

Addressing Institutional Investor Concerns

Over the past two months, The Clifton Group has received numerous inquiries from institutional investors seeking solutions to existing or anticipated challenges facing their funds. The overwhelming majority of investor inquiries relate to three key areas: **liquidity management, rebalancing overall fund exposures, and securitization of pending cash settlements.**

In this short paper, we discuss how derivatives-based overlay strategies may address these issues and provide investors the tools to better achieve their policy objectives.

Liquidity Management

Many Fund Sponsors' ability to effectively manage short and medium-term liquidity requirements has been severely impacted due to recent market events. Because many institutional asset allocation policies include no strategic allocation to cash, numerous investors are currently searching for opportunities to improve fund liquidity while minimizing the opportunity cost of holding cash balances within their funds.

By employing a cash overlay strategy, a portion of a fund's physical exposures can be replaced with exchange-traded index replicating futures. Overall fund economic exposures are maintained, but the desired amount of cash can be raised to fund operations, meet monthly benefit obligations, and accommodate alternative manager capital draw-downs. The use of futures can allow investors to earn the expected market risk premium on cash balances with access to an on-demand liquidity pool while maintaining their fund in alignment with their policy objectives. As cash balances fluctuate, futures positions can be easily adjusted to maintain the fund's effective cash exposure at desired levels.

Fund Exposure Rebalancing

Due to recent global equity market performance, equity exposures for most funds are meaningfully underweight relative to long-term policy targets while fixed income exposure is over-weighted. Typically, investors utilize periodic cash rebalancing to bring fund exposures in-line with targets. Such a strategy, in light of the current market environment, dictates selling fixed income holdings and buying equities. However, the relative illiquidity of the fixed income market, most notably in the mortgage, credit, and asset-backed areas, renders physical liquidations difficult, if not impossible, over the short-term. As a result, investors may find themselves "stuck" with relatively large imbalances between equities and fixed income. Furthermore, funds whose mandates require rebalancing upon violation of pre-determined thresholds could be forced to sell fixed income holdings at unattractive prices.

By utilizing index replicating futures investors can effectively reduce fixed income exposure while simultaneously increasing equity exposure without disrupting an existing manager structure or affecting any physical holdings. Investors can choose to maintain effective fund exposures within a pre-defined tolerance of their policy targets or implement tactical tilts based on their market views. Synthetic exposure balances can be rapidly and efficiently adjusted based on the needs of the investor. Index replicating futures offer a low-cost, efficient, and non-disruptive method to manage asset class exposures until physical securities moves can be completed.

Securitization of Pending Cash Settlements

Based on recent reports, a record number of hedge fund and other alternative manager redemptions are scheduled to occur in the fourth quarter of 2008. Institutional investors will generate several hundred billion dollars in cash and many will look to deploy it to more traditional asset classes quickly and efficiently. The challenge faced by sponsors is that alternative fund exposure is often eliminated weeks and months before actual cash is received. Overlays can close the gap in exposure related to pending settlement and desired market exposures.

Through the use of a futures-based overlay, fund sponsors can rapidly deploy cash to any number of equity and/or fixed income indices, allowing effective cash exposures to be controlled. Cash can be deployed as part of a rebalancing scheme to reduce exposure imbalances from long-term policy targets, or as a temporary bridge while planning to fund existing or new managers. As physical cash holdings are subsequently deployed, overlay exposures can be easily altered to mitigate any unintended leverage and performance risks. Eliminating the expected opportunity cost of holding excessive cash balances via a futures-based overlay allows fund sponsors to better manage overall fund exposures in an efficient and low-cost manner while enjoying on-demand access to physical cash balances.

Please call 800-328-5009 or email Clifton at info@thecliftongroup.com if you would like to obtain more information about the benefits and risks associated with these or any other derivatives-based strategies.