Passive enhanced and overlay solutions on the asset side

While organising pension asset management, institutional investors often start with a study for Asset-Liability-Management (ALM). ALM looks for a suitable asset allocation for the liabilities in the respective pension scheme. All solutions are positioned between a pure ‘matching’ of all future cash flows on the one hand side and a market driven asset allocation with equities, bonds and alternative investments on the other hand side.

No matter how the final asset allocation may look, the investor will start a manager selection process for every segment in the asset allocation as a next step. Independent of mandating an external investment consultant, it is always the aim to identify a specialised investment manager for every segment. In order to measure the success of the investment strategy, every segment has a clearly defined benchmark. Over the last years, there was a clear shift towards passive or passive enhanced mandates within the institutional asset management, as many active asset managers consistently underperformed their benchmark. At least for developed markets, investors are more and more reluctant to pay high management fees for the replication of beta. Successful ‘high alpha’ strategies with very high tracking error to the benchmark clearly mark the other extreme, but they seem to be very hard to get, especially in an ex-post consideration.

Passive enhanced strategies are a hybrid approach towards asset management, where the level of activeness is clearly pre-defined in terms of a tracking-error-budget. Of course, the main emphasis for this approach lies on the enhancement or optimisation. For passive enhanced strategies the asset management of corporates & markets can access the abundant resources of its large institutional platform. The optimisation can rather rely on fundamental or quantitative research, depending on the respective benchmark.

For Euro corporate bonds for example, we use a method called ‘stratified-sampling’ in order to identify suitable bonds from the benchmark universe for passive portfolio management. This portfolio marks the starting point for further optimisation. In this process we focus on the bonds with the highest risk (highest spread) and look for an alignment with our research department. If we have a negative view on a bond, we will remove this security from the portfolio and allocate the residual to bond issuers we have a positive assessment for. In order to measure the impact of the bespoke tracking error, we run an analysis to visualise the active risk of this position. Over an investment cycle, this risk conscious approach for optimisation shall provide investors with an enhancement compared to pure passive management.

Another very important aspect of risk management is described by our strategies for overlay management. Due to regulation in the aftermath of the last financial crisis, a general orientation along periodical goals for pension schemes and a reduced risk bearing ability, actively managing the beta risk in the asset allocation has become a pure necessity. Overlay management in general is applicable for all asset classes, where liquid hedging instruments are available. The three most important ‘beta-risks’ which means systematic and non-diversifiable risks are equity-beta-, duration- and currency-risks.

According to this, many institutional investors cannot afford a ‘long-only’ exposure to equities and are looking for risk management approaches in order to mitigate draw downs. The effectiveness of the overlay strategy can be measured by analysing the costs of hedging in times of rising equity markets, which define the level of participation in the positive performance of equities. If markets are under pressure, the overlay shall hedge the vast majority of the downside performance. If markets perform in a ‘range’ without clear trends, the perfect overlay would produce no signals at all.

All pension schemes are highly exposed to changes in interest rates. Due to the currently very low levels, investors see the risk mainly in a sudden increase in interest rates, which would affect their overall performance on a market to market basis. In general, various strategies are possible. The most common approaches are based on options. Overlay management offers an additional approach towards duration management based on liquid and listed index futures. In a first step, we run an analysis in order to show the impact of our Overlay management for your fixed income portfolio based on our historic performance.

The most common field for applying overlay management is by far for currencies: As the portfolios of institutional investors are more and more international, pension schemes have to decide how to deal with the resulting currency risks. Different from the asset classes described before, investors are not necessarily seeking exposure to currencies and often decide to ‘always hedge’ or ‘not hedge’ the risk. Currency overlay management provides a solution for clients dealing with this issue by optimistically hedging the respective currency risk according to the clients’ needs using simple and transparent currency forwards.

All hedging applied is based on well researched and scientifically proven models that form sophisticated decision making architecture and not on gut decisions. A major emphasis lies on model testing and development, an area where we have large resources on our platform.