

An introduction to overlay management

One of the central tenets of prudent investing is diversification.¹ To help diversify one's portfolio, however, it is often necessary to invest in different vehicles and with different managers. This can present challenges with the ongoing implementation of the investment plan. Fortunately, overlay² portfolio management can help streamline the implementation of multi-strategy portfolios.³

The role of an overlay manager is one of implementation and coordination. Overlay managers work with the underlying investment managers and vehicles to ensure all strategies are implemented in an efficient and coordinated manner, while ensuring compliance with the investment policy and guidelines at the overall portfolio level.

The Financial Research Corporation (FRC) has defined overlay portfolio management as:

"an overarching canopy of quantitative analyses and systems that operates an array of investments to achieve a desired net effect for an investor. Most typically the objective is after-tax total return, a set level of total portfolio risk, or cash flow management."⁴

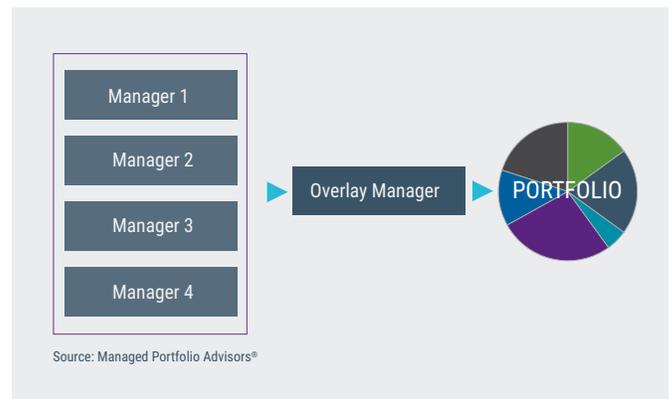
In some ways the role of the overlay manager is analogous to that of an orchestra conductor. The overlay manager (conductor) coordinates the activities of the underlying managers (musicians) to ensure a harmonious outcome.

The role of the overlay manager becomes especially important when implementing portfolios made up of multiple separate account strategies, as it would be difficult to implement multiple separate account strategies in a single account without one. In most cases the underlying managers communicate their portfolio composition and changes they are making in their investment strategy to the overlay manager. The overlay manager then replicates this investment strategy within that segment of the account.

Potential benefits of overlay management

A robust overlay management service can help capitalize on many opportunities to enhance a client's investment and service experience. Overlay solutions can do more than just reduce the operational challenges of managing diversified portfolios. They also have the potential to improve returns for investors. Potential benefits include:

- **Monitoring asset allocation and rebalancing.**⁵ Overlay managers typically monitor asset allocation on a very frequent basis and are able to react to situations promptly when the need to rebalance occurs. The process of rebalancing is also much simpler, as it all takes place within a single account and is coordinated by the overlay manager.
- **More timely implementation of manager and allocation changes.** Once a decision has been made to change a portfolio's allocations or manager composition, it is important that the changes be implemented in a timely manner. Overlay managers are typically able to react to the changes quickly and manage the transition in a coordinated manner.



¹ Diversification does not guarantee a profit or protect against a loss.

² A management style that harmonizes an investor's separately managed account strategies, as well as other investment vehicles, preventing the formation of inefficiencies. Overlay management coordinates the implementation of multiple investment strategies or disciplines within a single account while ensuring the account remains aligned with a prescribed asset allocation.

³ A type of investment account that includes several specialized investment manager strategies within one main account. The account is split into several sub-accounts in which each strategy is implemented. The multi-discipline account provides investors with an efficient way to get professional investment management and asset diversification. It is also referred to as a "multi-style" and "multi-strategy account" or "unified managed account."

⁴ "Overlay Portfolio Management Rules." FRC Monitor, December 2006.

⁵ Rebalancing may involve additional costs and tax consequences.

- **Coordinated implementation.** There may be cases where underlying managers hold or are trading the same securities. Because they coordinate activity across the entire portfolio, overlay managers can handle this in a more efficient and thoughtful manner.
- **Enhanced tax management.** Some overlay managers provide tax overlays on portfolios, taking advantage of opportunities to manage a client's tax liability generated by their investment portfolio.
- **Simplicity.** Use of an overlay manager can facilitate the implementation of a multi-strategy portfolio. Multiple accounts can be consolidated into a single account, eliminating multiple agreements, statements, etc. The overlay manager also serves as a one-stop shop for account management, ensuring allocations stay in line with desired targets when there are cash flows into or out of the account.

Managed Portfolio Advisors® approach to overlay management

As with other disciplines, the approach employed by overlay managers varies significantly. Managed Portfolio Advisors® (MPA) approaches overlay management as an investment discipline rather than a purely

operational, technology or administrative function. Our philosophy places a great deal of importance on preserving the integrity of the underlying investment strategies being used in the multi-strategy portfolios we are implementing. We refer to our approach as **Integrated Portfolio Implementation.®**

Some of our key differentiators are:

- **Real-time trading.** Managers communicate portfolio changes throughout the day and we implement these on a real-time basis, providing an experience similar to what a client would get if they worked directly with the underlying manager. Trading may also be coordinated with the manager.
- **Adaptable portfolio implementation.** Flexibility is one of the hallmarks of our approach, and we adapt our process to the underlying managers rather than forcing them to modify how they invest to fit with our process.
- **Fixed income separate account implementation.** Fixed income assets play a critical role in multi-strategy portfolios. With a dedicated team of fixed income traders, MPA has unique capabilities to implement a broad range of fixed income investment strategies.

- **Sophisticated tax management process.** MPA employs a variety of tax management techniques to help manage a client's tax liability.

MPA has been providing overlay management services for more than a decade. One of the earliest providers of this type of service, MPA has remained at the forefront of the industry in providing new and more sophisticated capabilities. MPA's flexibility in working with managers has allowed our clients to access a unique and differentiated universe of managers within multi-strategy portfolios.

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