that are more cost-effective than rebalancing physically. It's important to note that capturing this rebalancing benefit didn't require any market-timing skill. The portfolio is automatically rebalanced immediately after predefined thresholds are exceeded. This action removes emotional biases from the rebalancing decision.

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Conclusion

Adopting a preapproved, disciplined rebalancing strategy through an overlay program allows investors to adjust exposure quickly and relatively cheaply in times of high volatility. In addition, automatic rebalancing removes uncertainty and behavioral implications that can lead to inaction or the wrong action. Reacting to market volatility with a focus on controlling policy-based risk often produces meaningful amounts of incremental return.

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