When it comes to devising appropriate currency investment strategies, European pension funds can choose from a number of different alternatives. So, should managers consider currency as an asset class in its own right? What are the best strategies for pension fund managers to adopt when investing in currency? And what are likely to be the key innovations and trends in the attitudes and strategies adopted by pension funds in relation to currency investment over the next few years?

Currency matters
Generally speaking, although Mesirow Financial Currency management’s director of currency solutions, Michael DuCharme, believes currency as an asset class is an “interesting and worthwhile debate”, he argues that such discussion “distracts investors from the key issue - that currency matters and investors need to take action”.

He also observes that, because foreign exchange trading underpins all currency investment and risk management, it is crucial that investors measure their transactions and use that information to improve trading results.

“In an era where investment returns are expected to be historically low, investors can’t allow poor trading to squander even a few basis points of investment return. Having addressed that basic requirement, investors can focus on reducing unrewarded currency volatility using passive hedging techniques and then consider the opportunity to benefit from currency returns,” he says.

Elsewhere, Redington’s managing director, Dan Mikulskis, doesn’t consider developed market (DM) currency as an asset class or risk premia in its own right, but rather as part of a broader systematic (for example, trend following) or fundamental strategy. He also describes DM currency as a risk that arises in global portfolios and needs to be managed or hedged – ideally in a holistic way across all of the portfolio, and potentially an alpha or systematic beta tool for generating returns.

“DM currency exposure can make a big difference to outcomes, even over multiple year timeframes, but it is generally driven by macro political and economic drivers, which makes it hard to forecast and extract value from with confidence. Emerging market (EM) currencies are a bit different. They can be a systematic risk premia – take exposure to higher yielding currencies – but come with the risk of devaluations and drawdowns. They are usually picked up as part of exposure to EM equities or EM sovereign debt and can be a risk premium worth holding as part of a diversified portfolio,” he says.

Diversification benefits
Meanwhile, KBC’s chief investment officer, Luc Vanbriel, distinguishes between an alpha and beta view of currency investment. As far as the beta view is concerned, if observers were to split experiences between matching and return investments – or bonds and equities – he believes that the currency risk in the matching part is relatively too high.

“The question for the matching part is then whether there is enough market cap or liquidity in the currency of the home country. If that is the case, I would avoid a strategic long-term benchmark for the matching part with investments in a foreign currency. Otherwise, I would consider investing in foreign currencies but with a currency

Andrew Williams explores the many currency investment strategies available to European pension fund investors

Written by Andrew Williams, a freelance journalist

A wealth of choice
overlay in order to reduce the volatility of the currency,” he says.

For the return part of the portfolio, Vanbriel believes that currency hedging “doesn’t make any sense” – and, although fund managers could consider a home bias, he argues that this “depends on the maturity of the home country equity market”. From an alpha perspective, if currency investment is considered as an asset class in its own right, Vanbriel observes that it might be uncorrelated with other asset classes.

Ultimately, Mesirow Financial Currency Management’s managing director and head of portfolio management and research, Uto Shinohara, believes that as an asset class currency “has a place in the stable of alternative strategies that an investor should consider to diversify their portfolio”. In terms of diversification benefits, he also points out that currency has historically maintained low correlations to other asset classes, and importantly has shown uncorrelated behaviour during large market drawdowns.

“In a stable of alternatives, each funded vehicle has a small slice of the alternatives allocation, and thus the diversification benefit of each small slice is limited when considered in isolation,” he says.

“However, an investment in currency can be unfunded in nature, allowing for a much larger allocation without having to fund the investment. Consequently, currency’s portable alpha allows for its diversification benefits to be felt on a larger scale and can provide additional performance to return-starved pension funds without drawing upon the budget used to fund new investments,” Shinohara adds.

**Investment strategies**

When it comes to appropriate currency investment strategies, DuCharme advocates passive hedging “for starters”. Because some investors are unfamiliar with currency, he believes a basic hedging programme can provide comfort and confidence with currency management and investment techniques. Compared to some global peers, he also observes European funds seem exceptionally aware of the unrewarded effects of currency in an international portfolio, and many hedge that risk passively.

“Given that familiarity, European investors likely have the experience and confidence to explore opportunities to benefit from currency return. That investment might take different paths such as active currency overlay. An investor might even have a portfolio of strategies as many currency investments can be unfunded,” he says.

In Mikulskis’s view, the key strategy is to be diversified and risk managed – and not end up with excessively large bets, either consciously or unconsciously.

“It is very important to be aware of what overall DM currency risk exposures actually are, as exposures to DM currency will be acquired by exposure to other assets such as equity and bonds,” he says.

Looking ahead, Mesirow Financial Currency Management’s vice president, Brad Schrage, predicts that emerging trends and strategies will occur on several fronts. To begin with, he thinks that regulations will frame how currency is most efficiently managed, as was seen in requirements of collateral in various regions since the global financial crisis.

“Transaction costs always should be under scrutiny, so seeking innovations to tighten spreads even more will be an important consideration of pension schemes, especially in passive hedging strategies,” he says.

“Executing, allocating, and reporting at more granular levels will continue to augment current analytics and performance attribution of currency exposures for global portfolios. Finally various risk management strategies across the currency management spectrum will evolve with technology to help deliver more sophisticated solutions for pension plans,” Schrage adds.

Meanwhile, Vanbriel again points to the clear split between the long-term ‘beta view’ and the short-term ‘alpha view’ – and expects that the asset management industry will find strategies to exploit the currency universe, “but the question is how sustainable these strategies are”.

For Mikulskis, the differences in returns over recent years from hedged versus unhedged equities is prompting a bigger focus on foreign exchange (FX) hedging at an overall portfolio level.

“For pension schemes looking toward a cashflow-matched endgame approach, it is especially important to hedge FX – for example, exposure from USD bonds – to give certainty of actual cashflows. I expect this to become increasingly important and be a bigger theme in the future,” he says.

In the coming years, DuCharme hopes that transaction cost analysis and strong consideration of passive hedging will become standard practice in the industry. With regard to innovation, he also believes that there perhaps might be room in a portfolio for an exposure to cryptocurrencies, if the threats of fraud and manipulation can be addressed.

“Artificial intelligence might also find a place in currency investments because, if there’s any field where volumes of data are tailor made for analysis and machine learning, it’s currency,” he adds.

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