

# Adding alpha

Pension fund consultants have demonstrated that currency overlay managers can add value hedging an investor's currency exposures to protect underlying cross-border investments against currency losses. The consultants' studies of currency overlay managers' results indicate that active currency overlay management can be an attractive source of alpha to boost an investor's total portfolio return.

Watson Wyatt Investment Consulting has examined the returns of currency overlay managers in detail. Brian Hersey, investment director, and Jim Minnick, a consultant, at Watson Wyatt published their findings in *Global Pensions* in February 2000 in an article titled 'Active Managers Generating Positive Excess Returns Over Benchmarks.' They concluded that plan sponsors "must recognise their exposure to foreign currency and its impact on performance—exposure is unavoidable, but manageable." And, they stressed it is "reasonable to segregate the currency and asset decisions because the properties of currency are so distinct from those of financial assets."

Frank Russell Company, another large pension consultant, has also examined currency overlay managers. It titled its May 2000 performance review of overlay managers *Capturing Alpha Through Active Currency Overlay*. Frank Russell's research study covered 18 overlay managers who had submitted over 10,000 monthly returns. Frank Russell observed "positive excess returns for the vast majority of active currency overlay accounts". And, its research commentary concluded that "these excess returns, in combination with reasonable tracking errors, support Russell's qualitative assessment that positive excess returns from active currency overlay management assignments are likely to be sustainable and transportable across various base currencies and hedge ratios."

Brian Hersey and Kurtay Ogunc, at Watson Wyatt, published additional performance measurement data, in October 2000, and wrote: "The value added by currency overlay managers since inception stands at 1.34% with a success ratio of 0.511." They added: "Currency is lately viewed as a portable alpha engine by some practitioners due to the favourable results produced by a number of currency overlay managers and the ability to place the overlay on any portion of the portfolio."

The positive findings of the pension consultants that have studied overlay managers' performance records prompted Deutsche Bank Global Markets Research to publish a 70-page report, in January 2002, titled *A Guide to Currency Overlay Management*. The guide endorsed currency overlay as the next logical step global investors must take to attain superior returns.

AN OVERLAY STRATEGY CAN ADD ALPHA AS WELL AS HEDGE AGAINST FLUCTUATIONS IN CURRENCIES, WRITES ULF J. LINDAHL, CIO OF A. G. BISSET & CO



Deutsche Bank concluded that "investors and plan sponsors should consider increasing their focus on both the risk of, and the potential returns from FX" since "historical performance data suggests that active management of FX risk can significantly increase alpha."

In its contribution to Deutsche Bank's guide, Bill Muysken, head manager of global research at William M. Mercer Investment Consulting, added: "On balance, we believe that active currency management is worthy of serious consideration ... The empirical data on past performance of specialist currency overlay managers clearly favour the case for active currency management."

## THE NEED FOR CURRENCY SPECIALISTS

When plan sponsors in the US began to invest overseas in the mid-1980s it was the largest and most sophisticated pension plans, such as General Motors and CalPERS, that took the first steps. The process was similar in Europe where the largest pension funds in Holland and Belgium, for example, were also leaders in adding currency overlay programmes managed by independent currency specialists to control their currency risk.

Today, when pension fund consultants have found that currency overlay managers can add substantial value over time, currency overlay has become a "must have" for plan sponsors worldwide that seek to attain superior investment returns.

The need to appoint a currency overlay manager, or a team of overlay managers, became apparent over time since it became increasingly clear that international equity managers lack the necessary skills to manage currency exposures effectively. In fact, InterSec, a pension consultant owned by Deutsche Bank, has found that in its EAFE Plus performance universe of over 100 representative manager portfolios, not one equity manager in that universe had "added implicit or total currency value to their portfolio performance" over the past 10 years.

It is not difficult to understand why equity managers have done a poor job in hedging currency exposures. Their skills are in finding securities that are likely to rise in value faster than the underlying benchmark in a bull market and to select stocks that will fall less in a bear market. Their focus is on value and making money over the long term.

However, the essence of hedging currencies is to decide when to place and remove hedges. Currency managers, therefore, focus their skills on meeting the need for timing transactions to coincide with periods of strength and weakness in currencies.

As Watson Wyatt indicated, it is the differences in skills and objectives that necessitate a separation of currency management from asset management if superior returns are to be attained.

Although international equity managers will often inform their clients that they will "hedge opportunistically", they seldom have defined currency hedging strategies. If they do, these managers' currency returns should be compared with those of the established overlay managers to see whether their currency returns are acceptable or not. Harriett Richmond, head of currency management at JPMorgan Fleming Asset Management states the case well: "There is little reason to believe that investors who excel at stock picking will also excel at currency management. Specialisation should result in better overall decision-making, with low correlation between the different decisions."

