Viewpoints

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Welcome to our latest Viewpoints, a quarterly publication presenting candid discussions with industry experts on vital topics. In this issue, we explore the benefits and considerations of adopting an overlay with Joaquin Lujan, Co-Head of Alpha Strategies and Team Lead at New Mexico PERA, and Neil Olympio, Senior Solutions Strategist at LGIM America.

We are happy to answer any questions if you seek additional information and welcome feedback as we shape content for future issues.

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An exploration of the benefits and considerations of overlay adoption

The use of overlays is known to vary significantly across pension plan sponsors. With a better understanding of the value an overlay can add when combined with thoughtful risk management, overlay adoption can prove a powerful tool. Overlays can significantly reduce certain risks for plan sponsors and may allow for more efficient capital allocation with or without introducing leverage into the plan. By implementing an overlay as part of a broader strategy, plan sponsors can potentially solve some of their most pressing portfolio management problems: liquidity, cash drag, transaction costs and tracking error. In a conversation with Joaquin Lujan and Neil Olympio, we explore the benefits and considerations of adopting an overlay, specifically how they can help achieve a plan's unique objectives.

CW: *Before we start, I just want to thank you both for your time and willingness to participate in our quarterly Viewpoints publication. Joaquin, do you mind getting us started by sharing your background and current responsibilities at New Mexico PERA?*

Joaquin: Currently, I am Co-Head of Alpha Strategies and Team Lead for two profit centers: Long Biased and Long Short (our third is Private Markets Alpha). Recently, I've been focused on separating our excess return streams across the portfolio from our beta return streams. Once this is accomplished, we measure, size and optimize our excess return streams, or "All Alpha Portfolio," to increase our odds of success in hitting a 1% excess return target year over year.

Although we've received encouraging headlines related to the COVID-19 vaccines' effectiveness and distribution efforts, we're not quite out of the woods yet. What are your main concerns for the pension plan today and how do you determine the level of risk you're comfortable taking?

Joaquin: The existential risk for pension plans today is the prolonged low rate environment. Pension plans generally have liabilities that require ex-ante returns of 6-7.5% in order to stay solvent. With the 10-year Treasury range bound between 1-1.25%, we, and all other investors, are hard pressed to earn more than a 3-4% risk premium over that, regardless of asset type. Under this premise, we are convinced that pension plans aren't taking enough risk to achieve a 6-7.5% return. Given this low return outlook, we become focused on the question: how do we achieve our required return? The conventional approach is to take more risk by concentrating the portfolio in growth assets and hide the volatility through private market lags (more private equity, private credit and private real estate). This approach turns an existential risk of low rates into a

single-handed risk of betting on levered growth assets. Instead, our approach uses a modicum of leverage on a total portfolio that achieves a better Sharpe Ratio via greater diversification— "buy more assets, buy better assets." This approach is different, but by no means radical. It goes back to a fundamental investing truism that one should always look to maximize return per unit of risk and properly diversify. We've just added the necessary next step, leverage, which is designed to unlock a high Sharpe Ratio (i.e., diversification), so that you can more successfully achieve your absolute return target.

Neil, from LGIM America's perspective, what are the main considerations you often discuss with clients who are tackling this risk-return trade-off?

Neil: The return side seems to be rather well understood so we tend to spend more time working on the risk side. Risk to a corporate pension plan is likely different from how a foundation views risk; and importantly, two pension funds can define risk in different ways. For example, one might identify risk as increasing future pension contributions, while another plan sponsor might consider tracking error as their primary concern. Therefore, the first step in our approach is to work closely with our clients to ensure we determine the trade-off in a way that makes sense to their unique situation.

Second, clarifying the time horizon is crucial, as it will impact the risk-return trade-off.

Third, it is important to review the implementation plan and determine the associated cost. For example, what is the liquidity of the instruments we're looking to use?

In a nutshell, most investors focus on the cost of doing something; for example, how much would a specific put option cost us? While it makes sense that fiduciaries consider the cost vs. the benefits, they should also consider the cost of not doing something and assess the knock-on effects. As a result, we favor continuous monitoring of market conditions coupled with strong understanding of the investor's objectives and constraints to achieve the optimal risk-return trade-off.

I understand that New Mexico PERA utilizes sophisticated strategies throughout its policy, including risk parity, tactical allocation and derivative overlays. We believe derivative overlays can be a powerful tool to achieve plan objectives. They come in different flavors--spanning from simple cash equitization programs, completion and rebalancing, and correcting for structure risk or unintended or unrewarded deviations from policy benchmarks, among other variants. Could you tell us a little about how your plan uses overlays to achieve its specific objectives and how you determined these types of strategies were appropriate for your specific plan?

