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standards@cfainstitute.org

CFA Institute
Global Investment Performance Standards
RE: Guidance Statement on Overlay Strategies
915 East High Street
Charlottesville
VA 22902

Re: Comments to Guidance Statement on Overlay Strategies

Background: A.G. Bisset Associates, LLC (formerly A.G. Bisset & Co., Inc.) has managed active discretionary and passive currency overlays for institutional investors (pension funds, family offices, trusts, etc.) starting in 1988 against the dollar and as of 1992 against the euro as base currencies. We have also managed using sterling as the base currency.

We present our currency overlay composites prepared and presented in compliance with the GIPS standards. Bisset's compliance has been independently verified by Ashland Partners. We currently manage $1 billion in various currency overlay mandates.

I will restrict my comments to currency overlay since we do not manage any other types of overlays. We use only currency spot and currency forward contracts to implement our strategies so I will only comment on these instruments.

Currency Overlay Description

We agree with your comment that currency overlays can be passive or active. However, with respect to active overlays we believe it is important to distinguish between active overlays that are permitted to adjust the hedge ratio on the underlying currency exposures and those where additional exposure to a currency may be created. Both active overlays will generate returns. In an active overlay where exposure cannot be created, the added return comes from the manager's skill in placing and removing hedges at the appropriate times (as well as scaling the size of the hedges over time). In an active overlay that can create exposures, the added return may derive more from a manager's risk taking positions in the added exposures than from correctly hedging the underlying exposures. As a result, the two types of active overlays should not be merged into a single composite as it may mislead investors as to the true skills of a manager. The first overlay focuses on managing the currency risk the second on generating alpha using currency.

Determination of Total Overlay Exposure

Your example: "A portfolio has holdings denominated in USD, EUR, JPY, CHF and AUD. An overlay manager was appointed to hedge USD, EUR, and JPY to GBP and instructed to leave the CHF and AUD denominated assets unhedged. The overlay manager considers the GBP value of the USD, EUR, and JPY holdings as "overlay exposure," irrespective of the hedge ratio. The GBP value of CHF and AUD holdings is not included in the overlay exposure calculation because the overlay manager has no mandate to hedge these exposures."

We believe that calculation is problematic. It is our experience that U.S. investors who have EAFE-like or All-World-like portfolios, while non-dollar based investors with similar portfolio constructions, will often agree or mandate to leave some minor currencies unhedged due to the small percentages they represent of the total exposure. Or, they are left out because interest rate differentials make it prohibitively expensive to hedge them. And, currencies like the Korean won, for example, that can only be traded using Non-Deliverable-Forward contracts are often left out because of a client's internal restrictions on derivatives or because Dodd-Frank (and European equivalents) now requires NDFs to be traded through a SIF and they must be collateralized (a complications many clients prefer to avoid).

At the same time, while these currencies may be excluded from those actively hedged for several reasons they are typically included in the benchmark calculation against which the overlay results are measured. In addition, management fees are often charged on the total portfolio and not just on those currencies that are hedged.

In our view, the overlay exposure is the total portfolio reported to be managed by the manager even if some currencies in that portfolio are excluded by the client (or in agreement with the manager) for the reasons stated above.

Question arises: Assume two dollar-based investors have EAFE-portfolios; one permits all currencies to be hedged (including using NDFs) and the other does not. Should these two portfolios be permitted to be included in one composite assuming they are managed against the same benchmark and have no other restrictions that make them differ?

Your Question 2: As discussed, we don't think your described method for calculating currency overlay exposure inside a portfolio is appropriate.

Your Question 3: See comments above.

Your Question 4: Recommended if kept as is rather than required.

Currency Overlay Composite Construction Criteria

<u>**a) Base currency:**</u> We believe composites should not be permitted to include mandates that have different base-currencies since the results will be very different as you point out. Hedging USD against EUR will result in totally different returns compared to hedging EUR against USD when all other factors are the same.

However, it is also inappropriate to create composites that include all mandates managed against a particular base currency unless the underlying exposures, benchmarks, restrictions, etc. are essentially the same. A composite of multi-currency exposures managed against the euro that also includes a mandate where only the yen is managed against the euro, will create composite results that are useless in terms of an investor understanding the performance profile and how it may relate to his or her portfolio. It also prevents similar composites from different overlay manager to be compared to shed light on the different skill-sets managers may have or how their strategies may perform in different currency environments.

Thus, mandates that have the same base-currency but are significantly different as to exposures managed, benchmark used, imposed restrictions, or different due to other factors need to be grouped into composites that are relevant. For this reason, we find that most composites we have need to be single account composites that each fairly represents the results achieved. This renders the idea of a single composite representing a manager's skill (as in managing an S&P 500 portfolio) difficult to attain. Having multiple single account composites, unfortunately, creates a burden in terms of time and money to have the composites independently verified.

<u>**b) Benchmark hedge ratio:**</u> Using the benchmark hedge ratio as the overriding criteria (after separating accounts by base-currency) is not appropriate. An EAFE-portfolio with a 0% hedged currency benchmark and a portfolio with only yen and with a 0% hedged benchmark (all other factors the same) will have vastly different performance streams and must therefore be placed in two different composites that reflect, first the underlying exposures and then, second and third, other factors that make the return streams substantially different.

We have taken the approach to show our returns against both 0% hedged and 100% hedged benchmarks since we are permitted to use the entire range from 0% to 100% hedged for the currencies we hedge. As a result, an investor can use the two "polar" benchmarks to calculate a 50% or 75% hedged benchmark return (or any other ratio) to see what returns might be should there be a wish to have a benchmark ratio other than 0% or 100%.