## A CURRENCY OVERLAY CAN ADD VALUE

The objective of an active currency overlay programme is to mitigate the currency risk that arises when assets are invested across borders. Typically, an overlay manager will leave currencies unhedged when they rise in value and place hedges on them when they decline in value. To meet this goal, overlay managers make decisions on when to buy and sell currencies in the currency spot and forward markets.

In a currency overlay programme, the amount of currency that is sold to place a hedge on an existing, underlying investment is usually determined by the value of the investment. If a European pension fund has \$60m investment in US equities and the dollar is falling against the euro, a hedge will be placed on that amount. When the dollar begins to rise the hedge is closed with a purchase of the same amount of dollars. That locks in a gain that offsets the currency translation loss on the underlying investment. After the dollar has risen and it begins to depreciate again, another hedge is placed at a higher price. As this process is repeated over and over, currency by currency in a portfolio, an added value is generated that boosts a portfolio's overall return.

Traditionally, pension funds place a currency overlay on the portion of its assets that are invested in foreign equities and fixed income instruments and which are exposed to currency fluctuations to reduce the risk of adverse currency movements. However, the ability to apply a currency overlay to any portion of a portfolio, whether exposed to currency risk or not, makes currency management stand out among the various strategies investors can utilise to boost a portfolio's overall return. That is one reason currency management is attracting attention among sophisticated pension funds and investors as a source of alpha.

Initiating a currency programme to generate alpha is attractive because a currency alpha programme does not require a plan sponsor to change its pre-existing asset mix. A pension fund invested in equities and fixed income, for example, would need to sell a portion of those assets if another asset class, such as real estate, were to be included in the portfolio. However, it is only if the real estate return is higher than the equity and fixed income returns that a portfolio's total return is increased.

Adding a currency alpha programme only requires that foreign exchange trading lines are established at financial institutions at which currency forward contracts can be bought and sold by a currency manager. As a result, a pension plan need not sell a portion of its investments to initiate a currency alpha programme. Thus, the return that can be generated by a currency overlay programme comes as a pure addition to the underlying asset return. As a result, the currency return can be lower than equity and fixed income returns and still boost an investment portfolio's total return.

Continental European pension plans usually have a large exposure to the dollar and lesser exposures to the Japanese yen and Britain's pound sterling. In the past 10 years, for example, the value of that typical 'portfolio' of currency exposures increased 26% from January 1992 through May 2002 (see

### AG BISSET

A.G. Bisset & Company is one of the pioneers in the currency overlay industry and is the winner of *Global Pensions* 'Currency Manager of the Year 2001' award. Founded in Connecticut in 1981 by Alfred G. Bisset, president and CEO, the company introduced its model-driven currency overlay programme in 1988 and has since been awarded currency mandates by pension funds in Europe and the US. Assets under management total \$1.8bn, which include currency as an alpha strategy.

chart - bottom line). The positive return was mostly due to the dollar's dominant position in those portfolios and because the dollar rose against the deutschemark and the other European currencies until the euro was born, after which the dollar continued to rise against the euro.

An active currency overlay programme would have kept the three major currencies hedged when they fell in value against the DM/euro and left them unhedged when they rose in value. In the example illustrated in the graph, the cumulative overlay return was +45% over the almost 10 and a half years measured (see graph - middle line). The cumulative added value was +19%, or more than 100 basis points per year. And, because the overlay return was less volatile than the unmanaged exposure, the overall risk was reduced.

The added return a currency overlay programme can provide can be attained by simply appointing a currency overlay manager to manage the currency exposures of assets that are invested across borders. In just 10 years, exposures managed by overlay managers have surpassed \$100bn by a wide margin. Adding a currency overlay programme to a global portfolio is no longer 'exotic.' It is simply necessary for internationally diversified investors who seek superior returns to do so. Especially since InterSec projects that "the world's pension funds will control cross-border assets totalling well over \$3 trillion by 2005." That means one in five of those dollars will be subject to currency risk. To leave that risk unmanaged or in the hands of equity managers with little or no skill in hedging currencies would be irresponsible.

### USING CURRENCIES TO ADD ALPHA

Since the decisions overlay managers make to buy and sell currencies can be implemented with a foreign exchange trading line without having any pre-existing currency exposure, a currency overlay manager's expertise can be

