# Overlay Speak

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The typical investment mandate can be expressed quite easily: "Manager Smith is an enhanced equity index manager who is benchmarked against the Russell 1000." It is much harder to accurately represent *overlay* programs, because they appear complex and involve derivative instruments.

This article seeks to clarify the main types, objectives, workings, and advantages of overlays and related programs in a practical guide rather than a technical discussion. We first describe derivative investment programs and their objectives, and then discuss the relationship between derivatives and stock and bond securities. A simplified case study illustrates how overlays and related applications work in practice.

## OVERLAY OBJECTIVES

What is an overlay? It may be more productive to describe overlays than to provide a formal definition. Overlays are best understood in comparison to the most common type of investment programs, i.e., fully funded accounts (FFA). In an FFA, the owner of the account (whether pension plan sponsor, foundation, or individual investor—but hereafter called the plan) transfers cash to an investment advisor. Subsequently, the cash is usually fully invested. Typically, the investment advisor may invest in various instruments, but a mandate specifies that the total of such investments may not exceed the plan's contributions to the account.

Overlays, however, are understood and intended to augment investments with a value *well in excess* of the plan's cash contribution to the overlay account. In fact, the overlay manager is frequently hired to effect the asset allocation of the entire plan, while the vast majority of the plan's assets remains with FFAs at third-party investment managers. Various types of derivatives are used, but this does not necessarily imply that the plan will be levered.

Overlays are one of many possible derivative programs. The motivations for derivative programs vary, but most often they relate to one or more objectives:

1. *TAA:* The plan employs a manager who generates alpha through tactical asset allocation shifts, augmenting the effective asset allocation of the plan.
2. *Hedging Program:* The plan wants to hedge certain undesirable exposures that are generated by FFAs as a by-product of their process. For example, international equity managers may inadvertently generate certain currency exposures the plan wishes to avoid.
3. *Rebalancing:* The plan aims to realign asset class exposures with the desired policy mix at the lowest possible cost. Derivatives are less expensive than transacting in physical securities.
4. *Alpha Transport:* The plan wants to maximize its access to superior active skills of one or more of its managers in...

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