Tim Habicht interviewed **Peter Klöckner** and **Manuel Stratmann** on the subject of overlay management

Peter Klöckner
Managing Director, Pension Fund of the Rhineland-Palatinate Bar Council, Koblenz

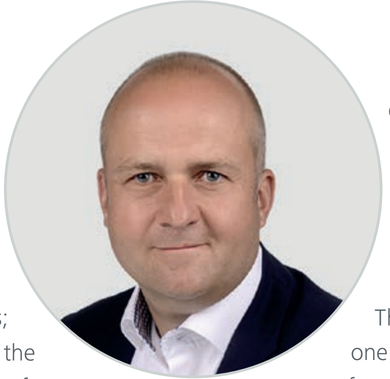
Manuel Stratmann
Team Head Overlay & Quant Models, Portfolio Management, Universal-Investment-Luxembourg S.A., Branch Frankfurt am Main

Tim Habicht
Founder and Managing Director of the news plattform Fundview

Institutional investors are facing major challenges: due to the persisting low interest rates worldwide, stable and predictable returns from the fixed income allocation are a thing of the past. Nevertheless, pension funds (Pensionskassen) and occupational pension schemes (Versorgungswerke) have to generate predictable and stable returns for their investors. Institutional investors tackle this problem by increasing their exposure to alternatives and equities. But how do investors deal with the higher risk on the equity side?

Peter Klöckner, responsible for the capital investments of the occupational pension schemes of the Rhineland-Palatinate Bar Council as well as the occupational pension schemes of the Rhineland-Palatinate Dental Association, also faced the same question. He decided to tackle this challenge by choosing an options-based overlay by Universal-Investment. Peter Klöckner and Manuel Stratmann, portfolio manager, will now shed some light on Peter Klöckner's decision to use this type of overlay, why he prefers options over futures and how this set-up worked out during the coronavirus crisis.

Peter Klöckner



Peter, why did you decide to use an overlay?

Peter Klöckner: Due to the continued low yields on the bond side and an increased exposure on the equity side, the overall risk limits have considerably been reduced. In addition, the high-risk asset classes may deliver both positive and, of course, negative surprises; this was recently impressively demonstrated by the coronavirus pandemic. That´s why it is important for us to take advantage of positive market developments on the equity side, but also to have a certain safety net when markets fall.

Is the equity side of the portfolio becoming more and more important for institutional investors due to the persistent low interest rate environment?

Peter Klöckner: Apart from the real estate sector, predictable income is on the decline in general. Conventional bond investments basically only yield a return with positions that are already part of the portfolio. Overall, the return on the bond side continues to decline. Hence, we as investors have to look for alternatives. Equities are a very attractive alternative. Due to the fact that stocks are real assets, they will overall become increasingly important. Nevertheless, it is obvious that the equity side, because of its greater importance and allocation in the portfolio, also needs protection to cushion possible corrections or crash situations.

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Peter Klöckner

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Where do you see the strengths of an options-based overlay? And did the overlay help to implement your strategic asset allocation or to hedge the equity side during the coronavirus crisis?

Peter Klöckner: Overall, we did relatively little during the crisis. The hedging measures were implemented at a volatility level at which the options were still relatively inexpensive. When the coronavirus became the focus of attention in Europe at the end of February and then got even worse in March, we didn't have to worry too much. Our positions and strike levels were selected in advance so that we could not fall below certain levels. The strike levels were calculated so that, taking all sources of income into account, we would not fall below a certain return profile per year for our overall portfolio. Regarding the coronavirus crisis, our hedge was closed one day after we hit the bottom of the curve; we were lucky there. Therefore, we were able to participate in the positive development of the markets with very little hedging efforts. In this respect, we did experience the rebound rally with the handbrake on, but we still benefitted from the recovering markets. This would not necessarily have been the case with a hedge based on futures. This flexibility in the options-based overlay is one of the reasons why we hedge using options, not futures.

Manuel Stratmann: Many investors still view options with a certain amount of suspicion, since there are several factors influencing the price while, in addition, they are not a linear financial instrument. That´s why the majority of our overlays are still futures-based. Initially, there are no *ex ante* costs here. This is a tremendous advantage over options. The challenge with futures is re-entering the market at the right time. Many of our clients are currently concerned with this task. In the case of options, however, the strike price clearly defines when they take effect. With rising markets, re-entry through the sinking delta works almost automatically. Therefore, they are less linear and significantly more flexible.

Is this flexibility in the options-based overlay a crucial point for choosing this hedging method?

Peter Klöckner: Yes, definitely. The disadvantages of the options-based overlay are obviously centred around the costs. First of all, you have expenses for the premiums and, thus, additional costs. With futures, however, the hedged part of the portfolio is frozen. I pay the premium for the options, but I also have an improved benefit from an increased participation in rising markets.

