CFA Institute®
Global Investment
Performance Standards

GUIDANCE STATEMENT ON OVERLAY STRATEGIES

EFFECTIVE DATE: 1 JANUARY 2022
PUBLIC COMMENT PERIOD: 29 AUG 2017 – 27 NOV 2017

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GUIDANCE STATEMENT ON OVERLAY STRATEGIES

Introduction

The following guidance has been developed to address applying the GIPS standards to overlay strategies. An overlay strategy is one in which the management of a certain aspect of an investment strategy is carried out separately from the underlying portfolio and it is offered as a separate strategy. Overlay strategies are typically designed either (1) to limit or maintain a specified risk exposure that is present in the underlying portfolio or (2) to profit from a tactical view on the market by changing a portfolio's specified risk exposure. In addition, some overlay strategies seek to add value against a specified target allocation or allocated capital at risk. Overlay exposure—the economic value for which a firm has investment management responsibility—is the notional value of the overlay strategy being managed, the value of the underlying portfolio being overlaid, or a specified target exposure. Overlay strategies are often unfunded and implemented using derivatives, which can lead to the overlay portfolio's fair value being very small, negative, or even zero. The overlay portfolio itself can be highly leveraged as a result of the use of derivatives.

An overlay portfolio may be managed either by the same firm that is managing the underlying portfolio or by a separate firm.

Scope of the Guidance Statement on Overlay Strategies

The purpose of this Guidance Statement is to provide guidance on how to apply the GIPS standards to overlay strategies and portfolios. Guidance is provided in the following areas:

- Common types of overlay strategies
- Definition of investment discretion
- Overlay exposure
- Composite construction
- Selection of benchmarks
- Treatment of external cash flows
- Return calculation
- GIPS Composite Reports
- Effective date

This Guidance Statement does not apply to firms that act as an overlay manager for multiple-strategy portfolios that are part of a wrap fee program or similar bundled fee programs. Firms that act as overlay managers for wrap fee portfolios should instead consult the Guidance Statement on Wrap Fee Portfolios, which is available on the GIPS standards website (www.gipsstandards.org).

Common Types of Overlay Strategies

Common types of overlay strategies include, but are not limited to, currency overlay, asset allocation overlay, interest rate overlay, absolute return overlay, and option overwrite overlay. This section briefly describes these types of overlay strategies.

Currency Overlay

A currency overlay strategy is typically used to increase, decrease, or maintain the currency exposure of an underlying portfolio by using derivatives, such as forward foreign exchange contracts. Currency overlay strategies may be passive, in which the overlay aims to eliminate a specific portion of the currency exposure in the underlying portfolio, or active, in which the overlay aims to add value by adjusting the currency exposure of the underlying portfolio. The following are examples of currency overlay strategies:

- Hedging against adverse movements in foreign currencies
- Participating in positive movements in foreign currencies
- Reducing the volatility impact of foreign currencies

Active currency overlay strategies may also be implemented on the basis of a notional amount, in which the objective is to add value by creating currency exposure up to this notional amount.

Asset Allocation Overlay

An asset allocation overlay strategy is typically used to increase, decrease, or maintain the asset class exposure of an underlying portfolio through the use of derivatives, such as futures, swaps, options, and/or swaptions. A tactical asset allocation (TAA) overlay is a type of asset allocation overlay in which the overlay manager attempts to profit by increasing or decreasing exposure of an underlying portfolio to one or more asset classes, countries, industry sectors, or other characteristics.

For example, a TAA overlay strategy could require the overlay manager to make tactical asset allocation decisions that are implemented using long and short derivative positions in the overlay portfolio. The overlay manager is provided the underlying asset class exposure with a target tracking error. In establishing the overlay portfolio's short positions, the overlay manager is required to take into account the underlying portfolio such that the total exposure to a particular asset class or security position cannot be below zero.

Interest Rate Overlay

An interest rate overlay strategy is typically used to adjust interest rate sensitivity by using cash instruments and interest rate derivatives, such as interest rate futures, swaps, and/or swaptions. In an active interest rate overlay strategy, the overlay manager separately manages the interest rate risk component of the underlying fixed-income portfolio such that incremental returns can be generated based on interest rate movements. A passive interest rate overlay strategy aims to manage the interest rate risk of the underlying portfolio on either a benchmark-relative or absolute basis. Benchmark-relative interest rate management aims to align the duration of the underlying portfolio with the duration of a benchmark. An interest rate overlay strategy on an absolute basis attempts to obtain a specified level of interest rate sensitivity and is often known as "dollar duration."

Interest rate overlay strategy examples include, but are not limited to, the following:

- Hedging a set of cash flows
- Managing an interest rate overlay to a specified benchmark
- Managing the target duration (the overlay manager uses interest rate instruments to adjust the duration of the underlying portfolio to a target duration)

Absolute Return Overlay

An absolute return overlay strategy is used to earn a positive return over time regardless of the direction of markets (e.g., up, down, or sideways). An absolute return overlay strategy is typically not limited by a benchmark.

Option Overwrite Overlay

An option overwrite overlay strategy is typically used to seek gains through premium income and trading in options on specific securities and indexes. An option overwrite overlay strategy involves using option positions in which target exposure is not tied directly to the value of an underlying portfolio. Instead, exposure is typically managed to a predetermined reference target or capital-at-risk amount specified by the client. Option overwrite overlay strategies are typically either risk-reducing (hedge) or return-enhancing strategies.

Definition of Investment Discretion

Overlay portfolios are subject to the same criteria for the definition of investment discretion as described in the explanation of Provision 3.A.2 in the GIPS Standards Handbook. That is, portfolios may be considered non-discretionary if documented client-imposed restrictions significantly hinder the firm from fully implementing its intended strategy.

