Inside **Strategic's** Office of the CIO

PORTFOLIO MANAGEMENT & TRADING: IN FOCUS

Perspectives from the Portfolio Management & Trading Team.

October 2026

Strategic Investment Group®

THE ROLE OF THE TEAM AND THE DISCIPLINE OF REBALANCING

How does the work of Strategic's portfolio management and trading team deliver value to clients?

The portfolio management group serves as a central link across the risk, operations, legal, and client portfolio management teams. The group is led by the Head of Portfolio Management and includes two dedicated traders.

We are responsible for the daily monitoring of every position and exposure across the entire client base, including the positions of outside managers and the securities we trade internally. Every day we confirm that each portfolio is positioned as our investment teams intend. The goal is to implement their ideas as efficiently as possible while incorporating cash needs and client-specific considerations into the plan. Ideally, each portfolio is positioned to optimize expected return while maintaining the liquidity needed to fund investments and meet the institution's obligations.

Rebalancing is the most visible part of that work. Our general rule is to rebalance each quarter to the client's long-term strategic asset allocation (SAA) weights, plus or minus our tactical tilts. By periodically reducing allocations that have grown above their targets and adding to those that have fallen below them, rebalancing restores client portfolios to their intended exposures and risk profiles. This disciplined process keeps short-term market movements from materially reshaping long-term allocation approved by the client. Internal trading capabilities also allow us to realign a portfolio between quarter-ends, whether it has drifted because of a withdrawal or a market move, and act when attractive opportunities appear.

We view rebalancing first and foremost as a matter of governance and risk management. Adhering to the investment objectives set out in the SAA ensures that the portfolio remains aligned with the goals set forth by each client's investment committee. Academic literature also supports a modest long-term compounding benefit from rebalancing, though the size of that benefit depends on the assets, the market path, and implementation costs.

LIQUIDITY AND MARKET EXPOSURE

How do you ensure an endowment can meet capital calls and spending draws while keeping its portfolio appropriately invested?

Managing portfolio liquidity always starts with a good forecast of future spending needs. We work closely with our operations and cash teams to maintain an accurate view of cash obligations well into the future, taking into account expected capital calls, scheduled spending distributions, and known withdrawals. Capital calls require particular attention because they arrive with far less notice.

There are two ways to prepare for those obligations. One is to hold excess cash at all times. Although simple, this approach creates cash drag because every idle dollar is not working toward the investment team's best ideas. Strategic takes what we consider to be a better approach: running cash tighter, adjusting exposures, and drawing on the Treasury account as payment dates approach. Our integrated portfolio management and trading team makes this possible, allowing us to hold less cash while keeping more of the portfolio invested. In most portfolios, we target no more than 2% on average in cash for day-to-day needs and use broader fixed income and futures implementation to avoid carrying more.

There is a distinction between setting aside cash and maintaining market exposure. If a portfolio needs to reserve cash for a payment, cash overlaid with futures allows us to hold the intended market exposure while the cash is set aside. Without that capability, the portfolio must hold cash or rely on mutual funds and exchange traded funds (ETFs), none of which provide immediate settlement.

KEY TAKEAWAYS

Investment Policy is only as good as its implementation.

- Cash vs. exposure: Idle cash is a cost. Missed market days are a bigger one.
- Know your position: You cannot act on a position you do not understand.
- Ready in stress: Liquidity is what you can sell on the worst day. Preparation is what turns that day into an opportunity.
- Stay invested: Transitions happen in the market, not on the sidelines.
- Every dollar has a job: Some seek alpha. Some hold exposure and stay liquid. Few sit idle.
- Bottom line. Money is available when you need it. The portfolio stays the one you approved.

SERIES OVERVIEW

A recurring series featuring perspectives from asset class leaders and other members of Strategic's Office of the CIO. Upcoming editions: Private Equity, Hedge Funds, Fixed Income, and more.

AT A GLANCE: PORTFOLIO MANAGEMENT & TRADING

- Dedicated team led by the Head of Portfolio Management, including two traders
- Daily monitoring of every position and exposure across all client portfolios, including manager look-throughs
- Quarterly rebalancing to strategic asset allocation targets, with realignment between quarters as needed
- Individualized Treasury account for every client
- Instruments traded directly: U.S. Treasuries, TIPS, equity and fixed income index futures, currency futures and forwards, ETFs

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We saw this play out when one client needed to make an unexpected withdrawal at its fiscal year-end. Roughly two-thirds of the amount needed for the withdrawal was already on hand in overlays. We raised the balance within a week while using futures to preserve the portfolio's long-term market exposure, allowing the client to receive its cash on time without its allocation changing in the process.

