

Streamlining Liquidity and Exposure Management Within Multimanager Funds

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It's becoming a common approach to use multimanager funds in defined contribution (DC) plans to increase efficiencies and 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. One key challenge of managing these funds is liquidity management. Using an overlay manager can help meet this challenge in a few surprising ways.

Key takeaways

- » An overlay can mitigate cash drag and provides operational efficiencies in fund liquidity management through two primary functions: cash overlay and centralized coordination of manager activity.
- » Implementing an overlay program in multimanager funds can create cash drag, which can improve tracking error and incrementally increase return.
- » Overlay within a multimanager fund increases staff efficiency and can improve fund performance by reducing administrative burdens and centralizing liquidity management.
- » Because it requires only a small portion of notional exposure to be held as collateral, overlay can also reduce transaction costs and residual cash.

Decomposition of short option performance

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

Liquidity management is a key challenge for fund managers managing these funds. 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. Using an overlay manager can help tackle this challenge, generating operational efficiencies, improved tracking error, and the potential for incremental return for the funds.

The challenge of liquidity management

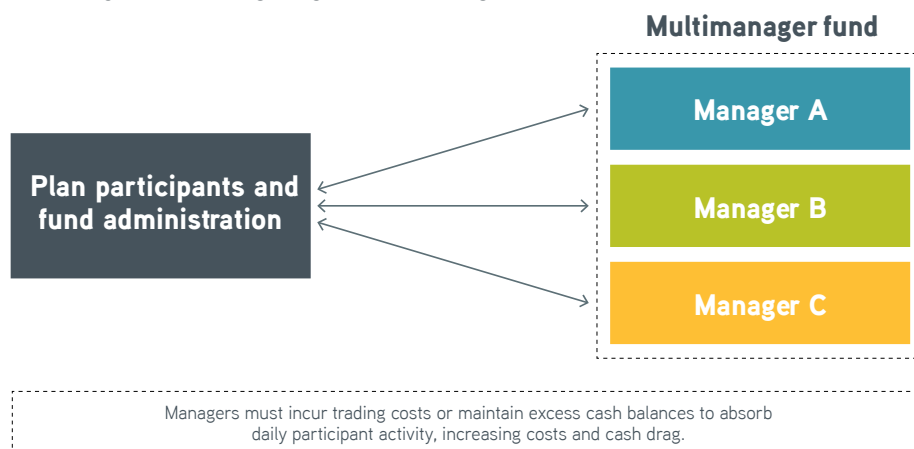
All multimanager funds must have a framework to support participant and investment manager activity. In many cases, a manager uses a liquidity sleeve holding cash to absorb this activity, serving as the account through which all this activity passes. However, in cases where there’s no liquidity sleeve,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

Creating liquidity management efficiencies with an overlay

An overlay can mitigate cash drag and provide operational efficiencies in fund liquidity management through two primary functions:

- *Cash overlay.*¹ Overlay exposure adds market exposure to align with fund liquidity and can reduce the impact of cash drag. Fund managers can adjust the overlay each day as contributions and redemptions occur, with lower transaction costs than trading physical securities. The overlay can also include frictional manager cash, reducing cash drag across all accounts in the fund. In this way fund managers can carry more liquidity—typically amounting to 2% to 5% of the total fund size—to reduce the frequency of raising or sending 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. The manager then adjusts overlay exposure to align with trading activity, mitigating unnecessary gaps or fluctuations in market exposure during the transition of assets.

FIGURE 1: LIQUIDITY MANAGEMENT BEFORE CENTRALIZATION



Source: Parametric, 3/31/2023. For illustrative purposes only. Not a recommendation to buy or sell any security.

The benefits of an overlay manager

Using an overlay manager for fund liquidity management can offer the following benefits:

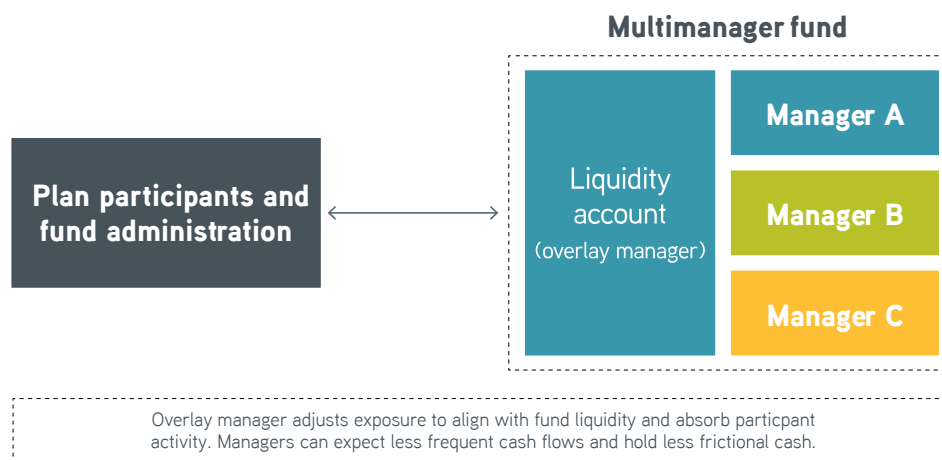
- Increased expected return by eliminating cash drag
- Improved fund tracking error by mitigating exposure gaps during investment activity
- Reduced transaction costs and residual cash in underlying managers
- Increased staff efficiency by reducing day-to-day administrative burden

An overlay can also improve liquidity management relative to a passive index fund. An overlay requires only 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, managers can trade index funds only at market close, which may require advance notice, potentially introducing unnecessary gaps in market exposure. On the other hand, managers can trade futures 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.

Conclusion

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

FIGURE 2: STREAMLINING LIQUIDITY MANAGEMENT MECHANICS AFTER INCORPORATING AN OVERLAY MANAGER



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Notes

1. Fong, Richard. 2022. "Cash Securitization: The Challenge of Effective Liquidity Management," Parametric, October 2022. <https://www.parametricportfolio.com/Insights-and-Research/Cash-Securitization>

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