PROPOSED GIPS GUIDANCE STATEMENT ON
OVERLAY STRATEGIES
WEBINAR

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WEBINAR AGENDA

• Guidance Statement on Overlay Strategies overview
• Public comment and consideration process
• Resources
• Q&A
HOW TO ASK A QUESTION

You may ask your questions by doing the following:

Type your question in the Q&A box at the bottom of your screen: We will try to answer your question during the Q&A sessions. If we can’t get to your question during the Q&A sessions, or if you have any follow up questions after the webinar, please submit your question to the GIPS Helpdesk at gips@cfainstitute.org and we will respond to you via email later.

Note: You may download a copy of this presentation at any time during this webinar.
REASONS FOR GUIDANCE ON OVERLAY STRATEGIES

• A key strategic priority of GIPS Executive Committee
• The GIPS standards currently offer little guidance
• Overlay strategies present a number of challenges including calculation of firm assets, composite construction, and return calculation.
• The growth of overlay strategies underscores the need for guidance in this area.
INTRODUCTION

• No uniform definition of the term “overlay strategy”
• Broadly speaking, overlay strategy is where the management of a certain aspect of the strategy is carried out separately from the underlying portfolio.
• Overlay strategies are typically designed to either:
  - limit or maintain a specified risk exposure present in the underlying portfolio, or
  - profit from a tactical view on the market by changing a portfolio’s specified risk exposure.
• The underlying portfolio may consist of cash and/or securities, or may be a notional amount representing exposure to a particular asset.
INTRODUCTION

• Overlay portfolio may be managed by same firm or separate firm that is managing the underlying portfolio.

• Overlay strategies are often implemented using derivatives, which can lead to the fair value of the overlay portfolio being very small, negative, or even zero.

• Overlay portfolios can be highly leveraged.
INTRODUCTION

• Firms that act as overlay managers for wrap fee/separately managed accounts must consult the Guidance Statement on Wrap Fee/Separately Managed Account (SMA) Portfolios.

• Overlay Guidance Statement is not applicable to firms that act as the overlay manager for multiple-strategy portfolios that are part of a wrap fee/separately managed account program or similar bundled fee programs.
COMMON TYPES OF OVERLAY STRATEGIES

Overlay strategies include, but are not limited to:

- Currency overlay
- Asset allocation overlay
- Interest rate overlay
- Option overwrite overlay
COMMON TYPES OF OVERLAY STRATEGIES

Currency Overlay Strategies
Used to increase/decrease, or maintain the currency exposure of an underlying portfolio by using forward foreign exchange contracts.

Examples of currency overlay investment objectives:
- Hedging against adverse movements in foreign currencies
- Participating in positive movements in foreign currencies
- Reducing the volatility impact of the foreign currencies in the portfolio
COMMON TYPES OF OVERLAY STRATEGIES

Asset Allocation Overlay Strategies

Used to increase/ decrease, or maintain asset class exposure of an underlying portfolio through the use of futures, swaps, options and/or swaptions.

A tactical asset allocation (TAA) overlay is a type of asset allocation overlay where the overlay manager attempts to profit by increasing/decreasing exposure.
COMMON TYPES OF OVERLAY STRATEGIES

Interest Rate Overlay Strategies
Typically used to adjust interest rate sensitivity by using cash instruments and interest rate derivatives, such as interest rate futures, swaps, and/or swaptions.

Examples include, but are not limited to:
- Hedging a set of cash flows
- Managing an interest rate overlay to a specified benchmark
- Managing the target duration
COMMON TYPES OF OVERLAY STRATEGIES

Option Overwrite Overlay Strategies
Typically used to seek gains through premium income and trading in options on specific securities and indexes.

Option overwrite overlay strategies are typically either risk-reducing (hedge) or return-enhancement strategies.
OVERLAY EXPOSURE

Overlay exposure must be the notional exposure of the overlay strategies being managed, the value of the underlying portfolios being overlaid, or a specified target exposure (‘the allowable methods”).
OVERLAY EXPOSURE FEEDBACK QUESTIONS

• Are the three "allowable methods" for calculating overlay exposure appropriate?

• Are there other methods for calculating overlay exposure that are also appropriate?