Investment restrictions imposed on overlay portfolios may be quite different from those typically encountered in traditional non-overlay portfolios. In addition to the examples included in the GIPS Standards Handbook of client-imposed restrictions that may cause a portfolio to be classified as non-discretionary, the following are examples of investment restrictions that may result in an overlay portfolio being characterized as non-discretionary, either initially or when the restrictions begin to hinder the manager's ability to implement the strategy:

- Maximum drawdown limits, loss limits, tracking error limitations, or other relevant limitations imposed by the client that result in the firm not being able to manage the portfolio in the intended manner.
- Counterparty limitations that may hinder the overlay manager's ability to obtain best execution of a transaction. These limitations could be directly imposed by the client or could result from credit restrictions placed on the client by counterparties.
- Client-imposed restrictions prohibiting the use of certain types of derivative instruments that the firm would normally use to implement its intended overlay strategy.

These examples do not automatically lead to classifying an overlay portfolio as non-discretionary, but the firm must evaluate each scenario based on the specific facts and circumstances to determine whether the client-imposed restrictions interfere with implementation of the intended overlay strategy.

The following are more specific examples of a counterparty limitation and a client-imposed investment restriction that may result in an overlay portfolio being characterized as non-discretionary.

Counterparty Limitation Example

An overlay manager typically implements its strategy by investing in various types of derivatives. A client's investment mandate, however, requires the overlay manager to use one specific counterparty for all derivative transactions. This overlay portfolio may be considered non-discretionary if the overlay manager is unable to implement the overlay strategy in the intended manner because of the counterparty restriction.

Client-Imposed Restriction Example

An interest rate overlay manager typically implements its strategy by entering into interest rate swaps to achieve each client's target duration. A new client's investment mandate, however, prohibits the use of interest rate swaps and requires the overlay manager to use futures instead. This overlay portfolio may be considered non-discretionary if the overlay manager is unable to implement the overlay strategy in the intended manner because of the investment restriction requiring the use of futures contracts.

Overlay Exposure

Overlay exposure is the economic value for which a firm has investment management responsibility. Overlay strategies are often unfunded and are implemented by using derivatives, which can lead to the fair value of overlay portfolios being very small, negative, or even zero. Composite assets and total firm assets for an overlay manager may, therefore, be quite small and may not be a good indication of the volume of assets being managed by the firm. The more meaningful information for an overlay manager would be composite and total firm overlay exposure.

Because of the nature of overlay strategies, the firm managing the overlay strategy might not manage the underlying portfolio. Therefore, it is helpful to understand the exposure overseen by the overlay manager. Overlaid assets must not be included in composite assets or total firm assets unless the underlying portfolio is managed by the firm. Firms also must not include overlay exposure in composite assets or total firm assets.

Overlay Exposure Principles

- Both total firm overlay exposure and total composite overlay exposure must fairly represent the overlay strategies being managed by the firm.
- Total firm overlay exposure must include all discretionary and non-discretionary overlay strategy portfolios for which the firm has investment management responsibility.[1]
- Total firm overlay exposure and composite overlay exposure calculations are independent of the total firm assets and composite assets calculations.
- Overlay exposure must be calculated by using the notional exposure of the overlay strategy portfolios, the value of the underlying portfolios being overlaid, or a specified target exposure. The same method must be used for all portfolios within a composite.[2]
- When calculating total firm overlay exposure, firms must sum the overlay exposures of all overlay portfolios managed, even if different allowable methods are used to calculate the portfolios' overlay exposure. For purposes of calculating total firm overlay exposure, firms must not recalculate overlay exposures to a single method.
- If the underlying portfolio is managed by the firm, the underlying portfolio must be included in total firm assets and must also be included in a composite and in composite assets, if appropriate.
- Both total firm overlay exposure and composite overlay exposure must include overlay strategies assigned to a sub-advisor provided the firm has discretion over the selection of the sub-advisor.

[1] Required for periods beginning on or after 1 January 2020.
[2] Required for periods beginning on or after 1 January 2020.

- If overlay exposure for portfolios within a composite is maintained in different currencies, the firm must convert the overlay exposure to the currency used in the GIPS Composite Report.

The following examples illustrate overlay exposure calculations.

Example: Currency Overlay Exposure

An overlay manager implements various passive currency hedging programs. The overlay portfolios managed have a variety of "base" currencies and a variety of "exposure" currencies (non-base currencies) that the overlay manager is responsible for hedging. Total firm overlay exposure is the aggregate value of all underlying portfolios in "exposure" currencies, irrespective of base currency, expressed in a single currency. Total composite overlay exposure is the aggregate value of underlying portfolios in "exposure" currencies included in a particular composite, expressed in a single currency. With respect to currency overlay, overlay exposure is also known as "hedgeable exposure."

A portfolio has holdings denominated in USD, EUR, JPY, CHF, and AUD. An overlay manager was appointed to hedge USD, EUR, and JPY to GBP and instructed to leave the CHF- and AUD-denominated assets unhedged. The overlay manager considers the GBP value of the USD, EUR, and JPY holdings as "overlay exposure," irrespective of the hedge ratio. The overlay exposure calculation does not include the GBP value of the CHF and AUD holdings because the overlay manager has no mandate to hedge these exposures.

Example: Beta Overlay Exposure

An overlay manager that does not manage the underlying portfolio is directed to obtain $500 million in notional exposure to the ABC Index. The overlay manager executes total return swap trades totaling $500 million notional exposure. Subsequently, the overlay manager is directed to pare its notional exposure to $250 million. Rather than paying break fees to reduce the exposure of the existing swap, the overlay manager enters into an offsetting swap whereby the portfolio pays the index return to a counterparty.

