CURRENCY INSIGHTS

Capitalizing on an Embedded Opportunity

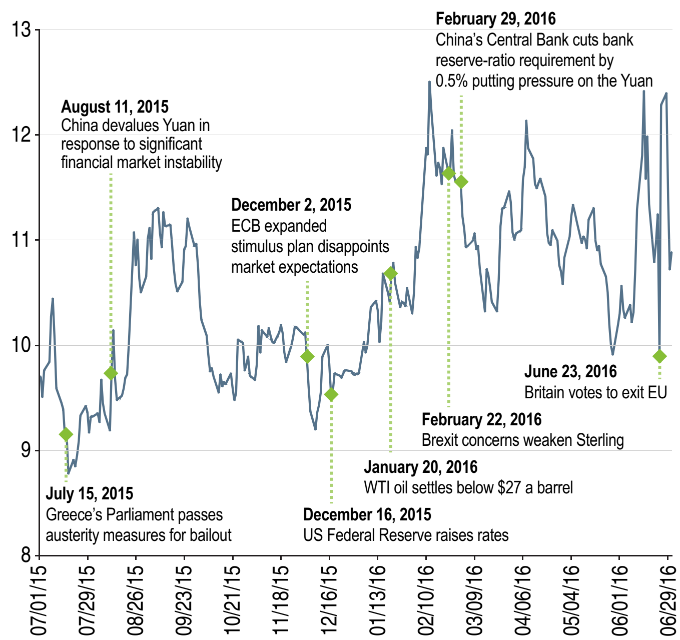
By Michael Miranda, CFA, Senior Managing Director and Chief Investment Officer

For institutional investors, the question of how best to handle the embedded currency risk in their international portfolio has long been one of debate. With principally three options available – remain exposed, hedge passively, or actively hedge – many market participants are reassessing their current stance as portfolio exposures and market backdrops have shifted dramatically.

The decision to not hedge a plan's currency risk (i.e. remain exposed) is one that investors have been forced to reconsider amidst capital market and portfolio changes since the global financial crisis. For some investors, a smaller allocation to international investments has left this currency risk below a materiality threshold, leaving their respective plans with an unhedged policy. However, a growing trend among investors has been continued investment in foreign assets, likely due to the attractive risk/return profile of both liquid and less liquid assets overseas. Including these allocations, however, the materiality of such exposures has grown in many instances quite considerably, increasing the relative importance of hedging such FX risk. For others, a belief that currency will be a diversifier to returns remains a central tenet supporting an unhedged posture. While this diversification benefit can certainly be true over longer market cycles, performance over the short to medium term can be significantly impacted. One need only look to the performance of emerging market currencies over the past two years to see that in many instances currency might both increase overall volatility and degrade local market returns. For these reasons, many investors are reevaluating whether the "remain exposed" approach is consistent with their strategic asset allocation framework and the exogenous market backdrop.

For those looking to hedge an embedded currency risk, an increasing number of investors are exploring the merits of active hedging. Currency volatility remains elevated for a number of reasons – shifting risk appetite in the capital markets, central bank policy divergence, a re-pricing in commodities, and emerging market dislocations to highlight a few. The following graphic overlays several notable events in the currency markets over the past year against the JPM FX Volatility Index.

JPM FX Volatility Index
July 2015 – May 2016



Source: Bloomberg, Mesirow Financial Investment Management

With volatility elevated, investors are looking for a more optimal manner to handle this key portfolio risk. While both passive and active applications look first to reduce the volatility contributions from currency, passive hedging brings with it numerous suboptimal drawbacks that an active approach can help rectify. For one, employing a static passive hedge ratio will result in negative cash flows when foreign currencies rise. Employing a passive hedge against this increase has resulted in a lost opportunity. Second, and equally noteworthy, a passive application will sub-optimally view risk as a static variable – one that mandates the identical removal of currency exposure irrespective of the market backdrop. This latter shortfall is significant. In regard to such passive applications, the embedded opportunity for risk mitigation or incremental return is not handled in an optimal manner. Rather, by increasing or decreasing the hedge program as currency movements occur, active management will help reduce volatility in a more optimal manner, mitigate negative cashflows, and allow for currency gains to augment local asset market returns. With active currency providing a more optimal management of portfolio risks, finding the right customized active solution remains a major focus for investors in 2016 and beyond.

Evaluating whether your plan is fine tuned to these changes will help ensure that currency plays its appropriate role in the overall portfolio. US investors with material international exposures are appropriately becoming more aware of both the risk and the opportunity that currency presents and implementing hedging solutions to accomplish this.

About us

As a leading, independent currency specialist, Mesirow Financial Currency Management has been delivering innovative, customized currency risk management solutions to institutional clients globally for over two decades. Being a private, employee owned firm, Mesirow Financial is free from many conflicts of interest associated with bank-affiliated organizations or publicly held firms and is fully aligned with the interests of its clients. Mesirow Financial delivers a full range of currency risk applications – passive and active risk management – customized to suit a client's particular context and objectives.

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