Portfolio Overlay Strategies

Managing risk, enhancing returns, protecting capital.

GRAYSWAN

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1. INTRODUCTION

Portfolio Overlay Strategies are valuable tools for institutional, family office and high net worth investors aiming to enhance returns, manage risk, and improve portfolio flexibility. Portfolio Overlay Strategies are particularly relevant and important when specialist asset class mandates are utilised rather than multi asset class mandates. These overlay strategies add an additional layer of active management i.e. (tactical asset allocation) as well as protection mechanisms (i.e. hedging) to an existing portfolio without impacting the existing underlying investment manager portfolios. In such cases, the asset allocation and hedging is managed from a top-level view by GraySwan.

2. TYPES OF PORTFOLIO OVERLAY STRATEGIES

There are several types of portfolio overlay strategies, but we will focus on two main types:

- TAA overlays: Tactical asset allocation overlays.
- Hedging overlays: Protection strategies to protect against various market risks.

2.1 TAA OVERLAYS

TAA overlays involve making short- to intermediate-term adjustments to a total portfolio's asset allocation based on market views (neutral, bearish, or bullish). Common instruments used include index- or sector-tracking ETFs or derivatives.

Strategic Asset Allocation (SAA) vs. TAA: Unlike SAA, which sets the long-term asset allocation mid-point or target allocation and which remains constant, TAA provides flexibility and adjustments to the asset allocation within a pre-defined range i.e. a minimum and a maximum allocation.

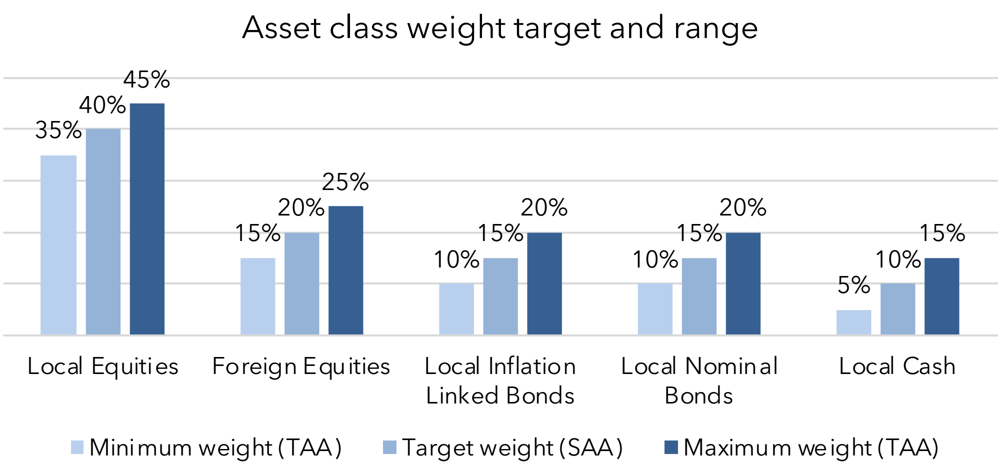
Example:

Strategic Asset Allocation:

- Local Equities: 40%
- Foreign Equities: 20%
- Local Inflation-Linked Bonds: 15%
- Local Nominal Bonds: 15%
- Local Cash: 10%

Tactical Asset Allocation Ranges:

- Local Equities: 35% to 45%
- Foreign Equities: 15% to 25%
- Local Inflation-Linked Bonds: 10% to 20%
- Local Nominal Bonds: 10% to 20%
- Local Cash: 5% to 15%



The tactical adjustments depend on the views (neutral, bearish, or bullish) on market factors such as the following:

- Economic indicators (GDP, inflation, employment data, consumer confidence)
- Interest rates and trends
- Market valuations (P/E ratios, bond yields, bond spreads)
- Market sentiment (surveys, volatility indices, trading volumes)
- Geopolitical events
- Currency exchange rates
- Monetary and fiscal policy
- Technical indicators (moving averages, market breadth)
- Global economic conditions
- Credit market conditions

TAA OVERLAY DECISION MAKING PROCESS

1. Strategic Asset Allocation (SAA)

- Establish the long-term SAA: Determine the long-term target asset allocation based on the investor's risk tolerance, investment objectives, and time horizon.

2. Tactical Asset Allocation (TAA)

- Set parameters for TAA adjustments i.e. the range relative to the SAA.
- Establish risk management guidelines to control the potential impact of the TAA decisions on the overall portfolio risk.

3. Develop the Tactical Asset Allocation (TAA) Views

- Develop views on short-to-medium-term market movements based on the market analysis.
- Identify opportunities or risks across all investable asset classes (e.g., equities, bonds, commodities, real estate).

4. **Implementation**

- Adjust the portfolio's asset allocation based on the TAA views, either increasing or decreasing exposure to certain asset classes via allocations to index tracking instruments or utilising derivatives.
- Execute the necessary trades to achieve the desired asset allocation adjustments.