In total, the overlay manager now has $500 million notional exposure of received ABC Index swaps and $250 million in paid ABC Index swaps for this portfolio at period end. The overlay manager must reflect $250 million of notional exposure, not $750 million, in both its total firm overlay exposure and total composite overlay exposure calculations in order to fairly represent the overlay strategy being managed by the firm.

To differentiate, if the overlay manager has a portfolio with $500 million notional received ABC Index swaps in one composite and a portfolio with $250 million notional paid ABC Index swaps in another composite, the overlay manager must reflect $750 million notional exposure in its total firm overlay exposure, as well as $500 million and $250 million in the respective total composite overlay exposure calculations at period end.

Example: Absolute Return Overlay Exposure

The typical objective of an absolute return overlay is to add an incremental return to the underlying portfolio. Absolute return overlay exposure is typically expressed as the target exposure of the overlay strategy.

Example: Calculating Total Firm Overlay Exposure When Different Methods Are Used

Firm A offers two types of overlay strategies. In one strategy, called "Global Equity Beta Overlay," the composite overlay exposure of €500 million is calculated using the notional exposure of all portfolios in the composite at period end. In the second strategy, "Active Currency Overlay," the composite overlay exposure of €750 million is calculated using the value of the underlying portfolios at period end. Firm A would calculate total firm overlay exposure of €1,250 million by summing the overlay exposures of €500 million and €750 million.

Example: Overlay Manager Invests a Portion of Target Exposure

A firm is hired to manage an overlay portfolio to a $100 million notional amount, but the firm tactically decides to gain exposure only to a $30 million notional amount. Because the firm has an investment mandate that allows exposure to a $100 million notional amount, the firm is accountable for the tactical decision not to invest the full notional amount. Therefore, the firm must use the $100 million, not the $30 million, when calculating overlay exposure.

Composite Construction

If a firm manages portfolios with overlay strategies, the firm is required to create an overlay composite for an overlay strategy when the overlay strategy is managed separately from the underlying portfolio and the firm offers the overlay strategy as a segregated account. Firms are not required to create an overlay strategy composite when the overlay strategy is implemented as part of a broader strategy, but they may do so.

Composites for overlay strategies are subject to the same requirements as those for non-overlay strategy composites. That is, composites must be defined according to investment mandate, objective, or strategy and the firm's criteria for defining composites must be applied consistently. (See the explanation of Provision 3.A.5 in the GIPS Standards Handbook for additional guidance.) Possible criteria for defining overlay strategy composites include exposure limits, target volatilities, and hedge ratios.

Currency Overlay Composite Construction Criteria

a. Base currency: Hedging a particular "exposure" currency to a particular "base" currency will produce different (and opposite) results from a portfolio that is hedged the other way. Therefore, base currency is a key characteristic by which currency overlay composites can be constructed.

b. Benchmark hedge ratio: The results of a 100% hedge to a particular base currency will differ from a hedge of anything other than 100% to the same base currency. In addition, the benchmark for each portfolio with a different hedge ratio will differ. Using the benchmark hedge ratio as a criterion for constructing currency overlay composites may be appropriate.

c. Passive and active investment strategies: Passive and active currency hedging overlay strategies have very different risk and return characteristics and, hence, there should be separate composites for passive currency hedging overlay strategies and for active currency hedging overlay strategies.

Interest Rate Overlay Composite Construction Criteria

Overlay managers often must manage interest rate overlay mandates based on specific client guidelines and/or liability data, duration targets, or interest rate risk hedge ratios. The overlay manager may use a customized benchmark based on the plan's liability. It may be appropriate to construct single-portfolio composites because of the customized nature of the investment mandates or to create a single composite and use a portfolio-weighted custom benchmark.

Absolute Return Overlay Composite Construction Criteria

Criteria for constructing absolute return overlay composites may include absolute risk–return profiles and asset class allocation.

Treatment of New/Terminated Overlay Portfolios in Composites

The GIPS standards require that composites include new portfolios on a timely and consistent composite-specific basis after each portfolio comes under management. Because overlay strategies often use derivatives, overlay portfolios are often invested more quickly than non-overlay portfolios, which might result in a new overlay portfolio policy that includes such portfolios in overlay composites more quickly than the inclusion policy for non-overlay composites. Firms must establish a new portfolio inclusion policy on a composite-specific basis and apply it consistently.

Firms must also establish policies and procedures regarding the handling of the termination of portfolios in a composite, and firms must apply those policies and procedures consistently, on a composite-specific basis. Terminated portfolios must be included in the composite's historical

performance up to the last full measurement period that each portfolio was under management and for which the firm has discretion.

Example: Currency Overlay

New currency overlay portfolios will be included in a composite from the first full month following the portfolio's inception date, whereas terminated currency overlay portfolios will be included through the last full month that the portfolio was managed to the strategy.

Example: Interest Rate Overlay

New interest rate overlay portfolios are included in the composite at the beginning of the month after the required amount of dollar duration to meet the client's interest rate hedging objective is obtained. Terminated interest rate overlay portfolios are included in a composite through the last full month the portfolio was managed on a discretionary basis to the required amount of dollar duration.

Selection of Benchmarks

The GIPS standards require benchmark returns to be presented in each GIPS Composite Report. It is not unusual for a custom benchmark to be used for overlay strategies. A benchmark comparison for overlay strategies is not always used to assess the manager's performance in the same way that a comparison may be used for non-overlay strategies. An overlay benchmark may not be an appropriate measure to evaluate the overlay strategy. Therefore, firms may take various approaches when selecting a benchmark for overlay composites. Some firms use market indexes, whereas others use absolute return targets as benchmarks. The GIPS standards also require disclosure of the benchmark description in each GIPS Composite Report. The benchmark description is defined as general information regarding the investments, structure, and characteristics of the benchmark. The description must include the key features of the benchmark or the name of the benchmark for a readily recognized index or other point of reference. If the firm determines that no appropriate benchmark exists for the composite, the firm must disclose why no benchmark is presented. If the firm uses a custom benchmark or combination of multiple benchmarks, it must disclose the benchmark components, weights, and rebalancing process, if applicable, as well as the calculation methodology. It must also clearly label the benchmark to indicate that it is a custom benchmark.

