Completion Portfolio Management: Using Completion Overlays and Sleeves to Enhance Portfolio Flexibility

Fund sponsors can spend significant resources developing an asset allocation framework that meets their goals and objectives. Typically included in this framework is a governance structure and management process for maintaining the desired asset allocation, selecting investment managers, and regularly monitoring portfolio performance and risks relative to those objectives. However, real-world constraints on capital and resources can make managing these competing interests difficult. A completion manager may help to relieve some of these concerns through improved monitoring, analytics, and exposure management that loosens these constraints and enhances portfolio flexibility.
Why Consider a Completion Manager?

Real-world considerations in asset allocation and manager selection often lead to unintended deviations, both persistent and transitional. For example, fund sponsors may see greater alpha-generating opportunities in Europe relative to other regions and allocate capital accordingly. These tilts and concentrations in some cases introduce the potential for meaningful divergence from desired portfolio characteristics and, ultimately, from performance objectives. Figure 1 illustrates the ongoing performance impact that a 10% tilt to Europe and away from Japan created relative to the benchmark. Note that, in 1999, this tilt led to underperformance of more than 4%.

Alternatively, fund sponsors might want to intentionally introduce tactical tilts. However, a traditional framework may lack the transparency to monitor these deviations, and capital constraints may limit the ability to manage the associated risks. A completion manager can serve as a natural extension to a traditional framework, allowing for greater control over the portfolio management process. Through this completion framework, expected returns may also increase through an optimized allocation of capital.

While the types of exposures covered vary widely, the role of a completion approach to portfolio management is essentially comprised of three components:

1. Regularly monitor portfolio exposures relative to the policy target
2. Generate portfolio analytics and reporting
3. Evaluate exposure management alternatives, risks, and costs
4. Manage portfolio exposures to mitigate unintended exposures (or provide flexibility to introduce active tilts)

Completion programs may be implemented through a partially funded overlay or a fully funded completion sleeve, summarized in Figure 2. These choices are not mutually exclusive and are both complementary to an existing manager lineup.

Figure 1: Impact of Exposure Tilts
10% Overweight Europe (Underweight Japan)
Yearly Return Difference vs. MSCI EAFE

Note: Impact calculated as the calendar year difference between the MSCI EAFE and a tilted portfolio. The tilted portfolio is approximated as MSCI EAFE + 10% MSCI Europe - 10% MSCI Japan, rebalanced monthly. For informational purposes only. Actual results may vary.
Figure 2: Completion Implementation Programs

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¹ OTC instruments may allow for the ability to manage more precise or esoteric exposures and may introduce additional risks. Note: The table above is specific to equity, but completion programs may be expanded to include other asset classes. For example, completion programs may be used to implement a desired duration or key rate profile. For informational purposes only.

Completion Overlays

Overlay completion can be thought of as an extension of traditional overlay management to include a more granular focus: countries, regions, sectors, styles, etc. For example, an investor may find their portfolio overweight to developed Europe due to a preference for high-conviction managers in that region. While traditional analysis may show developed international equity as on target, a significant tilt toward Europe may introduce unintended risks relative to the benchmark. Figure 3 illustrates how a completion overlay would seek to reduce this bias by removing exposure to developed Europe and adding exposure to a corresponding underweight region (e.g. Japan), often via futures. This structure is intended to loosen capital constraints, allowing for allocation of capital to preferred managers, while using an overlay to complete the policy asset allocation. The result is that unintended risks have been significantly mitigated, expected alpha has been retained, and portfolio flexibility has been improved.

Completion overlays introduce several considerations. First, derivatives may price rich or cheap, resulting in net headwinds or tailwinds to a completion program. Additionally, tracking error may exist between the instruments available and the benchmark.¹ Lastly, a margin pool must be created to support the program. For investors already using an overlay manager, this facility is already in place; however, completion positions may add incrementally to the margin required.

¹ For example, Euro Stoxx 50 futures may be used as a proxy for European equities, introducing tracking error relative to the benchmark (e.g. MSCI Europe ex-UK).
Completion overlay is used to mitigate overweight to Europe and underweight to Japan. Resulting “Net Exposure” is closer to the desired target.

Completion Sleeves

Beyond country and regional exposures, investors may desire to manage at the style, sector or factor level. In these situations, it is often most efficient to fund a completion sleeve, although custom over-the-counter (OTC) exposure may also be considered. For example, consider a portfolio that has an unintended bias toward growth equities. A completion manager can analyze portfolio holdings to determine the extent of the growth bias and create a portfolio sleeve consisting of value companies to offset this bias. Figure 4 illustrates how a completion sleeve serves as a complement to an already existing manager roster. The completion manager will regularly monitor the overall portfolio in an effort to maintain tracking error and other key portfolio characteristics within certain parameters.

Growth and value styles are a basic example of a completion sleeve application. Factors such as earnings quality, dividend yield, volatility, momentum, and profitability can be managed in isolation or in conjunction with other factors, all within the same sleeve. These factors can be maintained as part of a benchmark completion or as active tilts based on fund sponsor decisions.

Investors considering a completion sleeve should balance sleeve sizing within the context of tracking error tolerance and capital constraints. Although this implementation is somewhat simpler than an overlay approach, given the absence of margin, it is still important to understand the tradeoffs involved. Funding of a completion sleeve increases exposure to index-based management or systematic approaches, limiting the capital available to other more actively managed opportunities.
Completion management is considered an action-based extension of the risk-monitoring framework already in place for many investors. Completion managers can be engaged to track and control risks from exposures that may have otherwise been unmanaged. Armed with this ability, investors can implement completion overlays or sleeves to mitigate or actively manage portfolio risks and tilts. In addition to risk management, this structure may increase return expectations through an optimal allocation of capital. By loosening constraints and unlocking previously untapped potential, this complementary tool helps to create efficiencies and enhance portfolio flexibility.

Figure 4: Completion Sleeve Illustration

For illustrative purposes only. Actual portfolio allocation and sizing of completion sleeve may vary.

Conclusion

Completion management is considered an action-based extension of the risk-monitoring framework already in place for many investors. Completion managers can be engaged to track and control risks from exposures that may have otherwise been unmanaged. Armed with this ability, investors can implement completion overlays or sleeves to mitigate or actively manage portfolio risks and tilts. In addition to risk management, this structure may increase return expectations through an optimal allocation of capital. By loosening constraints and unlocking previously untapped potential, this complementary tool helps to create efficiencies and enhance portfolio flexibility.