Managing liquidity thoughtfully matters because market returns arrive unevenly. We are not trying to time the market. Instead, we aim to ensure that the need for cash does not undermine the ability to keep the portfolio invested.

MANAGING THROUGH MARKET STRESS

What did managing portfolios through March 2020 reveal about the importance of liquidity and the ability to act quickly?

March 2020 witnessed a rapid market drawdown followed by an equally speedy recovery. This period taught us that we need to have tools ready before the stress arrives. We find that our process of daily cash forecasting, position liquidity monitoring, and daily exposure reporting provides us the information we need on where each portfolio stands and prepares us to respond to unexpected sharp market movements.

These capabilities proved essential during this period. In such an unprecedented environment, no one knew how much cash an endowment might need to sustain operations. Dislocations of that magnitude are precisely when an implementation team, like Strategic's, can add value.

Because we managed a Treasury book for each client, we were able to raise cash and move client portfolios to overweight equities near the trough of the sell-off. We did not know the market would recover as quickly as it did. What we knew was where our portfolios were positioned, how to raise the capital to fund purchases, and which instruments were best suited to execute the trade.

This last point is often underappreciated. Having the authority and desire to add exposure during periods of market dislocations is not enough — you need a way to execute the idea. In March 2020, many of the securities that would typically be used to fund such a trade were unavailable: Treasury Inflation-Protected Securities (TIPS) were illiquid, ETFs were marked down, and even short-duration credit ETFs traded at meaningful discounts to their underlying value. Treasuries were the one remaining deep and liquid market. Brokers would not provide quotes on screen due to uncertainty, which resulted in having to trade over the phone. Our team's relationships and experience as well as their knowledge of which instruments to use were instrumental in working through the March 2020 market gyrations.

None of this would be possible without knowing your actual current positions. We work closely with our risk and quantitative strategies teams to track the daily positioning of every client portfolio at a granular level, including look-throughs into manager holdings, using proprietary tools built over many years. Knowing how your portfolio is positioned relative to target on any given day is the first step to being able to act.

PORTFOLIO TRANSITIONS AND LARGE CASH FLOWS

How do you maintain desired exposures while managing the large cash flows that arise in the case of onboarding a new client portfolio or in the event of large contributions and withdrawals?

The onboarding process begins with understanding the portfolio we are inheriting and where we want to move it in SAA terms. Staying in the market is the hard part. Many funds offer only monthly or quarterly liquidity and carry long settlement terms. You cannot control precisely when you can exit certain positions, or when the proceeds will be available to be redeployed.

So, we work with our operations team to understand the terms of every legacy manager, and with our risk team to understand how those managers are positioned. Then we use futures and Treasuries so that the transition is not dictated by manager liquidity windows or settlement dates. That lets us time the transition precisely and keep the client invested throughout, without the added expense of hiring an external transition manager.

CASH ON HAND VS. MARKET EXPOSURE

Cash available for a payment and the portfolio's economic exposure to markets are two different things. Futures allow a portfolio to reserve cash for an obligation while keeping its intended market exposure in place. Returns do not arrive evenly: the S&P 500 rose 24.7% over the 13 trading days from March 24 through April 9, 2020, against a 5.4% price return for the full fiscal year ended June 30, 2020. (S&P 500 price returns, excluding dividends.

Source: S&P Dow Jones Indices via FRED. Historical illustration only.)

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Contributions raise the same issue in reverse. One client had the opportunity to sell a significant land holding at an attractive price — a sale that would have increased the endowment materially. Deployed only through external managers, with subscription lead times and one or two liquidity dates per quarter, the proceeds could have sat idle in cash for months. Trading directly, we were able to put the contribution into the market immediately and hold the client's SAA regardless of the magnitude of the flow.

IMPLEMENTATION FLEXIBILITY

There can be several ways to implement the same investment decision. Why does having a broad range of options matter for clients?

Each instrument has advantages and drawbacks, so a large toolbox gives us more ways to accomplish what the investment team intends.

Futures are the clearest example of that flexibility. They are marked-to-market daily. The variation margin needed is limited to the daily change in value rather than the full amount of the position. That makes them the right tool when the cash to fund a position has not yet arrived . Say a fund redemption has been submitted but the proceeds are weeks away. A futures position lets us restore the market exposure immediately, while an ETF would require settled cash. The same feature makes futures useful as an overlay to keep a portfolio close to its SAA targets, to reposition around a manager change, or to respond when markets move quickly.

Instrument choice can also be a cost-benefit trade-off. In Canadian equities, where active management has not been well rewarded, we have combined a Canadian equity index future with a Canadian dollar future to replicate the exposure at very low cost rather than paying for an active manager.