• Should the allowable method(s) be required or recommended by strategy type?
OVERLAY EXPOSURE PRINCIPLES

• Overlay exposure must fairly represent the overlay strategies being managed.

• Overlay exposure calculations are independent of total firm and composite assets calculations.

• Total firm overlay exposure include all discretionary and non-discretionary overlay strategies where firm has investment responsibility. As well all overlay strategies assigned to a sub-advisor provided the firm has discretion over the selection of the sub-advisor.
OVERLAY EXPOSURE PRINCIPLES

• If underlying portfolio is managed by the firm, underlying portfolio must be included in total firm assets, and if appropriate, must also be included in a composite and composite assets, where as overlaid assets must not be included in total firm assets or composite assets when the underlying portfolio is not managed by the firm.

• Composite overlay exposure must be calculated using one of the allowable methods on a composite by composite basis.

• When calculating total firm overlay exposure, firms must sum the overlay exposures of all portfolios managed, even if different allowable methods are utilized…must not recalculate overlay exposures to a single method.
COMPOSITE CONSTRUCTION

• Composites for overlay strategies are subject to the Guidance Statement on Composite Definition; i.e. composites must be defined according to investment mandate, objective, or strategy and the firm’s criteria for defining composites must be applied consistently.

• Possible criteria for defining overlay strategy composites include exposure limits, target volatilities, hedge ratios, etc.
COMPOSITE CONSTRUCTION

• Composites must include new portfolios on a timely and consistent basis after each portfolio comes under management.

• Overlay portfolios are often invested quickly due to derivative use. May result in a new portfolio policy which brings portfolios into overlay composites faster than for non-overlay composites.

• Firms must establish a new portfolio policy on a composite-specific basis.
SELECTION OF OVERLAY BENCHMARKS

• The GIPS standards require benchmark returns to be presented in each compliant presentation.
• Not unusual to use a custom overlay benchmark.
• A benchmark comparison may not be an appropriate way to evaluate the overlay strategy.
• Hence, some firms use market indices or absolute return targets as benchmarks.
• Firms must determine which benchmarks are most appropriate for their overlay composites.
TREATMENT OF EXTERNAL CASH FLOWS

- External cash flows for overlay portfolios do not directly relate to physical cash flows into/out of the portfolio, but to changes in overlay exposure.
- Hence, client or underlying manager directed exposure changes are considered to be external cash flows. GIPS guidance on external cash flows, large cash flows, significant cash flows and temporary new accounts apply to overlay portfolios in this context.
TREATMENT OF EXTERNAL CASH FLOWS

• Large cash flows must be defined for each composite to determine when portfolios in that composite must be valued and portfolios must be valued on the date of all large cash flows.

• Firms with overlay portfolios must define a large cash flow at the level at which the firm determines that an external cash flow (i.e., overlay exposure change) may distort performance if the overlay portfolio is not valued.

• Firms must define a large cash flow amount in terms of the exposure, or a percentage of the exposure to overlay portfolio or overlay composite assets.
TREATMENT OF EXTERNAL CASH FLOWS

• Significant cash flow policy for overlay composites is optional.
• Significant cash flow would be defined at level an external cash flow (i.e., overlay exposure change) may temporarily prevent the firm from implementing the overlay composite strategy.
• Measure of significance must be a specific monetary exposure amount or a percentage of overlay portfolio assets.
• When there is a significant overlay exposure change, the entire portfolio would be temporarily removed from the composite.
• Alternatively, can use a temporary new account to remove the effect of a significant cash flow on a portfolio.
• See the GIPS Guidance Statement on Treatment of Significant Cash Flows for further information.
PERFORMANCE CALCULATION

• GIPS guidance on calculation methodology applies to overlay portfolios.
• The following slides provide additional guidance and new requirements on the time-weighted return calculations for overlay portfolios.
OVERLAY PORTFOLIO PERFORMANCE CALCULATION: NUMERATOR

• Must include all income as well as unrealized and realized gain/loss earned during the period, calculated after trading expenses (i.e., profit/loss).