Firms must determine which benchmarks are most appropriate for their overlay composites. When determining what benchmark information to present in a GIPS Composite Report of an overlay strategy, firms must be guided by the principles of fair representation and full disclosure.

Example: Currency Overlay Benchmark Description

The following benchmark disclosure examples are for passive currency overlays. The first example is for a multi-currency hedging program that aims to hedge 50% of the foreign currency exposure (risk currency). The second example is for a single-currency hedge with a 100% hedge ratio.

Benchmark Is 50% Hedged

The benchmark represents the performance of a one-month rolling currency hedge covering 50% of the exposure of each risk currency. The benchmark is constructed monthly by using mid-spot rates and one-month mid-forward points published by an independent source. The weighting of each currency in the benchmark replicates the currency weightings in the composite as of the beginning of each month.

Benchmark Is 100% Hedged

The benchmark is calculated from the cash flows arising from a passive hedge of the risk currency (EUR).

Example: Interest Rate Overlay Benchmark Description

The following benchmark disclosure examples are for interest rate overlays.

Benchmark Is a Blend of Interest Rate Swaps

The benchmark is a custom blend of various maturity interest rate swap indexes, less the one-month lending rate pro-rated for the number of days in the performance period and adjusted for the interest accrual on the difference in the value of the portfolio and the benchmark. The custom swap index returns are obtained from the index provider, and the custom swap blend may change from time to time at the client's discretion. The custom benchmark is rebalanced to the custom swap blend weights upon portfolio rebalancing, which is performed monthly.

Benchmark Is a Liability

The benchmark is the change in the present value of the liability's cash flows during the period.

Example: Absolute Return Overlay Benchmark Description

Because the composite's strategy is absolute return and investments are permitted in all asset classes, no benchmark is presented because we believe that no benchmark exists that reflects this strategy.

Example: Tactical Asset Allocation Overlay Benchmark Description

The benchmark is the target asset allocation blend, which is 40% XXX UK Equity Index, 25% YYY International Equity Index, and 35% ZZZ UK Fixed-Income Index. The benchmark is rebalanced monthly.

Treatment of External Cash Flows

The concept of external cash flows for overlay portfolios does not directly relate to physical cash flows into and out of the overlay portfolio but rather to changes in the overlay exposure (i.e., the notional exposure of the overlay strategy portfolios, the value of the underlying portfolios being overlaid, or a specified target exposure). Client or underlying manager-directed overlay portfolio exposure changes are considered external cash flows. GIPS standards guidance on external cash flows, large cash flows, and significant cash flows applies to overlay portfolios in this context.

With respect to large cash flows, the GIPS standards require that firms define large cash flows 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. These requirements apply to overlay strategy portfolios. Given the nature of overlay portfolios, it may be appropriate for a firm's large cash flow policy for overlay portfolios to differ from the firm's policy for other portfolios. Depending on the nature of the overlay exposure, it may also be appropriate to value for all changes in overlay exposure and not only large changes.

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 the overlay portfolio exposure or overlay composite exposure. Please see the calculation example below for the application of a large external flow to an overlay portfolio and the Return Calculation section for additional examples of the application of external cash flows to overlay portfolios.

The adoption of a significant cash flow policy for overlay strategy composites is optional. If such a policy is adopted, a significant cash flow would be defined as the level at which the firm determines that a client or underlying portfolio manager-directed external cash flow (i.e., overlay exposure change) may temporarily prevent the firm from implementing the overlay composite strategy. The measure of significance must be determined as either a specific monetary exposure amount or a percentage of overlay portfolio exposure (based on the most recent valuation), and no other criteria—such as the effect of the cash flow or the number of portfolios in the composite—may be considered. In the case of significant overlay exposure changes, the overlay portfolio would be temporarily removed from the composite while the new exposure is implemented. If a firm has adopted a significant cash flow policy for a specific composite, the firm must disclose how

it defines a significant cash flow for the composite and for which periods. See the explanation of Provision 3.A.12 in the GIPS Standards Handbook for further guidance on significant cash flows.

Example: Currency Overlay External Cash Flow Policies

A client-directed change in the foreign currency exposure of the underlying portfolio is considered an external cash flow. The overlay manager defines a large cash flow as an inflow or outflow that results in the currency overlay portfolio being outside the contractual tolerance limits of a 98% to 102% hedge ratio (around the target of 100%). Overlay portfolios will be revalued and performance will be calculated for all large cash flows.

The overlay manager defines a significant cash flow as an inflow or outflow that results in the currency overlay portfolio being outside the contractual tolerance limits of 90% to 110% hedge ratio (around the target of 100%). Overlay portfolios are temporarily removed from the currency overlay composite as a result of significant cash flows.

Example: Interest Rate Overlay Large Cash Flow Policy

The overlay manager manages an interest rate hedging portfolio to be duration neutral versus a relevant swap-blend benchmark. A client-directed cash flow resulting in an adjustment to the interest rate hedge will be considered a large cash flow, and the portfolio will be revalued when the effect of such a change is 0.50 years or greater than the target duration of the hedge.

Example: Cash Equitization Overlay Policy

An overlay manager is hired to equitize the underlying cash of an equity manager. The overlay manager uses derivatives to establish exposure equal to the cash held by the equity manager. When the equity manager informs the overlay manager that the amount of cash has changed, the target exposure has to be adjusted. This change in target exposure is treated as a large cash flow, and the portfolio is revalued.

