



Executive Summary

With the rise of global investing, we believe a well-defined currency hedging policy at the total portfolio level is more important than ever. In particular, we think it is critical for investors to distinguish between the currency translation risk that comes with investing abroad and the currency alpha risk that results from positions taken by managers of absolute return currency strategies or global macro mandates. As the proportion of foreign investment in portfolios rises, currency translation risk consumes an ever larger share of the total risk budget. As a result, a fund's currency hedging policy can have a far greater impact on investment returns than the alpha generated by risk-taking managers. Traditional approaches to currency management often do not differentiate between these two sources of risk. In the following discussion we argue the advantages of a more nuanced approach to global currency management. We suggest ways of implementing an effective hedging policy at the portfolio level, separate from a subsequent risk allocation process to alpha-generating currency strategies.

New Approaches to Global Currency Management

By

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Currency Translation Risk vs. Currency Alpha Risk

International investors hold two types of currency risk: currency translation risk and currency alpha risk. Failure to make that distinction between these different types of risk can result in significant currency losses. Currency translation risk is a by-product of foreign investment. Investors may gain diversification benefits by holding foreign assets, but they generally take on the currency risk without any expectation of adding value to the portfolio. Exchange rate movements may generate losses and gains that may have a significant impact at the total portfolio level.

By contrast, currency alpha risk results from active bets in absolute return currency strategies or global macro strategies that aim to profit from differences in currency rates, interest rates and other macro arbitrage opportunities around the world. Managers of these types of strategies are paid to increase the amount of currency risk in a portfolio, with the objective of generating positive cash flows. We believe allocating to these strategies should form part of the "alternative investments" category of a portfolio's risk budget, where the objective is to gain exposure to independent return streams that are uncorrelated with existing holdings.

Thinking in terms of allocating to risk exposures rather than to individual asset classes quickly shines a bright light on the prominence of currency translation risk.

We believe that increasing acceptance of the concept of risk budgeting, the broader acknowledgement of liability-driven investment and new accounting rules have all prompted new thinking about how to implement currency management for global investors. Growing pressure on institutional investors like pension funds to match their liabilities is prompting them to assess how hard their risk budgets are working.¹ By decomposing risk, it is possible to compare the expected returns of each risk exposure. Thinking in terms of allocating to risk exposures rather than to individual asset classes quickly shines a bright light on the prominence of currency translation risk. For example, it would not be unusual to see a 33%² allocation to foreign assets for European clients, resulting in a 33% exposure to the movements of foreign currencies. This unrewarded risk can have a major impact at the total portfolio level. To illustrate from historical experience, the strength of the euro over the two-year period from June 2006 to June 2008 resulted in a 15% currency translation loss vis-à-vis their domestic currency in the MSCI Developed Market ex EMU Index.³ Doing the math, this would have caused a cumulative loss of about 5% at the total portfolio level with respect to the one-third foreign assets allocation, potentially wiping out all alpha generated by active managers in the entire portfolio. In contrast, the 15% currency translation gain over the subsequent four months would have created an equivalent 5% windfall gain for the total portfolio.

This example highlights why we believe a well-defined currency hedging policy at the total portfolio level is so important. While there are many factors that will determine the appropriate currency hedging policy for any given investment portfolio, we argue there are notable pros and cons to the methods used to implement that policy. For the purpose of illustration, let us assume that your board has already decided to adopt a strategic hedge on foreign currency exposure and that whatever the strategic stance, it cannot be more than 50% right in the long term. A fully hedged position works only when the base currency rises; whereas an unhedged position works only when the base currency weakens, and a partially hedged position is only partially right all the time.

One option is to use a simple approach by applying a passive hedge. Although this may reduce currency losses, it also reduces the opportunity to make currency gains, so there may be no expected return from this approach. We believe there are better alternatives to this traditional approach to currency hedging, which distinguish between the two types of currency risk and design strategies appropriate for each.

1 No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

2 Mercer 2009 European Asset Allocation Survey.

3 Pareto research. See index definition on page 7.

A major drawback to the traditional approach is that it mixes the objectives of hedging currency translation risk and alpha-generating currency strategies. By assuming that currency translation risk can be managed with a passive hedge and focusing on generating currency alpha, it fails to address a fundamental problem that at any particular time, the strategic policy hedge might dictate a currency position that is precisely the wrong place to be for the portfolio.

Rethinking Traditional Approaches to Currency Hedging

Traditional approaches to currency hedging assume that currency can be managed in the same way as equities and bonds. This method attempts to apply the Capital Asset Pricing Model⁴ to currencies, using the familiar language of alpha and beta, with little effort to justify the underlying assumptions. In our opinion, using the term “beta” carries at least two unfortunate connotations: that the strategic currency position offers an expected return and that it should be implemented passively. Furthermore, investors may be inclined to trust that the strategic stance is in some sense “correct,” because it is often derived from an asset liability study; albeit one that most likely failed to decompose currency risk from asset risk. The result is to match the strategic stance with a passive hedge and then add an alpha-seeking module in a combined package. This is not a natural combination, because the purpose of the passive hedge is clearly to reduce currency risk, which is a policy hedging decision; whereas the purpose of the alpha-seeking module is to increase currency risk, which amounts to spending part of the alternative investments risk budget. Moreover, the investment guidelines often constrain the alpha-seeking module by linking it to the underlying exposures, limiting the size of positions with an upper bound on benchmark-relative volatility.