• Accrual accounting must be used for instruments that accrue interest.
OVERLAY PORTFOLIO PERFORMANCE CALCULATION: DENOMINATOR

• Must be calculated by 1 of the following methods:
  - Notional exposure of overlay strategy as of beginning of period
  - Value of underlying portfolio being overlaid as of beginning of period
  - Specified target exposure as of beginning of period, which can be defined as either a target exposure or determined by a formula used to calculate the target exposure for each period.
OVERLAY PORTFOLIO PERFORMANCE CALCULATION: DENOMINATOR

• All portfolios in the composite must utilize the same method to calculate the denominator.
• Method used to calculate the denominator of the portfolio return must be the same used to calculate the composite’s total overlay exposure.
• Firms must consistently apply the methodology chosen to calculate the denominator.
TREATMENT OF COLLATERAL

• Use of derivatives often requires collateral.
• The use of the collateral value as the denominator is an inappropriate method and results in a misleading return.
• Collateral value is typically a fraction of the exposure value.
• If management of collateral is part of the overlay strategy, then collateral income must be included in the numerator and the value of the collateral as of the beginning of the period must be included in the denominator.
• If collateral management is not a part the strategy, collateral income must be excluded from the overlay portfolio return unless the collateral income is not available due to administrative limitations.
• Firms must establish a policy on the treatment of collateral in the portfolio return calculation on a composite specific basis.
COMPOUNDING RETURNS OVER TIME

• Generally, returns of overlay portfolios are geometrically linked over time. The purpose of geometric linking is to account for the compounding effect of returns.

• However, when the exposure remains constant over time, the overlay portfolio’s return must not be linked. Instead returns must be calculated as the cumulative profit/loss for the calculation period divided by the denominator.
• Do you agree that overlay returns must not be geometrically linked when the exposure remains constant, but rather the returns must be calculated as the cumulative profit/loss for the calculation period divided by the denominator?
OVERLAY COMPOSITE CALCULATION

• Overlay composite returns must be calculated using one of the methods described in the GIPS Guidance Statement on Calculation Methodology.

• When calculating overlay asset-weighted composite returns, the portfolios’ returns must be weighted based on the same denominators used to calculate the respective portfolio returns.
DISCLOSURES

• In addition to the required and recommended disclosure items within the GIPS standards, the proposed overlay guidance contains additional required disclosures for overlay strategy compliant presentations.
DISCLOSURES

• Firms must disclose:
  - both total firm overlay exposure and total composite overlay exposure as of each annual period end
  - allowable methodology used to calculate total composite overlay exposure and the allowable methodology (methodologies) used to calculate total firm overlay exposure
  - methodology used to calculate overlay portfolio returns, including how the denominator is calculated
  - if collateral and collateral income is reflected in the return, including when the inclusion of collateral income is due to administrative limitations
DISCLOSURES

• Firms that manage overlay strategies can choose not to present (a) composite assets and/or (b) either total firm assets or composite assets as a percentage of total firm assets when these numbers are not considered meaningful.

• Must disclose when these items are not presented because they are not considered meaningful.
• Overlay strategy compliant presentation examples:

A) Asset Allocation Strategy
B) Currency Overlay Strategy
C) Option Overwrite Strategy
PROPOSED EFFECTIVE DATE

• Firms would be required to apply this guidance for periods beginning on or after 1 January 2019.
• Firms are encouraged, but not required, to apply this guidance prior to the effective date.
PUBLIC COMMENT & CONSIDERATION PROCESS

Next Steps:
• Comments submitted through 27 November 2017
• 12 consultation questions
• GIPS Overlay Working Group to review all responses
• Document updated as needed
• GIPS Technical Committee Review
• Final review by GIPS Executive Committee
ADDITIONAL QUESTIONS?
RESOURCES

• The gipsstandards.org website:
  - Current edition of the GIPS Standards & GIPS Handbook
  - Complete list of Guidance Statements
  - Q&A database
  - White papers, educational materials and webcasts

• Helpdesk (gips@cfainstitute.org)

• Firm notification requirement (gipscompliance@cfainstitute.org)

• GIPS newsletter

• Twitter: @GIPS

• Certificate in Investment Performance Measurement (CIPM): cfainstitute.org/cipm
UPCOMING EVENTS

13 September 2017

GIPS Interactive Workshop – San Diego, California, US
Fundamentals of Performance Measurement & Attribution Workshop - San Diego, California, US

14-15 September 2017

GIPS Annual Conference – San Diego, California, US