Example: Return Calculation for a Notional Exposure Change Attributable to a Large External Cash Flow

The overlay manager does not manage the underlying portfolio. The overlay manager defines a large cash flow as an external cash flow greater than 10% of notional exposure.

Reference	Date	External Cash Flows ($)	Notional Exposure ($)	Profit from Overlay Strategy ($)	Total Return (%)
(A)	(B)	(C)	(D)	(E)	(F)
(i)	31 Dec 19		100,000,000		
(ii)	20 Jan 20	20,000,000	120,000,000	1,600,000	1.60
(iii)	31 Jan 20			1,120,000	0.93
(iv)					2.54

(i) As of 31 December 2019, the notional exposure (D) is $100 million.

(ii) As of 20 January 2020, the overlay manager is advised that the notional exposure (D) has increased to $120 million because of a $20 million external cash flow (C), which is a large cash flow because it is greater than 10% of the notional exposure. The profit (E) from 31 December 2019 to 20 January 2020 is $1.6 million, or a total return (F) of 1.60%.

(iii) The profit (E) from 20 January 2020 to 31 January 2020 is $1.12 million, or a total return (F) of 0.93%.

(iv) The overlay portfolio's January 2020 total return (F) is calculated by geometrically linking the two sub-period total returns such that [(1 + 1.60%) × (1 + 0.93%) − 1] = 2.54%.

Return Calculation

Given the nature of overlay strategies, the GIPS standards assume that all overlay return calculations are time-weighted returns. When calculating returns for overlay strategies, all provisions that apply to non-overlay portfolios apply to overlay portfolios. In addition, overlay portfolio return calculations are subject to additional requirements. The following sections provide additional guidance and requirements on the time-weighted return calculation for overlay portfolios for periods beginning on or after 1 January 2020.

Collateral/Margin

Overlay strategies typically require collateral (sometimes referred to as margin). The collateral provided may be for the required minimum or for a larger amount. The required minimum amount may be determined by law or regulation. The collateral can be managed in different ways, which can affect the overlay portfolio return calculation. For example, consider the following different scenarios:

- A client or another party manages the collateral separately from the overlay strategy. The overlay manager has no discretion over the collateral, so the collateral income should not be included in the overlay portfolio return.
- The collateral is actively managed by the overlay manager as part of the overlay strategy. In this scenario, the collateral income should be included in the overlay portfolio return.

Firms must establish a policy for the treatment of collateral in the portfolio return calculation on a composite-specific basis. To help prospective clients interpret the composite return presented, the firm must disclose if collateral and collateral income are reflected in composite returns.

Numerator

The numerator of the overlay portfolio return calculation must include all income and unrealized and realized gain/loss earned by the overlay portfolio during the period, calculated after the deduction of transaction costs incurred during the period (e.g., commissions on futures transactions or clearing fees on cleared swaps)—that is, the profit/loss.

Accrual accounting must be used for fixed-income securities and all other investments that earn interest income, except that interest income on cash and cash equivalents may be recognized on a cash basis. Any accrued income must be included in the beginning and ending portfolio values when performance is calculated.

If the management of the collateral is part of the overlay strategy, then any collateral income earned during the period should be included in the numerator.

Denominator

When calculating returns for an overlay strategy portfolio, the denominator must be one of the following:

- The notional exposure of the overlay strategy portfolio as of the beginning of the period;
- The value of the underlying portfolio being overlaid as of the beginning of the period; or
- The specified target exposure as of the beginning of the period, which can be defined as a target exposure or determined by a formula used to calculate the target exposure for each period.

Firms must consistently apply the methodology chosen to calculate the denominator. They must use the same method for calculating the denominator for all portfolios within a composite when calculating overlay strategy portfolio returns. In addition, firms must use this same method to calculate a composite's total overlay exposure. For periods ending prior to 1 January 2020, firms may use these same methods but are not required to do so.

When the overlay manager is hired to manage a level of notional exposure (e.g., $100 million) but chooses to invest only a portion of the notional exposure (e.g., $30 million), the denominator is the level of notional exposure the overlay manager was hired to manage (in this case, $100 million).

Some overlay strategies require the use of a specific denominator. For example, when an interest rate overlay is benchmarked to a set of cash flows, the notional amount of derivatives required to hedge the interest rate exposure will not equal the present value of the cash flows being hedged because the notional amount will vary depending on the instruments chosen to implement the hedge. An interest rate overlay return calculated by dividing the profit/loss earned by the portfolio during the period by the notional exposure of the instruments used would not be comparable to the change in present value of the cash flows being hedged. Therefore, the denominator for an interest rate overlay benchmarked to a set of cash flows must be the sum of the present value of the cash flows being hedged as of the beginning of the period.

The use of derivatives often requires collateral. The value of that collateral is typically only a fraction of the exposure value. Using the collateral value as the denominator for an overlay strategy instead of the exposure value is an inappropriate method. The value of the collateral should not be included in the denominator unless management of the collateral is part of the overlay strategy.

Compounding Returns over Time

Non-overlay portfolios generate profits and losses that can be reinvested, which affects the amount of assets that are assumed to be invested in the subsequent period. For example, if a $1,000 portfolio earns a 10% return in Period 1, it has $1,100 to invest in Period 2. It is therefore appropriate to compound (i.e., geometrically link) returns. Overlay portfolios also generate profits and losses, but these returns are not assumed to be reinvested into the overlay portfolio in the next period. Returns for an overlay portfolio are based on an economic exposure value and not on actual assets. For example, if a firm manages an overlay portfolio with a $1,000 exposure and the overlay portfolio has a gain of $100, the $100 gain is not added to the $1,000 exposure amount. In the subsequent period, the exposure amount continues to be $1,000. For this reason, returns of overlay portfolios may be arithmetically linked (i.e., summed) over time rather than geometrically linked.