5. **Monitoring and Review**

- Continuously monitor the performance of the TAA positions and the market conditions.
- Regularly review the assumptions and inputs used in the TAA decision-making process to ensure they remain valid.
- Evaluate the performance of the TAA strategy by comparing the actual portfolio performance to the SAA as well as any other relevant benchmarks.
- Analyse results: Analyse the results to understand the contribution of TAA decisions to overall portfolio returns and risk.

6. **Feedback and Adjustment**

- Use the insights gained from performance evaluation to refine the TAA process and improve future decision-making.
- Adjust the TAA strategy based on changing market conditions, new information, and performance outcomes.

2.2 HEDGING OVERLAYS

Hedging overlays protect against risks such as market volatility, currency fluctuations, and interest rate changes. Common hedging instruments include derivative instruments like options, futures & forwards, and swaps.

Options:

- **Put Options:** Right to sell an asset at a predetermined price.
- **Call Options:** Right to buy an asset at a predetermined price.

Futures & Forwards:

- **Futures:** Standardised contracts to buy or sell an asset at a future date for a predetermined price.
- **Forwards**: Customised contracts to buy or sell an asset at a future date for a predetermined price but not traded on exchanges, offering more flexibility.

HEDGING OVERLAY DECISION MAKING PROCESS

1. **Risk Assessment**

   - Determine the specific risks that need to be hedged, such as currency risk, interest rate risk or equity risk.
   - Quantify the exposure to each identified risk using quantitative and scenario analyses tools.

2. **Hedging Objectives**

   - Select the appropriate hedging instruments, such as futures, options, swaps, or forwards.
   - Consider the characteristics of each instrument, including cost, liquidity, and the correlation with the underlying exposure.

3. **Hedge Instrument Selection**

   - Select the appropriate hedging instruments, such as futures, options, swaps, or forwards.
   - Consider the characteristics of each instrument, including cost, liquidity, and the correlation with the underlying exposure.

4. **Implementation**

   - Execute the necessary trades to establish the hedge positions.

5. **Monitoring and Adjustment**

   - Regularly monitor the hedged positions and the underlying exposures to ensure the hedge remains effective.
   - Adjust the hedging positions as needed based on changes in market conditions, portfolio composition, or risk tolerance.
   - Evaluate the performance of the hedging strategy by comparing the actual results to the objectives and benchmarks.
   - Adjust the hedging strategy based on the performance evaluation and any changes in the investment environment or risk profile.

6. **Reporting and Compliance**

   - Maintain thorough documentation of the hedging process, decisions made, and rationale for those decisions.

3. HOW DO PORTFOLIO OVERLAY STRATEGIES WORK?

A portion of the total portfolio's assets (e.g., 10%) is allocated for use of tactical asset allocation and hedging decisions. When not actively used, this portion is placed in a liquid investment instrument like a Money Market Fund or account. Funds are transferred to a Broker's initial margin account when needed, with margin serving as a deposit for any derivative exposure.

Examples of Portfolio Overlay Strategies in action:

3.1 TAA OVERLAYS

Using Index Futures:

Scenario: The investment manager expects the local stock market to perform well for the 12 months.
Action: Buy Equity Index futures (e.g., JSE All Share futures).
Outcome: If the market rises, the futures contracts gain value, enhancing returns.

Using an Index Fund:

Scenario: The investor anticipates stocks will outperform bonds.
Action: Sell bond holdings and buy a diversified equity index fund.
Outcome: Increase exposure to potential stock market gains.

3.2 HEDGING OVERLAYS

Protective Put Strategy:

Scenario: The investor wants to protect against an equity market downturn.
Action: Buy put options on a major equity market index.
Outcome: If the market falls, the put options increase in value, offsetting losses.

Currency Hedging with forwards:

Scenario: The investor is concerned about the Rand appreciating.
Action: Buy a put option on the USD / ZAR.
Outcome: Offset currency appreciation losses with the option contract gains.

4. CONCLUSION

Portfolio Overlay Strategies offer a valuable means for institutional, family office and high net worth investors to enhance returns, manage risk, and increase flexibility without altering the fundamental structure of their portfolios. By implementing tactical asset allocation (TAA) and hedging overlays, investors can make short-to intermediate-term adjustments based on market conditions and protect against various risks.

Key Benefits:

- Enhanced Returns: TAA overlays allow for tactical adjustments to capitalize on short to medium term market opportunities.
- Risk Management: Hedging overlays provide protection against market volatility, currency fluctuations, and interest rate changes.
- Increased Flexibility: Portfolio Overlay Strategies enable investors to respond to changing market conditions without altering their long-term strategic asset allocation.

Continuous Monitoring and Adjustment:

- Regular monitoring and review are crucial to ensure the effectiveness of Portfolio Overlay Strategies.
- Strategies need to be based on performance evaluations, changing market conditions, and new information.
- Transparent reporting and thorough documentation need to be maintained to keep stakeholders fully informed.

Contact GraySwan today and connect directly with Gregoire Theron and Duncan Theron. Collectively, they boast more than 50 years of investment experience and have been working together for more than 20 years as a dynamic and cohesive decision-making unit, supported by our highly experienced and stable investment team. Their insights can help you navigate complexity, manage risk, and invest with confidence.

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