Manuel Stratmann: With futures, there is an immediate interdependence: the market gains one percent, I lose the same on the futures side. The delta fluctuates with options. When the market rises, the portfolio also participates positively in the rising market movements. This simplifies market re-entry of the options-based overlay. The crucial difference is: options initially produce costs, which in turn offer a downward protection and an automated market re-entry. With futures, there are no upfront costs, but further cash involvement depends on market development. Opportunity costs may appear here.

Manuel Stratmann

Peter Klöckner: If the market rises and you have a short future position, then, on the one hand, I have a positive portfolio development. But I also have a negative future performance, on the other hand. And this has to be settled at some point – either from existing liquidity or by selling positions. This contradicts the existing equity exposure. This exposure can be easily controlled and adjusted through options.

» The overlay offered by Universal-Investment is set apart by its flexibility.

Peter Klöckner »

Are many investors too short-sighted when they just want to hedge their portfolio, thus, resulting in substantial performance being lost in a rebound?

Peter Klöckner: That is not necessarily the problem. In my opinion, the reason why many investors shy away from an options-based overlay are the costs. In the case of portfolios worth millions, there are also higher expenses for the premiums. But given the momentum that the markets have had in recent years, these costs are justified. The cost for an option premium has to be seen in comparison to the overall portfolio and also in comparison to the asset class equities itself. In some cases, this cost can be quickly turned around. I want to have the equity exposure for my portfolio; that is also the reason why we rely on an options-based overlay and do not want to minimise or get rid of our equity exposure by using futures.

Could the coronavirus crisis act as a positive catalyst for options-based overlays?

Peter Klöckner: I think that many institutional investors will hedge their equity exposure with an overlay, especially after the extreme fluctuations during the pandemic. I cannot judge whether this will happen through options, futures or a mixture of both. However, we favour the options-based overlay for the reasons mentioned. This overlay may, however, also increase the total equity exposure. Due to the low interest rate environment, this will become increasingly important for future asset allocations in order to achieve the targeted return.

Manuel Stratmann: I can confirm this from both the investment as well as the provider side. Overall, we see significantly more requests for our overlay offering. The reasons for this are the extreme market fluctuations in December 2018 or March 2020. Another factor is that investors have to position their portfolios differently because the fixed income side lacks sufficient returns in the foreseeable future. Of course, investors deal with this topic and therefore allocate more funds to alternatives or equities. As a result, investors inevitably have to deal with the possibility of hedging these assets and implementing an overlay.

Why did you choose the overlay by Universal-Investment?

Peter Klöckner: Before implementing this overlay, we screened several offers. The overlay offered by Universal-Investment was set apart by its flexibility. For us, the other solutions were too static regarding the use of futures. We had joint discussions with Universal-Investment on the use of futures or a mix of futures and options. In the end, we made a decision in favour of the options-based overlay. Universal-Investment was the first point of contact for us because we already have a large part of our assets with them. Overall, Universal-Investment already has a great understanding of our portfolio. We don't have the manpower to build an overlay team or implement an overlay ourselves, so it was important for us to find an external partner who was on a par with us. A big advantage at Universal-Investment is that we receive the complete added value including monitoring, implementation and reporting from a single source. As we are implementing a fund of funds structure and are using the overlay for this, it is very helpful on the balance sheet to have only one point of contact for these services. If we would have done this with a different partner, we would have needed to structure this differently on our balance sheets. From a regulatory and organisational point of view, there is a clear advantage of implementing the overlay through Universal-Investment.

» Transparency and openness are key.

Manuel Stratmann »

Let us take a look at the situation from the opposite angle. Manuel, how did you approach the implementation of the overlay for both pension funds?

Manuel Stratmann: Due to the construction of the fund of funds and, thus, different target funds, the implementation of the overlay was quite a challenge. We had to adjust our internal front office software and the risk reports to these circumstances as well as develop them further. Overall, we have found a stable technical solution that has proven its worth even during the strong market fluctuations.

How important is it, apart from the technical implementation, to communicate with the client directly and to work with them in a transparent way?

Manuel Stratmann: It is definitely very important. Transparency and openness are key. This also relates to the expectation management we conduct with the client. We have to clearly demonstrate what our service and the product can and cannot achieve. For us, honesty and transparency are key to any collaboration.

The risk environment has drastically changed during the coronavirus crisis. How do you have to set up an overlay based on options during these times?

Manuel Stratmann: That's right. The current market environment and the increased volatility are a challenge for options-based overlays. Options that hedge against a price drop require a higher upfront premium payment than before the crisis. On the one hand, this is initially a disadvantage. On the other hand, you may also take advantage of this by collecting higher premiums by selling call options or by implementing put spreads in the hedges. This at least offers a certain downside protection. Generally speaking, an options-based overlay approach can be implemented in a very flexible and creative way to minimise the risk on the equity side.

Thank you very much for this interview.

THE INTERVIEW TOOK PLACE IN JUNE/ JULY 2020