Although arithmetically linking overlay portfolio returns is permitted, firms may choose to geometrically link overlay portfolio returns. Overlay portfolios create real profits and losses. When geometric linking is used, it is assumed that profits and losses are reinvested and earn the overlay portfolio return in the next period. Additionally, most performance systems are built to geometrically link returns.

The following example illustrates arithmetically linking and geometrically linking portfolio returns:

					Year-to-Date Total Return	
	Date	Target Exposure (€)	Profit/Loss from Overlay Strategy (€)	Monthly Total Return (%)	Arithmetically Linked (%)	Geometrically Linked (%)
(A)	(B)	(C)	(D)	(E)	(F)	(G)
(i)	Jan 2020	500,000,000	50,000,000	10.00	10.00	10.00
(ii)	Feb 2020	500,000,000	20,000,000	4.00	14.00	14.40
(iii)	Mar 2020	750,000,000	–36,000,000	–4.80	9.20	8.91

(i) The monthly total return (E) for January 2020 is 10% and is calculated as €50 million profit (D) divided by €500 million beginning-of-period target exposure (C).

(ii) The monthly total return (E) for February 2020 is 4.00%, calculated as €20 million profit (D) divided by €500 million target exposure (C). The year-to-date total return arithmetically linked is 14.00% (F), calculated by summing the monthly total returns (E) for January and February 2020: 10% + 4% = 14%. The year-to-date total return geometrically linked is 14.40% (G), calculated by linking the monthly total returns (E) for January and February 2020: (1 + 10%) × (1 + 4%) – 1 = 14.40%.

(iii) The monthly total return (E) for March 2020 is –4.80%, calculated as €36 million loss (D) divided by €750 million target exposure (C). The year-to-date total return arithmetically linked is 9.20% (F), calculated by summing the monthly total returns (E) for January, February, and March 2020: 10% + 4% + (–4.8%) = 9.20%. The year-to-date total return geometrically linked is 8.91% (G), calculated by linking the monthly total returns (E) for January, February, and March 2020: (1 + 10%) × (1 + 4%) × [1+ (–4.8%)] – 1 = 8.91%.

Composite returns for overlay composites may also be arithmetically linked. A firm must be consistent with the methodology used to link returns over time at the portfolio and composite levels.

Once a firm has chosen whether to arithmetically link or geometrically link returns, the firm must consistently use the methodology selected for each composite. The firm must disclose if it chooses to arithmetically link overlay strategy portfolio or composite returns.

Performance Calculation Examples

Example: Passive Currency Hedge Overlay

The passive hedge is designed to eliminate a portion of the currency risk in an international portfolio. Performance is typically calculated with reference to the "hedgeable notional exposure"—that is, the value in base currency of the underlying portfolios being hedged. The change in cumulative value in the base currency of the hedges in any period is often referred to as the "contribution from hedging." The performance of the currency overlay is then calculated as follows:

$$\frac{\text{Contribution from hedging (base currency)}}{\text{Hedgeable notional exposure at beginning of period (base currency)}}$$

The overlay manager will often determine what change in value of the underlying exposure would require a rebalance back to the target hedge ratio. For instance, the overlay manager may decide that hedge ratio variations between 98% and 102% (around the target of 100%) do not require the currency hedges to be rebalanced. In the event that the hedge ratio variation is breached and a rebalance of the currency hedge is implemented, then portfolio performance for the partial period before and after rebalancing must be calculated and linked to derive the full-period portfolio performance. Please see the following example.

Reference	Date	Hedgeable Notional Exposure (base currency) (€)	Profit from Hedging (base currency) (€)	Total Return (%)
(A)	(B)	(C)	(D)	(E)
(i)	31 Dec 19	100,000,000		
(ii)	20 Jan 20	120,000,000	1,600,000	1.60
(iii)	31 Jan 20		700,000	0.58
(iv)				2.19

(i) As of 31 December 2019, the hedgeable notional exposure (C) is €100 million, expressed in base currency. Currency hedges are implemented to hedge the currency risk associated with this hedgeable notional exposure.

(ii) As of 20 January 2020, the overlay manager is advised that the size of the hedgeable notional exposure (C) has increased to €120 million because of new investment into the underlying portfolio. This results in a hedgeable notional exposure increase of €20 million and the need to adjust the hedge size. The profit from hedging (D) from 31 December 2019 to 20 January 2020 in base currency is €1.6 million. The first sub-period total return (E) is calculated by dividing the profit by the beginning-of-period hedgeable notional exposure: €1,600,000/€100,000,000 = 1.60%.

(iii) The profit from hedging (D) from 20 January 2020 to 31 January 2020 is €0.7 million. The second sub-period total return (E) is calculated by dividing the profit by the beginning-of-period hedgeable notional exposure: €700,000/€120,000,000 = 0.58%.

(iv) The overlay portfolio's January 2020 total return (E) is calculated by geometrically linking the two sub-period total returns: [(1 + 1.60%) × (1 + 0.58%) − 1] = 2.19%.

