

CURRENCY MANAGEMENT - A SOURCE OF RETURN

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Interest in currency management has increased in recent years. There have been two primary forces driving that interest among institutional investors. The most important has been a realization and acceptance that currencies can be managed profitably. The other factor is the increased need to manage the risk that is associated with the currency exposures that arise when investments are made across borders. Since, investments in foreign equities and bonds have increased the currency risk associated with those investments has become significant for many investors.

Investors have responded to the risks and rewards currencies provide by adopting two distinct strategies: currency overlay programs and currency alpha programs.

OBJECTIVES OF OVERLAYS AND ALPHA PROGRAMS

The objective of a currency overlay program is to control the currency risk that is unavoidable when investments are made outside a home country. For example, investing in Japan means an investor becomes exposed to fluctuations in the Japanese yen. If the yen depreciates, its decline can reduce or even eliminate the investment return. That is true for investments in any country. A currency overlay seeks to manage that currency risk: a currency manager will place a hedge when a currency begins to decline while the hedge will be removed when a currency begins to rise. The risk of currency losses is reduced while the overlay can generate a return that can boost a portfolio's overall return. Investors generally apply an overlay program to all of their currency exposure and expect an added value that may annualize between 1% and 2% over time.

The objective of a currency alpha program, often made as an investment in a currency fund, is to benefit from currency as an asset class. An investment in a currency alpha program is attractive because currency returns are uncorrelated with those of equities and fixed income. Investors usually commit a relatively small percentage of their assets to currency alpha strategies and expect the return to be comparable to those of other alternative asset classes.

EXCESS RETURN VERSUS REAL ADDED VALUE

Performance data on currency managers have been collected by several pension consultants. They have found that overlay managers, as a group, provide risk-reduction and add value over time. However, there is some confusion as to how the added value should be measured: as "excess return" against a benchmark or as "real added value." The measures are not the same.

Currency overlay managers are measured against benchmarks that can be 0%, 50% or 100% hedged. The “excess returns” they report are therefore not directly comparable and a positive “excess return” against a benchmark may not mean a portfolio’s total value has been increased. An example illustrates that paradox.

If a currency appreciates 10% the return of the 0% hedged currency benchmark is 10%. A 100% hedge would eliminate that return and the 100% hedged benchmark’s return would be 0%. A 50% hedge would have a 5% return. If an overlay manager achieves a return of 7.5%, the manager would report an “excess return” of 2.5% versus the 50% hedged benchmark. However, since the return was 2.5% lower than the 0% hedged benchmark’s 10%, the manager did not increase the portfolio’s total value but reduced it 2.5%. A manager with a return of 12.5% has an “excess return” of 7.5% against 50% hedged and a “real added value” of 2.5% against 0% hedged. Measured against the 0% hedged benchmark’s 10%, that manager has an “excess return” and a “real added value” of 2.5%.

As illustrated, it is crucial to understand how currency managers and consultants measure overlay returns and what they mean when they speak of added value.

OVERLAY PERFORMANCE

What is the real added value that can be expected from a currency overlay? Mellon Analytical Services has detailed performance data on eighteen overlay managers they measure quarterly. For the ten years through June 2006, the average added value for all base-currencies measured against 0% hedged benchmarks (real added value) was an annualized +0.95%. The real added value for the nine managers that had ten-year records ranged from +1.66% to +0.08%.

Since the essence of a currency overlay is to place a hedge as soon as a currency begins to decline – to avoid loss – and to remove a hedge when a currency begins to rise – to participate in gains – the real added value overlay managers achieve can be highly cyclical. When currencies decline over two to three years, which is not uncommon, they are generally hedged and gains on hedges can be substantial resulting in real added value that can be significantly higher than the average long-term added value of 0.95%. For example, if currencies drop 10% and they are hedged, the added value can be 10%! However, in years when currencies rise, they will be generally unhedged and there will be few opportunities to generate added value since a manager’s unhedged return will largely mirror that of the unhedged benchmark.

MULTIPLE MANAGERS

It is customary to appoint a team of two to three overlay managers. There are two reasons for this. Firstly, in most portfolios up to 90% of the currency risk can be concentrated in the dollar, euro and the yen for sterling-based investors, while the risk is concentrated in the euro, sterling and the yen for dollar-based funds. Since that concentrated risk cannot be diversified away, and any manager may place an incorrect hedge on those important exposures, it is prudent to diversify the single manager risk. Secondly, since only a handful of overlay managers have records that span more than ten years, and the added value for the group has ranged between +0.08% and +1.66%, the risk is high that a

selected manager may produce an added value below average. Having two or more managers increases the probability that the long-term added value will mirror that of the average annual return of about 1% as reported by Mellon Analytical Services.

CURRENCY ALPHA PROGRAMS

There are two avenues open to investors who seek to use currency as an asset class. The obvious alternative is to invest in a pooled vehicle or “hedge fund” that trades currencies. That investment is not that different from an investment in other alternative asset classes except that the currency return can be expected to be uncorrelated with other returns. The absolute return achieved will be a function of the leverage used by the fund manager. From January 1999 through June 2006, the average annual return of the Parker FX Index, which tracks over fifty currency managers, was 4.3%. The returns ranged from -4.9% to 14.9%.

With an average expected return of 4.3%, it is important to select currency managers with strategies that can beat that average or an investment in a currency fund would simply contribute to lowering a pension fund’s total return if it expects to earn a higher return on its equity and fixed income assets. The less obvious currency alpha alternative bypasses that “obstacle.”

In currency overlay programs, managers place and remove hedges using currency forward contracts. They do not require an up-front investment. As a result, a currency alpha program can be initiated as segregated account and structured like a currency overlay program, but with the manager buying and selling currencies for profit and unconstrained by any underlying currency exposure. In these alpha programs there is often no need for any up-front investment. The benefit of this approach is that an investor can continue to reap the return on the portion of equity or fixed income assets that would have to be sold to invest in a currency fund. Thus, a currency alpha program structured like an overlay produces a return that is added on top of the return of other asset class. That means an alpha program with a return lower than that of the expected return of equities can still boost a portfolio’s total return while reducing its risk due to the uncorrelated nature of the currency returns.

WHICH PROGRAM SHOULD A FUND HAVE?

All investor who have pre-existing currency exposures, whether they are 5% or 50% of a portfolio, need a currency overlay program to reduce the risk of currency losses and to benefit from the proven ability of currency overlay managers to add return.

Since currency returns are uncorrelated with other returns, it makes sense for all investors who seek diversification to include currency in their alternative asset class allocations. However, since currency alpha programs may have return streams that may not fully compensate for currency losses related to pre-existing cross-border investments, investors are wise to have both.