The importance of the Treasury portfolio in helping to manage portfolio positioning is often overlooked. Many investors replicate fixed income with a broad aggregate bond ETF. We think that is a missed opportunity. Fixed income balances the risk in the rest of the portfolio. In many cases, it is also a client's first source of liquidity and its least volatile asset. A broad ETF does not let you use those properties precisely.

Instead, every Strategic client has an individualized Treasury account that we manage directly. It lets us meet liquidity needs in almost any circumstance, because the Treasury market is one of the deepest in the world and, as March 2020 showed, liquidity elsewhere dries up faster than most people expect. It also lets us manage portfolio duration exposure precisely rather than relying on cash bond turnover. That liquid, controlled position frees capacity elsewhere in the portfolio, for capital calls or for somewhat less liquid investments such as direct lending. And Treasuries serve as collateral for futures overlays, so the same holdings support liquidity, duration, and exposure management at once.

TAILORING IMPLEMENTATION TO EACH INSTITUTION

Every institution has its own circumstances. How does having an internal team help you tailor implementation to a client's needs?

We take pride in building specific solutions for clients with complex situations. Most involve a cash need, a concentrated holding that the client is required to keep, or an unwanted exposure that we want to manage around.

For example, one client considered borrowing several million dollars from its endowment for an institutional need and repaying it later. Before that decision was made, we framed the true implementation cost: days out of the market, what would need to be sold and repurchased, market impact, and direct trading costs. We were then able to raise the money by using overlays and repositioning the Treasury book, so the client met its need without taking the portfolio out of the market.

Holdings kept for non-investment reasons are usually restricted gifts, such as a single stock the endowment is not permitted to sell. When that creates a concentration risk the portfolio does not need to carry, derivatives may be able to offset part of the undesired exposure while the holding stays in place.

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For appropriate clients, the same capabilities support overlay programs. Our hedge fund portfolio is built on the belief that investors should pay for alpha not beta. As a result, the portfolio is constructed to be low beta to both equities and fixed income, so that it provides a relatively pure source of alpha. As a result, the alpha can be combined with a low-cost source of market exposure, such as S&P 500 futures, to create an attractive position in an asset class such as U.S. large-cap equities, where alpha has traditionally been hard to find. Effective execution of these strategies requires daily liquidity monitoring, the ability to manage daily margin and collateral requirements, and the risk management tools to ensure that you are pairing an alpha stream that is uncorrelated with the market exposure rather than duplicating it.

WHY INTEGRATION MATTERS

For an investment committee evaluating an OCIO, what difference should it expect from having portfolio management and trading integrated within the investment team?

The most important thing for any of our clients is that the money is there when they need it, and that the growth of their assets is appropriate to the needs of the institution. Our portfolio management and trading team is designed to serve those two objectives.

Our integrated portfolio management and trading team has a clear, detailed view of each portfolio's current and target positioning, expected cash needs, and the effects of meeting those needs. That perspective enables the team to maintain market exposure through cash flows and transitions and act on opportunities arising in the markets or from the institution's circumstances.

Every dollar in the portfolio should have a job.Some dollars are placed where our investment teams expect alpha. Others provide broad market exposure while remaining liquid. Few sit idle. Without an internal implementation team, an OCIO often must trade one against the other, holding cash to fund high-conviction ideas or accepting exposure gaps to meet obligations. With an internal team, that trade-off largely goes away.

FINAL THOUGHTS

Investment policy is only as good as its implementation. Our approach to portfolio management and trading rests on daily knowledge of every exposure, a liquid Treasury foundation for each client, and the ability to move market exposure directly rather than waiting on manager liquidity and settlement cycles. Those capabilities let us hold each portfolio to the allocation its committee approved, meet obligations without idle cash, and respond when circumstances change.

We welcome further questions and ongoing dialogue as part of our engagement with clients and prospective clients.

FIVE QUESTIONS TO ASK YOUR OCIO ABOUT IMPLEMENTATION

1. How do you know where our portfolio is positioned today, including what our managers hold?
2. How much cash do we carry, and why that amount?
3. When we have a capital call or a spending draw, what happens to our market exposure while the cash is raised?
4. How would you transition our current portfolio without leaving us out of the market?
5. Who executes trades for our portfolio, and how do they coordinate with the people making the investment decisions?

ABOUT STRATEGIC

Strategic Investment Group® is an Outsourced CIO (OCIO) firm that provides institutions with the capabilities of a full investment office. Acting as an extension of our clients' investment teams, we deliver portfolio construction, manager selection, and ongoing risk management within a structured fiduciary framework. Strategic was founded to provide mission-driven institutions access to the investment office they would build if they had the time, the people, and the scale to do so internally.

LEARN MORE AND CONTACT US

Learn more about our investment approach and how we work with mission-driven institutions.

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