However, it is important to recognize that a client's selection of a particular benchmark ratio may come with restrictions. A manager managing against a 50% hedged benchmark and who can hedge the underlying exposures from 0% to 100% will have a different return stream from a manager that has the same 50% hedged benchmark and portfolio, but is restricted to hedge only in a range of 25% to 75%. These two mandates should not be placed in the same composite.

There is also an issue of how the benchmark is calculated. Since internationally diversified portfolios (EAFE for example) that are managed actively by the underlying manager may result in currency exposures that significantly differ from that of the EAFE index and that of other mandates that have EAFE as the benchmark. A manager may significantly underweight Japan, for example. As a result, all of our benchmark returns are customized and calculated based on the actual exposures as they evolve over time using WM Spot prices for translation (0% hedged) and their 1-month forward points to calculate a 100% hedged benchmark return assuming hedges are rolled monthly.

c) Passive and active: Yes, passive and active overlay returns cannot be placed in the same composites, and passive hedging mandates must also be grouped to have largely similar underlying exposures. It is not useful to have a passively hedged euro exposure included in a composite that has a passively hedged yen exposure. Any restrictions for two similar passive portfolios (hedge range 0% to 100% for the euro versus one with a range of 25% to 75% for the euro) will result in different return streams and should not be grouped together.

New and Terminated Accounts

We agree with the inclusion of first full month and inclusion through full month prior to termination.

Treatment of External Cash Flows

Our clients report exposures differently. Some have fixed exposures that change very infrequently. Others have fixed exposures that change quarterly (or somewhat randomly) based on the asset growth/shrinkage of the underlying portfolio. Some clients report exposures monthly at various periods of delay after month-end determined by the availability of the data and other factors.

For clients that report fixed exposures, we treat every change as a cash inflow/outflow. Assuming the change takes place intra-month, we calculate an asset-weighted return for the first part of the month and another for the second part that reflects the new exposure and we adjust the benchmark calculation accordingly. The returns are linked to provide a single monthly return. The returns are included in composites.

When exposures change monthly and with a lag after month-end, each month starts with the preceding month's exposure. When the new asset report is received it replaces that prior month's exposure as the base amounts to be hedged and hedges are adjusted to match the new exposures as needed. Unless there is a very large change, we do not calculate a return for the days up to the receipt of the asset-report and one for the days after. We assume the new exposure was known on day 1.

In general, calculating time-weighted returns for an overlay is easy to do for the overlay manager, but custodians cannot typically do this so there is frequently a problem for them to produce independently calculated overlay returns to report to their clients.

Performance Calculation

Your Question 5: Yes, we believe both methods are acceptable. We use the value of the underlying portfolio (which is the currency exposures reported to us).

Your Question 6: We believe the collateral income should NOT be included or at most that it should be recommended that it is included. It is a separate management function that does not reflect the currency hedging skill-set. With EMIR and Dodd Frank treating collateral for currency forward contracts (initial and variation margin) differently this issue has become far more complicated than a few years ago. As these rules change over time, return streams become less comparable when collateral management income in included. And, in some cases the collateral is used to buy futures in underlying equity indexes to ensure a client is fully invested in the underlying equities further muddying the issue of what is currency hedging return or not.

Your Question 7: At best it should be a recommendation but not required for currency overlay since the collateral requirements for differently domiciled clients and instruments used vary.

Compounding Returns over Time

Your Question 8: We agree that the currency overlay returns must be geometrically linked when the overlay exposure changes over time.

However, this is a complicated issue. Assume we begin with €10 million to hedge to USD. In Month 1 we sell €10 million forward for six months. At the end of Month 1, the return is the change in the value of the €10 million plus the gain/loss on the hedge for that month, which is unrealized. In Month 2 we value the €10 million at the prior month's end value in USD. We keep the hedge in place. At end of Month 2, we take the change in the value of the €10 million and add in the gain/loss on the hedge for Month 2 to get to the monthly return. Month 3 the process is repeated, but mid-month we remove the hedge by buying the €10 million back for the previously established value date. The gain/loss on the hedge since inception is now locked in but it is not realized until the value date when it, in theory, can be added to the underlying portfolio. In practice, the gain is sent to the client's account at its custodian by the counterparty bank and the money may be used for other purposes than adding it back to the underlying portfolio. When a hedge has a loss, it has to be paid by the client to the counterparty bank and typically from an account other than the portfolio managed in the overlay. Thus, these cash-flows in practice do not impact the underlying portfolio (not reinvested or diminishing the assets managed) but are nevertheless included in the performance calculations of the overlay. Over short periods of time, the distortion is minor but over decades, the compounding of the returns can meaningfully distort returns.

Your Question 9: In principle yes, but as described above it is not so easy. Assume we adopt the process above for clients that report exposures monthly, but adopt the other process for our clients that report constant exposures and changes in them infrequently. If both happen to have €10 that remain the same for say six months, the return calculations would be different for the two clients even though the actual gain/loss on hedges would be the same in dollars.

We agree with your performance calculation example for the passive currency overlay.

Your Question 10: No comment. We only have notional overlay assets.

Your Question 11: The required disclosures appear appropriate.

Your Question 12: The effective date seems appropriate. We can meet the standards by then. Required restatement of GIPS-compliant performance of prior composite returns would be impossible for us to implement since our composites begin in 1992 and 1993 and cover many accounts no longer managed and for which only paper records of trades and statements have been retain in storage to meet requirements to have retention of the supporting material. It would be impossible, too time consuming, and, in fact, impossible to restate the results since some records were lost during the storm Sandy when it hit our area and liquefied old statements that were water damaged in storage. No electronic records remain for the accounts included in the early years of these 25-year composite records.

I trust my comments will be helpful in your efforts to complete the standards for currency overlay.

Please send any questions by email to ulf@agbisset.com

Sincerely,

Ulf J. Lindahl
Chief Executive Officer