INVESTOR CHALLENGE

Institutional Investor Uses Parametric Overlay Program to Manage Liquidity During Market Stress

CHALLENGE

Could an investor maintain sufficient liquidity during market stress?

SOLUTION

Parametric offers an overlay program that can be used for plan expenses and to rebalance a portfolio back to the policy targets.

RESULTS

The investor wasn't forced to sell assets at a discount and remained on target.

Challenge

One of the major concerns for an institutional investor is maintaining sufficient liquidity in their portfolio during periods of high volatility and market stress. During the market volatility caused by the COVID-19 pandemic, for example, an institutional client was challenged to raise cash for ongoing plan obligations (such as benefit payments and capital calls). At the same time, there was a desire to rebalance the portfolio out of asset classes that were overweight to their policy target (such as fixed income) and into asset classes that were underweight (such as equities).

Investors who chose to sell fixed income exposure were often forced to do so in illiquid markets.

The problem this investor faced during this time was that the institution's desired source of liquidity was the fixed income market, which at the time was strained from a liquidity perspective. Investors who chose to sell fixed income exposure were often forced to do so in illiquid markets in which assets were sold at steep discounts. During the COVID-19 pandemic, this had a negative effect on portfolio returns. However, equities were a good target for liquidity because they remained relatively liquid during this period of market stress.

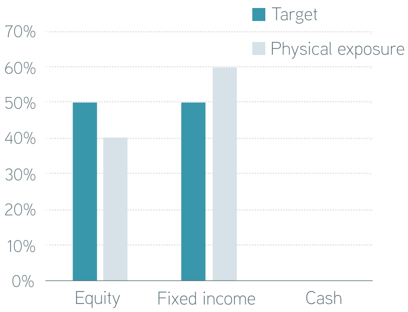
Solution

Parametric recommended an overlay program, which allowed the client to raise cash from the most liquid portion of their portfolio to use for plan expenses and to rebalance the portfolio back to policy targets.

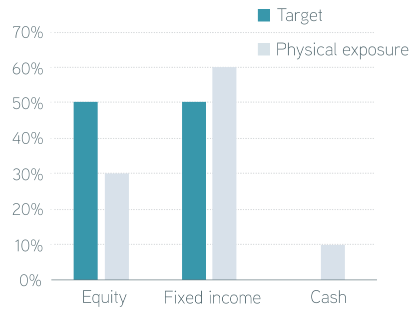
While counterintuitive at first, the solution allowed the client to sell physical equities to raise liquidity for ongoing cash needs and to fund a rebalancing overlay. It may appear that this left the client with a more severe underweight to equities, but the overlay program used this cash not only to replace the equity exposure that was sold but also to rebalance the overall portfolio exposures back to target. As a result, the client was in a position to both create sufficient liquidity and maintain their desired asset allocation.

The solution allowed the client to sell physical equities to raise liquidity for ongoing cash needs.

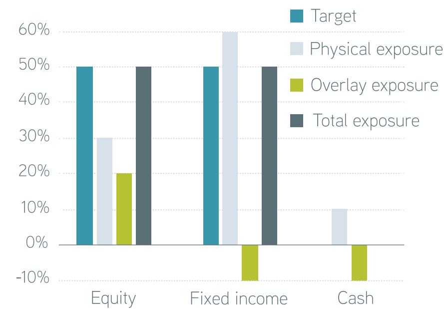
Portfolio asset mix with overlay



The portfolio begins underweight to equity and overweight to fixed income.



The client sells physical equities, reducing the exposure but creating cash.



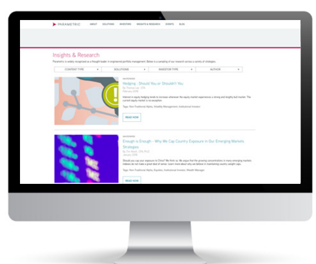
Through an overlay, the client can use the cash to trade derivatives to bring asset classes back to target.

The scenario presented is hypothetical and is presented for illustrative purposes. It does not reflect the experience of any specific investor. All investments are subject to risks, including the risk of loss.

Results

During the COVID-19 pandemic, a number of institutional investors—much like this client—made smart use of an overlay program and found themselves able to generate liquidity to rebalance their portfolio in a way they may not have been able to independently. By selling out of liquid asset classes, the client sidestepped the negative effects of selling assets at a discount and instead remained on target.

> The client sidestepped the negative effects of selling assets at a discount.



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