Example: Interest Rate Overlay Benchmarked to a Blend of Interest Rate Swaps

The overlay manager determines the dollar duration required to achieve the client's specified interest rate target hedge, taking into account the client's specified other fixed-income assets that contribute to the hedge. In this example, the dollar duration required for the overlay manager to complete the hedge is $4 billion. The overlay portfolio's benchmark is a 50%/25%/25% blend of 10-, 20-, and 30-year swap indexes, which has a weighted duration of 14.03 years. Dividing the required $4 billion dollar duration by the 14.03 years weighted duration equals $285,103,350 swap notional in a 50%/25%/25% blend of 10-, 20-, and 30-year swap indexes required to achieve the client's target hedge. This amount is the specified target exposure for the period, because (1) the benchmark resets each month, while the portfolio does not necessarily terminate existing swaps and roll into new swaps each month, and (2) the portfolio may be positioned differently from the benchmark because of yield curve bets. Therefore, the portfolio may not have the same swap notional exposure as the benchmark. To provide a fair comparison of the portfolio dollar return versus the benchmark dollar return, the portfolio return calculation uses the specified target exposure as the denominator.

In the following example, the specified target exposure does not change during the month.

Reference	Date	Specified Target Exposure ($)	Profit from Overlay Strategy ($)	Total Return (%)
(A)	(B)	(C)	(D)	(E)
(i)	31 Dec 19	285,103,350		
(ii)	31 Jan 20		20,950,375	
(iii)				7.35

(i) As of 31 December 2019, the specified target exposure (C) is $285,103,350.

(ii) The profit (D) for January 2020 is $20,950,375.

(iii) The overlay portfolio's January 2020 total return (E) is calculated by dividing the profit by the beginning-of-period specified target exposure: $20,950,375/$285,103,350 = 7.35%.

In the next example, the client increases the specified target exposure on 15 January 2020. The increase in specified target exposure qualifies as a large cash flow because the firm's large cash flow policy defines a change in specified target exposure of more than 2% as a large cash flow.

Reference	Date	Specified Target Exposure ($)	External Cash Flows ($)	Profit from Overlay Strategy ($)	Total Return (%)
(A)	(B)	(C)	(D)	(E)	(F)
(i)	31 Dec 19	285,103,350			
(ii)	15 Jan 20	350,914,354	65,811,004	15,675,250	5.50
(iii)	31 Jan 20			10,144,535	2.89
(iv)					8.55

(i) As of 31 December 2019, the specified target exposure (C) is $285,103,350.

(ii) The profit (E) for the first half of January 2020 is $15,675,250. This first sub-period total return (F) is calculated by dividing the profit from the overlay strategy (E) by the beginning-of-period specified target exposure (C): $15,675,250/$285,103,350 = 5.50%. At the close of business on 15 January 2020, the client increases its target exposure by $65,811,004, which is considered a large cash flow (D) per the firm's policies. The new specified target exposure (C) at the close of business on 15 January 2020 is $350,914,354.

(iii) The profit (E) for the period after the large cash flow is $10,144,535. This second sub-period total return (F) for the second half of January 2020 is calculated by dividing the profit (E) by the beginning-of-period specified target exposure (C): $10,144,535/$350,914,354 = 2.89%.

(iv) The overlay portfolio's January 2020 total return (F) is calculated by geometrically linking the two sub-period total returns: [(1 + 5.50%) × (1 + 2.89%) − 1] = 8.55%.

Example: Cash Equitization Overlay

The overlay manager has been directed to obtain ABC Index exposure to equitize $249,186,371 in cash as of 31 December 2019. The overlay manager obtained the exposure by entering into a total return swap on ABC Index. The overlay portfolio's total return for January 2020 is calculated as follows:

Reference	Date	Exposure ($)	Profit/Loss from Overlay Strategy ($)	Total Return (%)
(A)	(B)	(C)	(D)	(E)
(i)	31 Dec 19	249,186,371		
(ii)	31 Jan 20		−7,602,981	
(iii)				−3.05

(i) As of 31 December 2019, the underlying cash portfolio to be equitized (C) is $249,186,371.

(ii) The loss (D) for January 2020 is $7,602,981.

(iii) The overlay portfolio's January 2020 total return (E) is calculated by dividing the loss (D) by the beginning-of-period exposure (C): −$7,602,981/$249,186,371 = −3.05%.

Overlay Composite Performance Calculation

Similar to non-overlay composites, composite time-weighted returns for overlay composites must be calculated using one of the following approaches:

a. Asset-weighting the individual portfolio returns using beginning-of-period values;

b. Asset-weighting the individual portfolio returns using a method that reflects both beginning-of-period values and external cash flows; or

c. Using the aggregate method.

When calculating asset-weighted composite returns for an overlay composite, the portfolios' returns must be weighted based on the same denominators used to calculate the respective portfolio returns.

GIPS Composite Reports

Overlay strategies can be more complex than non-overlay strategies. Firms must be guided by the ethical spirit of the GIPS standards in determining the level of disclosure required to enable a prospective client to interpret the overlay strategy's GIPS Composite Report.

When preparing a GIPS Composite Report for an overlay composite, firms must consider the required and recommended presentation and reporting and disclosure items within the GIPS standards that apply to all composites. Firms must also consider the following requirements that are specific to overlay strategy composites:

- The firm must present composite overlay exposure as of each annual period end. (This is required for periods ending on or after 31 December 2020.) For those periods for which the firm presents composite overlay exposure, the firm may choose not to present composite assets.
- The firm is not required to present total firm assets and may instead choose to present total firm overlay exposure as of each annual period end. However, total firm assets or total firm overlay exposure must be presented as of each annual period end. Firms may also choose to present both total firm assets and total firm overlay exposure.
- The firm must disclose the methodology used to calculate composite overlay exposure. Because there are different allowable calculation methods, this disclosure will help prospective clients interpret the information presented.
- The firm must disclose if collateral and collateral income are reflected in the overlay strategy composite returns. This disclosure will help prospective clients interpret the returns presented.
- The firm must disclose if it chooses to arithmetically link overlay strategy portfolio or composite returns (new requirement).
- If a firm chooses to apply this Guidance Statement retroactively, it must disclose if any restatement of the historical track record was necessary as a result of the retroactive application (new requirement).