Joaquin: In 2015, we started using plain vanilla overlays to "equitize" our cash holdings. That is, we used overlays to make sure our cash holdings, those necessary for operational functions of the fund, stayed invested in the market and at our strategic asset allocation targets. More recently, however, we have graduated to something that sounds more sophisticated but is still quite simple and effective. In short, we found that we, and most allocators, don't take enough active management risk in the right markets for fear of running afoul of tracking error guardrails, whether those guardrails are explicit or implicit.

Traditionally, the decision to pursue active management comes from the premise that there are excess returns to be had in inefficient markets where skillful asset selection processes can produce better returns than a purely passive approach. Moving into inefficient markets and hiring a specialist long-only active manager, however, comes with two sources of risk for institutional investors: 1) the tracking error risk of 'tilting' away from the policy benchmark (out of ACWI and into Russell 2000, for example); and 2) the tracking error risk the manager generates in pursuing their strategies relative to their market benchmark (i.e., the tracking error the manager generates versus the Russell 2000, for example). If we are of the mindset that market timing, factor betting and off-benchmark risk by themselves are low Sharpe or low information ratio endeavors (ACWI beta vs. Russell 2000 beta), where does that leave us if it is in these very markets we believe there are exploitable inefficiencies through asset selection skill?

Enter our Structure Risk Overlay Program. Partnering with our solutions-based overlay manager (LGIM America), we take each active off-benchmark strategy and hedge the beta back to our policy beta. That is, we sell the off-benchmark risk (like Russell 2000) and buy back our policy benchmark risk (ACWI). What remains are the excess returns from active management that are largely constituted by asset selection skill or idiosyncratic alpha. To be fully transparent, the split in our excess return is still 1/3 factor, 2/3 idiosyncratic, but by implementing our Structure Risk Offset Program, we increase our information ratio for each active strategy from about .30-.50 to .80 and up to 1.0 or more for our All Alpha Portfolio as a whole. In sum, our Structure Risk Overlay Program allows us to run more active strategies, in less efficient markets, and eat more idiosyncratic pure active return/pure active risk while achieving a total information ratio that improves upon traditional approaches.

Neil, are you finding that plan sponsors are becoming more comfortable implementing an overlay strategy that employs leverage to achieve their investment objectives?

Neil: As a global firm, we have witnessed the various comfort levels across the globe several times when it comes to derivatives. For example, in the UK we have seen a faster adoption than in the US among our client base, and corporate plan sponsors have expressed more interest in derivatives

overlays than their public counterparts. The trend, however, is shifting and US investors appear to feel increasingly more comfortable with derivatives overlay. It is due in part to improved effort from raising awareness about the usefulness of derivatives for risk management purposes. For example, if I tell you that leverage can magnify profits, but also losses, this might scare you when you think about the loss side. However, if the design is aligned to a given outcome and scaled accordingly (hedging, for example) it may not be so scary after all. Context and design matter.

How is success typically measured for these more customized, intricate programs?

Neil: One challenge is the fact that there is no one-size-fits-all overlay product, and this makes it difficult to have a standard definition of success. With these mandates, success happens when we have found the optimal combination between the plan sponsor's desired outcome, long-term objectives, constraints and market conditions (cost, liquidity etc.).

The nature of the mandate will determine the best approach for performance measurement. For example, if we're looking to replicate market exposure using an overlay, it makes sense to target the performance of the instrument used to achieve that exposure, or the difference between the market return and the cost of getting the exposure synthetically. It is crucial, however, to also consider the broader benefits of such an approach; for example, the capital efficiency provided might help the plan invest the additional capital available in a strategy that helps increase the expected return of the portfolio.

A good collaboration between plan sponsors, their consultants and the investment manager is essential and helps ensure alignment on the definition of success.

In the past few months, we've completed a historic Presidential election, experienced another surge of COVID-19 infections, witnessed the emergency use authorization of two vaccines by the FDA while navigating market volatility and stretched valuations. Looking ahead, what are the major themes you anticipate developing throughout 2021?

Joaquin: I think there will be two major themes emerging. One will be inflation risk, or money debasement risk, given the amount of money created since 2008. This as the Fed continues to signal that they are more worried about the risk of deflation now than the risk of inflation in the future. Second, which is related to the first, will be the political discourse about whether deficits still matter. If politically we block or slow the fiscal stimulus measures, because all of a sudden "deficits matter," then we run the risk that we slow the path toward reflation (or creating inflation that debases the cost of the current debt load). Slowed fiscal stimulus will slow the long-term growth prospects much beyond the current COVID-19 related rebound.

Neil: Joaquin put it very well, so I'll just add that our ability to face the new variants of COVID-19 and react quickly enough will present challenges, but it will also present opportunities. Market participants might favor countries that are able to get their economy back on track sooner.

