Currency hedging programmes are intended to minimise unwanted currency risk in an international portfolio and a one-size-fits-all approach is not appropriate for all investors. Risks unique to the region can help guide hedging programmes in selecting and structuring cost-effective instruments tailored for the portfolio's currency exposure profile. One unique risk is the cost of carry. This article describes the components of the cost of carry, highlights how carry has increased the cost of hedging for some investors, and identifies three strategies for investors who hedge currency risk and experience prolonged periods of carry cost.

If a European investor is exposed to fluctuations in the dollar resulting from an investment in a US security, the investor could sell US dollars (and buy euros) to eliminate some or most of the currency risk. The quoted forward rate will differ from the spot rate, and the difference between the quoted rate as a percentage of the spot rate is called carry. Carry can be either positive or negative for the passive hedger and is based on two factors: interest rate differential and cross-currency basis. When quoting a forward, the currency with the higher interest rate is priced at a discount to the currency with the lower interest rate in a no-arbitrage pricing relationship known as covered interest rate parity. Investors in countries with low interest rates that hedge currency risk of countries with high interest rates will sell the local currency at a discount and incur a carry cost at the inception of the hedge. Carry is a realised cost, the wider the differential the more material it is to total portfolio performance.

Interest rate differential is the difference between the interest rates along the forward curve for the two regions of the currency pair being priced. Covered interest parity (CIP) assumes the relationship between interest rates and the spot and forward currency values of two currencies are in equilibrium. In cases where this relationship doesn't hold due to other factors, the difference between CIP and market rates is known as the cross-currency basis. Carry can be examined for each currency pair, but an analysis of carry may be more meaningful in a portfolio of many currencies. Chart 1 presents the comparison of estimated carry resulting from selling currencies in the MSCI World currency basket against four base currencies. Australian investors benefitted from positive annual carry for most years since 2004, while Switzerland and the Eurozone incurred negative carry costs when hedging currency risk in a typical developed international equity portfolio.

The most material currency exposure in the index, USD represents almost 60% of the MSCI World currency basket as of January 2018. This substantial exposure is
not unique to equities. For fixed income securities, as of January 2018, USD represented approximately 43% of the Bloomberg Barclays Global Aggregate Index. It is common for USD to represent a significant proportion in traditional asset class benchmarks.

Chart 2 illustrates the cost to hedge a US asset using one-year forwards from January 2014 to January 2018. In January 2018, investors were paying the highest cost of carry in the past five years due to US Federal Reserve rate hikes. As a result of those increases, the positive carry that some high-interest rate currencies enjoyed relative to USD, has decreased while the negative differential and carry costs for some low interest rate currencies has become more pronounced.

Investors experiencing a high cost of carry in their currency hedging programme may consider strategies to mitigate this cost. These strategies include tenor management, a capped forward strategy, and active currency management.

Many hedging programmes are benchmarked to an index or custom currency basket. In either case, one-month forward contracts are typically used to calculate benchmark return. Investors who are not held to fully replicating a basket of one-month forwards, tenor management may be an option. Tenor management allows the investor to adjust the duration (or tenor) of the currency forwards to benefit from the interest rate differentials across different periods. This is an effective strategy for those who do not want to materially deviate from their hedging policy but are interested in incremental return.

A second strategy involves combining a call overwriting strategy with an existing currency forward, known as a capped forward. In a capped forward strategy, an investor hedges currency risk using a forward contract in a conventional manner by selling the local currency and buying the base. Simultaneously, the investor also sells a call option on the base currency against the local exposure with a strike price set at a premium to the current spot price (an out-of-the-money call option). The investor participates in the appreciation of their base currency up to the strike on the call by receiving a premium from selling the call. That premium reduces the net overall cost of the hedge, which is illustrated by Table 1. This strategy can add 25-60bps of value on an annualised basis. However, investors need to be aware that gains on their hedge will be capped at the strike of the call.

Investors who have historically hedged their risk passively might consider dynamic currency management. Dynamic currency management involves adjusting the hedge ratio of each currency within a predefined limit and risk budget. This is designed to reduce risk compared to traditional passive hedging while adding value of 100-150bps per annum depending on the strategic ratio and volatility. With hedging costs approaching approximately 3% for euro and over 3% for Swiss based investors, a dynamic hedging programme could reduce this cost by 50%. Mesirow Financial Currency Management has a global client base with $9 billion allocated to dynamic currency management. Our clients varying dynamic benchmarks by region, which is not a surprise given the different risk profiles and hedging philosophies across the globe.

As the cost of hedging acts as a headwind on plan returns going forward, investors should consider all appropriate methods to reduce these costs. The three strategies outlined provide different methods to mitigate hedging costs with varying degrees of potential value add for plans. For clients with material costs to offset, dynamic currency management may provide the greatest offset. In the current context of equity valuations near all-time highs and bond yields at structural lows, every basis point saved by asset owners will contribute to the future financial success of the plan and its beneficiaries.

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Premium on 10% OTM Call

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<th>Currency</th>
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