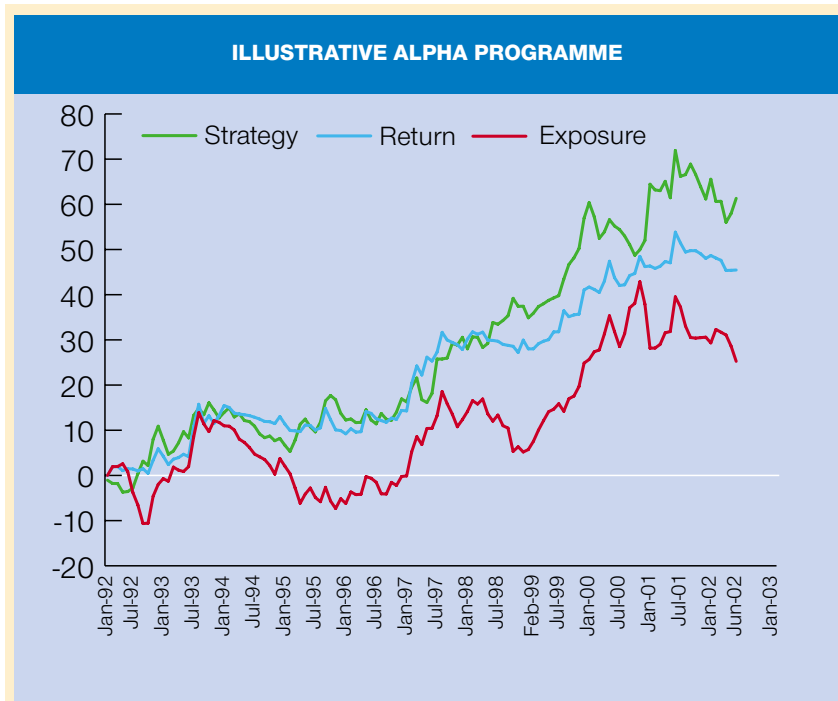
### CURRENCY OVERLAY HAS BECOME A "MUST HAVE" FOR PLAN SPONSORS WORLDWIDE ULF LINDAHL



harnessed to extract alpha from the currency market. In this application, currency becomes an alpha strategy that can boost a portfolio's total return over time.

When the decisions to buy and sell currencies are applied to generate alpha, the currency manager is unconstrained by currency exposures generated by underlying investments. The mix and size of currency forward contracts need not be matched with underlying investments in foreign equities or fixed income instruments but can be optimised to achieve an added value that can be superior to that achieved by a traditional overlay programme.

The additional return an unconstrained but conservative and unleveraged currency alpha programme can create in addition to the added value a traditional overlay can produce can be substantial. The increased return is derived from taking larger positions in strong currencies when they rise and taking larger short positions in weak currencies when they fall. In the illustration, the alpha programme added an additional 16% (see top line in the graph) over and above the 19% the overlay added compared to an unmanaged



exposure. The alpha programme's total cumulative currency return, before fees, was +61% from January 1992 through May 2002.

The alpha programme shown in the graph had a return that averaged 5.8% per year. The return is superior to the total return that can be expected from short- and long-term fixed income instruments when interest rates begin to rise and bond prices fall. And, an average annual return of 5.8% may be competitive with equities in the conservative investment climate that has emerged after the technology bubble burst in March 2000.

A currency alpha programme is distinguished from other alpha strategies in more ways than one. Not only can it be applied to any portion of an underlying portfolio without having to liquidate a portion of existing investments but the currency return is usually not correlated with equity and fixed income returns. A portfolio's overall risk can therefore be reduced with a currency alpha programme while its total return is increased.

The high liquidity in the global currency

movements of the major currencies against it. As a result, they can be excluded from an alpha programme.

Emerging market currencies can provide interesting returns since they often are associated with high interest rates. However, there is a reason for those high interest rates - the risk of devaluation. Many investors have been tempted in the past to invest in these currencies to capture their high interest rates. However, many have also been burned and lost significant amounts when currencies were suddenly devalued. As a result, it may be prudent to exclude these currencies from an alpha programme.

Managing currencies to make a profit is not a new concept. Over the years there have been many currency funds set up for high net-worth individuals interested in having currencies managed on a leveraged basis by hedge fund managers and commodity traders who make aggressive and leveraged currency bets while charging high management and incentive fees. What is now emerging is a move by some overlay managers to take the next logical step. They have begun to apply their proven currency management skills and institutionally friendly investment strategies to assist pension funds to add alpha at a time when traditional investment returns are diminished relative to those that were reaped in the past two decades.

Plan sponsors that have successful overlay programmes in place, or who have examined the currency issues closely, are now moving to add currency alpha strategies to harvest the added return these programmes can provide. For example, *Global Pensions* reported in February that one of Holland's largest corporate pension funds had appointed A. G. Bisset & Company to manage a currency alpha mandate. It is likely only one of many currency alpha mandates that will be initiated by pension funds in Europe and the US in the years ahead.

In the words of Brian Hersey and Kurtay Ogunc of Watson Wyatt Investment Consulting; "Institutional investors with long-term investment horizons, such as pension plans with good funding levels and university endowments, should seriously consider currency management as an asset class, which provides excellent portable alpha properties not found in any other investment product. If one is looking for a specialised niche to boost returns over policy benchmarks, the currency overlay area promises to be the next undiscovered, yet full of potential, layer in the institutional portfolios."

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