

Currency risk – a problem that has not gone away



Ulf J Lindahl and Uto Shinohara of A G Bisset & Company look at the potential offered by hedging as a way to reduce risk when investing internationally

Since many currency programs ran into anticipated problems in 2008 and have been terminated, pension schemes wonder how they should manage the currency risk that is associated with their investments: to hedge or not to hedge? This article examines the alternatives and concludes that an active hedging program is likely to deliver superior results compared to no hedging or a passive hedge of part of the exposure.

Investing in different assets to reduce a pension scheme’s risk is a key objective in managing pension funds effectively. The large investments pension funds had in UK equities some years ago has spawned, since 2001, a disinvestment out of FTSE 100 companies into international equities to reduce risk through diversification.

How successful has the strategy been? Risk was reduced but perhaps not as much as anticipated. The correlation between UK equity returns and local equity returns in Germany, Japan and the United States, for example, is high. In 2000 into 2010, the correlation of monthly returns averaged 0.76, that of quarterly returns averaged 0.80, and that of annual returns averaged 0.92 (see table).

Although the diversification achieved some risk reduction, it created a new and greater risk: currency risk. Since exchange-rates move largely independently of equity markets, the currency risk is distinct and is significant in the short- and long-term. It must, therefore, be assessed separately; it was not.

Many investors saw their currency exposure as an “unrewarded risk” since currency was said to have no long-term expected return. Many schemes left their currency exposure unmanaged thinking currency returns would even out over time. This strategy of “benign neglect” ignored the significant risk the currency exposure imposes on a fund’s total return over one to three year horizons and that unmanaged currency exposures can unpredictably and seriously

impact a fund’s (triennial) valuations.

Annual currency changes can be large. For example, in six of the past ten years, and in sixteen of the last thirty years, the dollar’s value changed by 10%, or more, against sterling. What does this mean for a pension fund? If the international allocation is 40% and half of that exposure is in the dollar – a common occurrence – a 10% change in the dollar’s value over a year, when measured over a scheme’s entire portfolio, will cause the portfolio’s total return to rise or decline by 2%.

In a post-2008 age, as schemes target long-term returns of 6% to 8%, a 2% annual swing factor is material and cannot be left unaddressed. That is why many schemes chose to hedge their currency risk, fully or partially. A permanent passive hedge, it was thought, would largely remove the currency risk with no meaningful impact on a scheme’s return since it was assumed currency has no long-term return.

The events of 2008 confirmed our long-held view that passive hedging is a flawed strategy. Many funds suffered dearly and passive hedging programs have been terminated. Why is the passive strategy risky? The notion that currency has no long-term return ignores the evidence. Currencies have long histories of trending up or down for several years and that these price-changes often exceed 25%. The flawed thinking led to severe stress when large hedging losses had to be paid.

When currencies appreciate and a hedge is in place, the hedging loss offsets the valuation gain on the underlying investment, and, therefore, removes the currency return from the portfolio. However, a hedge only changes the currency risk to cash flow risk, which is often deemed to be worse by schemes that have experienced large passive hedging losses. In theory, a passive hedge will gain cash back in the downward phase of the currency cycle, but the unpredictable nature of the need for cash to settle

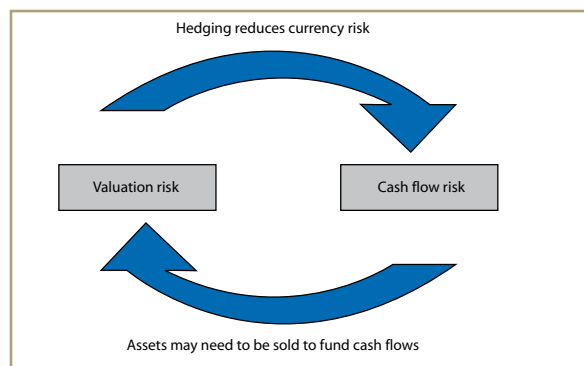
hedging losses makes passive hedging a risky strategy, especially since the currency risk has not been removed but has only been transformed into another type of risk.

In an active hedging program, a currency manager assesses if currencies are likely to rise or fall and places and removes hedges accordingly. Thus, exposures will be generally unhedged when currencies rise and an investor benefits from the higher valuation. Exposures will be generally hedged when currencies decline; gains on hedges then offset valuation losses. An active hedging program can therefore deliver results that have superior return and cash flow profiles over time compared to passive hedging strategies and leaving exposure unmanaged.

While active currency hedging also has risks, studies by pension consultants have found that active hedging has delivered positive results over time. Hence, there is a solution to the currency risk dilemma; incorporating an active hedging program in the portfolio.

Ulf J Lindahl is chief investment officer, and Uto Shinohara is director of research at A G Bisset & Company www.AGBisset.com

Chart: Active hedging program



Source: A G Bisset & Company

Table: Correlations in Equity Returns with UK Equities

Return	Japan	USA	Germany	Average
Monthly	0.59	0.85	0.84	0.76
Quarterly	0.62	0.89	0.89	0.80
Annually	0.85	0.95	0.95	0.92

Source: A G Bisset & Company