A major drawback to the traditional approach is that it mixes the objectives of hedging currency translation risk and alpha-generating currency strategies. By assuming that currency translation risk can be managed with a passive hedge and focusing on generating currency alpha, it fails to address a fundamental problem that at any particular time, the strategic policy hedge might dictate a currency position that is precisely the wrong place to be for the portfolio. To take a representative example, a portfolio similar to the one described earlier that was passively fully hedged from July 2008 to October 2008 would have generated a negative cash flow equivalent to 5% of the total portfolio, while an equivalent loss would have been incurred by an unhedged position over the two years leading up to June 2008. Suppose the currency alpha module had succeeded in making a respectable 2% gain on the 33% of the portfolio in either of the two periods mentioned above, its impact at the total portfolio level would have been 0.66%. So currency translation risk can have a far greater impact on the portfolio than currency alpha.

⁴ The Capital Asset Pricing Model (CAPM) is used to determine a theoretically appropriate required rate of return of an asset, if that asset is to be added to an already well-diversified portfolio, given that asset's non-diversifiable risk.

We believe active hedging is a more attractive alternative to the passive approach, because it allows a skilful active manager to seek to control currency translation losses by adjusting the portfolio's currency hedges towards the ideal stance in any currency environment, always respecting a hedge range from 0% to 100%, with no cross-currency trades.

There is a second important drawback to the traditional approach. By tying the currency alpha component to the underlying investments, the manager's ability to add value is constrained by asymmetric exposure limits (i.e., the inability to short), over-dependence on the movements of the base currency and an investment universe that is limited to the exposures held in the underlying portfolio. Last but not least, this approach also allows the alpha manager to charge a fee based on the size of the underlying portfolio rather than the actual size of exposures used to generate alpha.

A more nuanced asset allocation approach deals with the two types of currency risk separately at different levels. Foreign currency translation risk is important for investors whose liabilities are denominated primarily in base currency. As the earlier examples demonstrated, an incorrect currency hedging policy can result in significant losses at the total fund level. Currency translation risk should be addressed strategically at the total fund level, whereas the allocation to currency alpha risk is part of subsequent decisions about how to allocate risk to alternative investments that are uncorrelated to conventional stocks and bonds. Our view is that it is necessary to separate the two decisions and seek the best managers for each of the two types of risk.

Having adopted a strategic stance, a currency hedging policy must also address the question of how that stance will be implemented: passively or actively. We believe active hedging is a more attractive alternative to the passive approach, because it allows a skilful active manager to seek to control currency translation losses by adjusting the portfolio's currency hedges towards the ideal stance in any currency environment, always respecting a hedge range from 0% to 100%, with no cross-currency trades. We believe this can add value over time. We believe investors should seek the best manager with a demonstrable track record in actively managing currency translation risk.

We believe innovative institutional investors are increasingly rejecting traditional currency approaches in favour of distinguishing between higher level risk-matching decisions and lower level alpha-seeking decisions.

When it comes to currency alpha, investors should allow active managers the freedom to pursue strategies based on their expectation of market performance, by removing unnecessary constraints that might impede a manager from translating insights into value.⁵ Active positions should be freed from any links to the currency exposures of the assets held in the portfolio. This allows managers to add alpha that is unrelated to existing holdings. Since the primary objective of any alpha-seeking manager is to add value, diversification is essential. Therefore we believe investors may benefit from pursuing a combination of investment styles, either by hiring several currency alpha managers or perhaps a fund of currency funds.

To sum up, we believe innovative institutional investors are increasingly rejecting traditional currency approaches in favour of distinguishing between higher level risk-matching decisions and lower level alpha-seeking decisions. Firstly, they seek managers with the skills to manage currency translation risk, noting the advantages of a successful active hedging program over a passive hedge. In our view, by reducing currency translation risk, part of the total fund's risk budget becomes available to invest in better rewarded risk exposures. Secondly, if currency alpha is seen as an attractive addition to the alternative investments risk budget, they seek to diversify with multiple sources of currency alpha.

⁵ Roger Clarke, Harindra de Silva, and Steven Thorley, "Portfolio Constraints and the Fundamental Law of Active Management," *Financial Analysts Journal*, September/October 2002, Vol. 58, No. 5: 48-66.



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Gavin Francis is Managing Director of Client Portfolio Management at Pareto Investment Management, Ltd. Gavin and his team are the primary client point of contact on all matters regarding the management of Pareto's Currency Overlay and Alpha strategies. Since joining

Pareto in 1997, Gavin has acted as Client Portfolio Manager for clients in Europe, North America, the Middle East and Australia. He developed Pareto's performance attribution systems and has a keen interest in analysing the way risk is managed in portfolios. Gavin holds an MA in Mathematics from St. John's College at Cambridge University and is an associate member of the CFA Society of the UK.

Index description

MSCI Developed Market ex EMU Index

The MSCI World Index is a free-float-adjusted, market-capitalization-weighted index that is designed to measure the equity market performance of developed markets. **Developed Markets (DM), Emerging Markets (EM) and Frontier Markets (FM) Coverage:** MSCI covers 24 developed, 21 emerging and 31 frontier markets. If there is no designation (such as 'EM' or 'AC') before a regional or composite index, the index consists of developed markets only. MSCI Developed Market ex EMU covers the developed markets without the 16 member-countries of the European Economic and Monetary Union. **The indexes are trademarks of the provider and are used herein solely for comparative purposes.** The foregoing index licensor does not sponsor, endorse, sell or promote the investment strategies or products mentioned in this paper, and it makes no representation regarding the advisability of investing in the products or strategies described herein.

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