Please see Appendix A for a sample GIPS Composite Report for an overlay composite.

Effective Date

This Guidance Statement has an effective date of 1 January 2022. GIPS Composite Reports that include performance for periods beginning on or after 1 January 2022 must be prepared in accordance with this Guidance Statement. Firms are encouraged, but not required, to apply this Guidance Statement prior to the effective date. This Guidance Statement is not required to be applied retroactively, and no restatement of GIPS-compliant performance is required. Firms may choose to apply this Guidance Statement retroactively and, in this case, must disclose if any restatement of the historical track record was necessary as a result of the retroactive application.

APPENDIX A: SAMPLE GIPS COMPOSITE REPORT FOR A CURRENCY OVERLAY STRATEGY

Tumble Management Limited

Passive Currency Overlay Composite

Composite Characteristics	
Reporting Currency:	CHF
Benchmark:	Custom — 100% Hedged
Description:	The composite includes all institutional and retail passive currency overlay portfolios that aim to hedge the underlying portfolio to the Swiss franc with a tracking error target of 25 bps per annum. Currency forwards traded over the counter have counterparty default risk.
Composite Inception Date:	1 July 2011
Composite Creation Date:	December 2011

Calendar Year	Composite Gross Return (%)	Custom Benchmark Return (%)	Composite Standard Deviation 3-Yr Annualized (%)	Benchmark Standard Deviation 3-Yr Annualized (%)	Number of Portfolios	Internal Composite Dispersion (%)	Year-End Composite Overlay Exposure (CHF millions)	Year-End Firm Overlay Exposure (CHF millions)
2011*	3.88	4.03	n/a	n/a	2	n/a	357	3,068
2012	10.94	11.05	n/a	n/a	3	n/a	370	2,385
2013	7.02	6.97	n/a	n/a	3	n/a	357	2,070
2014	3.35	3.37	1.87	1.91	5	n/a	429	1,789
2015	(13.14)	(13.13)	3.56	3.59	6	n/a	611	2,451
2016	7.98	8.16	4.01	3.99	6	0.09	602	3,385
2017	6.70	6.75	4.26	4.25	7	0.15	867	5,206
2018	(13.89)	(14.06)	4.17	4.17	2	n/a	203	4,820
2019	(9.06)	(9.05)	3.86	3.90	2	n/a	231	3,863
2020	(7.45)	(7.53)	3.08	3.12	2	n/a	275	3,379

*Partial-period return for the period 1 July 2011 through 31 December 2011.

As of 31 December 2020	Composite Gross Return (%)	Benchmark Return (%)
1-Year	(7.45)	(7.53)
3-Year annualized	(10.18)	(10.26)
5-Year annualized	(3.45)	(3.55)
Since-inception annualized	(0.82)	(0.81)
Since-inception cumulative	(7.55)	(7.39)

1. **Compliance Statement**

   Tumble Management Limited claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Tumble Management Limited has been independently verified for the periods 1 January 2014 to 31 December 2020. The verification report is available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report.

2. **Definition of the Firm**

   Tumble Management Limited is an independent investment management firm that manages currency overlay portfolios for institutional clients and is a regulated company.

3. **Methodology Used to Calculate Overlay Exposure**

   Tumble Management Limited does not manage any of the underlying assets for its overlay portfolio clients. Firm overlay exposure represents the total value of all underlying assets for which Tumble Management Limited has a mandate to manage the currency overlay. Composite overlay exposure represents the total value of all underlying portfolios being overlaid in this composite.

4. **Performance Calculation for Portfolios**

   Portfolio performance is calculated on a contribution-from-hedges basis, whereby the change in the portfolio's cumulative marked-to-market value is divided by the underlying portfolio value being overlaid at the beginning of the period.

5. **Treatment of Collateral**

   Management of the collateral is not part of the overlay strategy. Therefore, the value of the collateral and any collateral income are not included in the overlay performance calculation.

6. **Leverage**

   This strategy uses forward currency contracts extensively to sell one currency to invest in another currency, in order to adjust the underlying portfolio's currency exposure. In volatile periods, liquidity and correlations between currencies may influence returns significantly.

7. **Custom Benchmark**

   The benchmark is 100% hedged. The benchmark is based on a zero-cost one-month rolling hedge, whereby mid spot rates and one-month bid–offer forward points are applied. The composite custom benchmark is calculated using the benchmarks of the portfolios in the composite and is rebalanced monthly based on the beginning values of the portfolios. As of 31 December 2020, the custom benchmark was composed of 68% XYZ World Index and 32% XYZ World ex-Switzerland Index. The components of the custom benchmark and their underlying weightings for all monthly time periods are available upon request.

8. **Fees**

   Performance results are presented gross of investment management fees and net of transaction costs. The performance will be reduced by the fees associated with portfolio management. The standard investment management fee schedule is 0.10% of notional value up to CHF300 million and 0.05% thereafter.

9. **Ex Post Standard Deviation**

   The three-year annualized standard deviation measures the variability of the composite gross returns and the benchmark returns over the preceding 36-month period. The three-year annualized ex post standard deviation for the composite and benchmark is not presented for 2011 through 2013 because the composite had fewer than 36 monthly returns.

10. **Internal Composite Dispersion**

    The composite dispersion is measured by the equal-weighted standard deviation of the returns for each portfolio in the composite. The measure of dispersion considers only portfolios included in the composite for the full year. When the composite consists of five or fewer portfolios for the full year, no dispersion measure is presented.

11. **Availability of Information**

    A list of composite descriptions is available upon request. Policies for valuing portfolios, calculating performance, and preparing GIPS reports are also available upon request.

12. **Trademark**

    GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.