

REDUCING COST OF CUSTOM-BETA PORTFOLIO AND ADDRESSING CASH DRAG



EXTENDING THE TEAM OF A UNIVERSITY ENDOWMENT, WHILE REDUCING COSTS

Organization

A private research university with a \$15+ billion investment program, serving over 30,000 students. The university's investment program consists of three distinct investment pools. Seeking to enhance returns while managing costs, the investment team looked to expand their toolkit and improve efficiency in portfolio construction.

Challenge

Reducing the cost of custom-beta portfolio and addressing cash drag

The client identified cash drag as a primary challenge, which was impacting overall portfolio performance. Their portfolio consistently held higher-than-desired uninvested cash due to two main factors:

1. The need for **operational cash reserves** to ensure sufficient liquidity.
2. **Receivables from manager redemptions**, which left excess cash sitting idle for lengthy periods of time before cash was available and it could be reinvested.

While these cash reserves were necessary for day-to-day operations and portfolio rebalances and a feature of alternative investments, respectively, they introduced a drag on performance relative to the pool's long-term objectives.

Additionally, the university had developed a custom-beta portfolio utilizing equity and fixed income ETFs. This structure was designed to maintain desired public market exposure while giving active managers flexibility to take off-benchmark positions. However, the investment team sought a more cost-efficient way to implement this approach. Specifically, they questioned whether a combination of synthetic and physical instruments might offer cost savings compared to an ETF-only strategy—without sacrificing the desired exposures. The challenge, therefore, was twofold:

1. **Minimizing the impact of cash drag** while ensuring liquidity.
2. **Optimizing the custom-beta portfolio** to achieve cost savings without compromising portfolio objectives.

Solution

Cash drag

To address the cash drag issue, we implemented a cash equitization strategy using highly liquid global equity futures. By aligning the overlay with the client's public equity benchmark, we sought to keep the portfolio fully invested while preserving liquidity for operational needs. Given that cash drag in a typical multi-asset portfolio can reduce annual returns by approximately 16 basis points¹, this solution was expected to generate a meaningful long-term benefit.

Custom-beta portfolio

For the custom-beta portfolio, we conducted a comprehensive cost-benefit analysis comparing different implementation methods:

- **ETFs** – Readily available and easy to trade but subject to management fees and tracking error.
- **Derivatives (Futures & Total Return Swaps)** – Generally cheaper to trade but carry financing costs that can accumulate over time.
- **Physical Separate Accounts** – More expensive to set up but often the lowest-cost option for long-term exposure.

By evaluating the client's specific exposures, investment time horizon, and market conditions, we were able to determine the optimal combination of instruments to achieve their goals.

Results

Expanded toolkit, lower costs, and a broader conversation

- **Cash Overlay Implementation:** The overlay has performed in line with the benchmark, maintaining beta exposure while ensuring liquidity for operational needs. This approach has minimized the negative impact of cash drag on the portfolio.
- **Instrument Optimization:** Our analysis revealed that while derivatives are the cheapest to trade, current financing costs are historically high, making them less attractive for longer-term holdings when liquidity is not an issue. In contrast, physical separate accounts, though costly upfront, proved to be the most cost-effective solution for flexible and custom broad market exposures. For highly liquid benchmarks, ETFs remained the preferred choice when tracking error and management fees were low.
- **Ongoing Risk & Portfolio Review:** Beyond addressing these immediate challenges, the project catalyzed broader discussions about total risk management across the university's entire investment plan. With a more cost-effective, flexible and efficient structure in place, the client is now re-evaluating other aspects of their portfolio and process, including transition management, private markets distributions, and using part of their fixed income portfolio for the dual purpose of pledging collateral.

By engaging in this process, the university's investment team has expanded its resources, reduced costs, and positioned itself for more agile decision-making in response to evolving market conditions. Partnering with an organization like Russell Investments, which offers a broad range of tailored solutions, can provide meaningful support in achieving investment goals.

¹ Source: Russell Investments. Impact from 12/31/78 to 12/31/24. Based on a typical U.S. multi-asset portfolio consisting of 2.5% total cash (1.5% operational cash plus idle cash held by active equity managers: 1.5% U.S.

equity and 2.0% International equity) vs. a pro-rated target of 40% Russell 3000, 20% MSCI ACWI ex-U.S., 40% Bloomberg Barclays U.S. Aggregate.

QUESTIONS?

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