

Question 1: Are these examples regarding the determination of discretion appropriate or are additional examples or other criteria needed? If additional examples or other criteria are needed, please explain your suggestions.

We can think of two other other examples of (semi-) discretionary overlay portfolios that could be added for clarification:

- a passive fx mandate where the client determines the required open exposures and the instruments to use and other managers manage the underlying portfolios and with that determine the currency distributions in the portfolio. The FX manager only has an execution role. This could still be a discretionary portfolio since it is very much the same as a passive equity portfolio where the manager also only has an execution role (follow the index).
- An overlay portfolios where the manager is only allowed to trade if a certain trigger is hit. For example, an interest rate overlay aimed to match duration to 50% of the underlying portfolio with a bandwidth between 48% and 52%. Trading is only allowed if the duration is more than 2% away from the target, to avoid transaction costs.

Question 2: Are the three "allowable methods" for calculating overlay exposure appropriate?

As the authors of this guidance statements noted in the introduction, Overlay portfolios are typically implemented to manage a specific risk on an aggregated account level. Therefore, the exposure (and hence the return calculation as discussed later in the guidance statements) should reflect the basis for the risk management, which is the aggregated account level. This could be different from the exposure that the client allows the manager to manage.

As for the example of the Currency Overlay: The exposure should include also the CHF, AUD and GBP exposures of the underlying although the manager should not implement any hedges for the CHF and AUD, since the currency overlay is implemented over all those currencies. The client is interested in how well the currency dimension is managed on an overall account level and therefore the return for the overlay portfolio should be a contribution to the total account return. The fact that no hedges should be implemented for CHF and AUD should be reflected in the benchmark return for the overlay mandate. Since the goal is to manage the currency risk of the account, the client is not interested in the return of the overlay portfolio, but of the managed risk.

As for the Beta Overlay Exposure: It will be hard to determine when off opposite derivatives can be off-set. Does off-setting mean that cash flows should fully off-set (so in the case of interest swaps coupon payments on the same dates and the notional repayment on the same dates) or would measures like BPV be more appropriate? This could require complex 'effectiveness' tests similar to hedge accounting regulations.

As for the Absolute return overlay exposure: this seems the easiest one, although off-setting of notional exposures (for example: long in futures Shell and short in futures Exxon Mobile) will again be difficult to classify.

Question 3: Are there other methods for calculating overlay exposure that are also appropriate? If so, please explain.

See previous answer. The aggregated risk/account value also seems appropriate, especially since this one is the least subjective in terms of measurement.

Question 4: Should the allowable method(s) be required or recommended by strategy type? If so, please propose a required or recommended method by strategy type.

For the avoidance of doubt, the allowable method(s) per strategy type should be required.

Question 5: Are the methods used to calculate the denominator in an overlay portfolio return calculation appropriate?

We would expect that a measure describing risk exposure is used. The benchmark return should represent what the manager is supposed to do. I would expect more emphasis in the guidance statements on the benchmark return calculation. This is to ensure that the excess return correctly shows the management capabilities of the required strategy of the manager.

With the risk exposure used in the return calculation and a correct benchmark return, the excess return gives prospects a good indication of the expectations that they can have of the contribution that the manager could have when they would manage the risk of their account.

As a side comment, the proposed benchmark in the asset overlay example is probably not a very appropriate benchmark, since the mandate is to implement a tactical asset overlay which in the end will not have any net exposure. Therefore a benchmark which is a combination of long positions in different asset class benchmarks does not reflect the mandate that the client gives the manager in a fair way.

Question 6: Is the requirement to include collateral income in the overlay portfolio return when the collateral is actively managed appropriate? If not, should this be changed to a recommendation?

Yes, the requirement is appropriate.

Question 7: Is the requirement to establish a composite specific policy on the treatment of collateral appropriate? If not, should this be changed to a recommendation?

A policy on firm level should do, with possible exceptions on the composite level.

Question 8: Do you agree that the returns for overlay portfolios must be geometrically linked when the overlay exposure changes over the time period? If not, please explain what method(s) you believe is appropriate.

There can be a case made to link them geometrically as arithmetically. Since the profit and loss of the previous period does not impact the exposure for the next the case that is usually made for geometric linking does not hold. Therefore arithmetic linking over time could also be appropriate.

However, since the statement is to geometrically link when exposure changes, we agree. If the exposure does not change, arithmetic will be more appropriate.

An issue here is of course that there should be a clear definition of exposure and a threshold to clarify what a 'change' in exposure means.

Question 9: Do you agree that overlay returns must not be geometrically linked when the exposure remains constant, but rather the returns must be calculated as the cumulative profit/loss for the calculation period divided by the denominator? If not, please explain what method(s) you believe is appropriate.

See question 8: there are clear examples of constant exposure where the cumulative profit/loss for the calculation period divided by the denominator makes sense and there are also clear examples where the exposure (or even long/short direction) changes over time. However, the difficulty is in the grey area between. What is defined as a constant notional and when do we consider the notional to be changed to the extent that geometrically linked returns are required?

Question 10: Should text be added to this Guidance Statement recommending disclosure of the sum of (a) total firm overlay exposure and (b) total firm assets, also known as total firm economic exposure?

No, only as separate numbers. This should not be measures since it can have an overlap. Keep them separate!

Question 11: Are the required disclosures appropriate? If not, please explain.

We would expect that firms must disclose the benchmark construction and that the benchmark return and excess returns are presented. This to ensure that the way that the manager manages the risk is correctly presented. The portfolio return does not reflect this.

Generally speaking, we would not require firms to present overlay exposure, but rather leave firms with the option to do so.

Question 12: Is the proposed effective date appropriate or would additional time be needed to implement this Guidance Statement?

We foresee that it will take time to implement software for the required calculations. Therefore, 2019 might be too soon and 2020 seems more appropriate.