On the client side, it is likely to translate into requests for a couple of solutions: tail-risk protection and tactical ways to reflect the disparity among countries' economies in portfolios. Client hedging activity has already picked up in the first few weeks of 2021, and we expect it to continue. An additional trend worth noting is the search for managers and products, with a high degree of versatility. This is particularly helpful to achieve economies of scale, capital efficiency and improved governance. Examples include an investment solution that uses Treasuries as collateral for equity exposure, or funds that help achieve both fixed income and equity exposures in the same investment vehicle. Overall, this provides an advantage for managers capable of implementing cross-asset solutions.

Ever since the Great Financial Recession, we've been stuck in this low yield environment. Given the shock we experienced last year and the subsequent Government actions taken, it seems we're destined for this type of market going forward. This seems like one of the biggest hurdles facing investors today. How do you navigate this low rate, low return environment while still trying to achieve your investment objectives?

Joaquin: Well, I spoke about our overarching approach earlier, which essentially boils down to "buy more assets, buy better assets." To be more specific, lever a high Sharpe Ratio portfolio. This concept can be implemented in more ways that just risk parity and portable alpha. More recently, we have taken the concept and applied it to investment grade fixed income through what we call "Build Bonds Better." We take the three main risks of the US Aggregate (rates, MBS and IG credit) and reoptimize the mix such that we end up with something that has a higher Sharpe Ratio than the US Aggregate, maintains its diversification properties versus growth or equity risk, and utilizes derivative instruments so that we can lever it to our desired volatility and achieve the absolute return and risk that is more impactful and accretive to the total portfolio. To be more concrete, we think our reoptimized mix can achieve a 5% return at a 9% volatility versus the US Aggregate, which comes at a 1% return and 4% volatility.

What do you think is the most underappreciated risk in the market right now?

Joaquin: I think the most underappreciated risks are macro in nature. The first is the skills gap in the country, which translates to a wage and wealth gap that flows into our national politics in ways politicians have turned

toxic. I think solving this skills gap is the only fundamental way of saving our system in the long run. The weight of the problem feels intractable, but we can chip away at it with some vision and long-term commitment. Similarly, retirement security is underappreciated. Moving over to public pensions, I think too few people understand the existential threat in which they find themselves. If pensions crumble under their historic costs and today's low rate environment, I fear that the government infrastructure or the delivery of public goods that civil servants provide are in grave jeopardy. Teachers, universities, engineers and first responders are a few that come to mind. What would we do without them? And, if higher salaries are off the table, how will governments attract a competent workforce without pensions?

I would like to end with one last question for you, Neil. For a plan that may be new to the overlay space, can you describe a simple implementation approach and outline the key considerations to be aware of?

Neil: That's quite a broad question, Chris. Surprisingly, the answer is: it depends. We encounter similar situations with many of our clients, so I'll aim to provide a brief overview.

Assuming a client is looking for full funding, one crucial question is: how important is getting to the objective quickly versus getting to the objective smoothly? There's typically little intersection between these two dimensions, but we will aim to identify the optimal trade-off.

Overall, in the interest of brevity, here are some considerations we would have:

- Improve governance by finding the optimal approach for the plan that will make implementation as smooth as possible
- Reduce inefficiencies by improving the cost structure (e.g. rebalancing) and finding an optimal way to achieve market exposure
- Explore portfolio protection strategies; because, most often, outperformance is created not really by outperforming when times are good but rather by not experiencing significant drawdowns
- Educate plan sponsors on the potential risk reduction benefits of derivatives to expand the range of favorable investment outcomes with a risk-conscious framework - a prudent use of leverage can be a very effective way to help plan sponsors reach their objectives

In summary, as we primarily use overlays as a risk management tool, we would work with the plan sponsor and their consultant to illustrate the risk reduction features of some derivative strategies and the potential capital efficiency provided, for their specific circumstances.

Thank you so much for your time and sharing your thoughts and experiences regarding LGIM America's custom Multi-asset capabilities. ■

About LGIM America

LGIM America (LGIMA) was founded in 2006 with the purpose of helping people achieve their long-term financial goals. We offer a range of strategies to help our institutional clients (corporations, healthcare agencies, non-profit, education, public plans and Taft-Hartley) manage their investment objectives, which can range from market-based alpha-oriented strategies to those that are designed to be more liability-centric, derivative overlays, or indexed solutions. Encouraging a diverse and inclusive environment coupled with a solutions-focused culture allows us to increase our breadth of knowledge and the likelihood of improved client outcomes and stronger financial performance. We have teams of experienced, innovative professionals committed to helping plan sponsors meet their pension promises, managing investment exposures efficiently to seek enhanced returns while mitigating risks, and working to generate returns while making a positive societal difference. As of December 31, 2020, LGIMA had $241 billion assets under management.

For further information about LGIM America, find us at www.lgima.com

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