INVESTMENT

Ripples in the currency market

Lynn Strongin Dodds reveals why managing currency volatility is currently rising up the agenda of pension fund investors

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After years of steady movements, currency volatility is firmly back on the European pension fund map. Diverging central bank policy, a strong dollar, plummeting pound and impending elections in France and Germany will continue to send ripples across the FX markets this year.

This was evidenced by Mercer's recent *2017 Investment Themes and Opportunities* report, which confirmed that the political upheavals witnessed by the US election, Brexit, rising populism and growing protectionism underlies the importance of having a clear currency strategy that not only mitigates the risk but also actively exploits the prospects that arise.

One of the issues though is that "many pension funds across the EMEA region have ignored currency for a long time", says Millennium Global Investments CEO Mark Astley. "However, doing nothing is a dangerous position to take. For example, using the MSCI World index as a proxy, around 37 per cent of variance comes from currency, so if a fund invests in international equities there is currency risk."

The Swiss experience two years ago also should serve as a salutary lesson. Many institutional investors were caught by surprise when the Swiss National Bank cut the franc's peg to the euro. Willis Towers Watson estimated that as much as CHF30bn (€27.9 billion) may have been wiped off portfolios but pension funds such as AHV, BVK, and Publica, who had hedges in place, were able to avoid the erosive impact.

Passive or not?

To date, passive strategies continue to be the most popular, although active and dynamic are attracting their own following. "People are definitely reviewing their currency hedging strategies because the large macro events we have seen in the past year have had a big impact on currency movements," says Mercer European director of strategic research Phil Edwards. "The simple passive currency hedge with a hedge ratio of around 50 per cent on equities is most common, but hedge ratios vary depending on an investor's overseas exposures and governance structures."

The main criticism is that passive strategies are too static throughout market conditions, such as currency valuations, economic developments, sentiment and the cyclical nature of currency markets. "There are two ways to look at currency – one as an overlay and the other as an asset class and an uncorrelated diversified source of return in its own right," says Insight Investment senior fixed income product specialist Emma du Haney. "We are seeing an increased allocation to the second approach because of greater volatility that creates more opportunities."

Mesirow Financial, which has a systematic and qualitative process, echoes these sentiments, particularly for "European pension funds where a significant chunk of their portfolios will be exposed to the US dollar and British pound", its chief investment officer Michael Miranda says.

These currencies have until recently gone in opposite directions over the past year, with sterling plunging around 20 per cent due to the concerns over the type of Brexit the UK government will negotiate, while the greenback rose nearly 4 per cent against a basket of currencies following Donald Trump's victory last November and is up roughly 25 per cent since 2014.

Although Trump has tried to talk the dollar down, the currency only briefly dipped before rallying on strong economic data and comments made by Federal Reserve chairwoman Janet Yellen that a series of rate hikes were planned throughout 2019. Many believe this divide with the European Central Bank and Bank of Japan, both of whom will continue to suppress interest rates, creates the perfect backdrop for an active strategy.

As with passive frameworks, it will vary depending on a particular pension fund's objectives and constraints, but in general the benefit is that currency hedge ratios are adjusted over time, depending upon the macroeconomic and financial market circumstances of the day, according to Astley. In other words, they will be increased in anticipation of periods of base currency appreciation and reduced when it is expected to decline.

"The aim is to actively reduce risk and add value over periods of time," says Record Currency Management CEO James Wood-Collins. "We think it is particularly relevant now because in Europe and the UK we are in a low-yield environment and any strategies that can enhance yield are attractive. Also the environment for return-seeking strategies looks more favourable now than in many years."

He adds: "Fund managers have different approaches but we have a predominantly systematic process that incorporates four patterns of behaviour – carry, momentum, value and emerging markets. Combining all four provides a good degree of diversification and a smoother return stream for investors."

Historically, the carry trade – buying high-interest-rate currencies and selling those with low rates – has been the most popular and is now making a comeback as central banks are no longer moving in lock step. Value, on the other hand, buys currencies that are undervalued relative to their 'fair value' and unloads those that are overvalued, while momentum involves purchasing currencies that have experienced high recent returns and sells those on the other end of the return scale.

J.P. Morgan Asset Management also believes in adopting a multi-factor approach, including some signals extracted from equity markets in building its active framework, according to its chief investment officer for currency management, Roger Hallam.

One of the issues is that in-depth research is required for active strategies because they are typically limited to G10 currencies. As State Street Global Advisors EMEA head of currency James Binny notes: "If you are an active equity manager, for example, you can choose from hundreds of stocks but in currencies, you typically only make decisions regarding 10 if you cannot use emerging market currencies. This is why it is important to look at as many factors as possible."

Dynamic hedging

One variation that is gaining recognition is dynamic hedging, which takes advantage of the currency factors of carry, value and trend by changing the actual hedge ratio, currency by currency, over time within perimeters around a neutral strategic hedge ratio. According to Russell Investments head, currency and overlay strategy EMEA Klaus Paesler: "Dynamic is reactive to market conditions and though it can be more volatile than passive, it can generate greater return or ensure that the pension fund loses less from currency risk. It differs from a fully active strategy in that it is adjusted monthly according to the three factors and does not take big bets, rather a range around the current currency exposures already in the fund."

Although the more active and dynamic fund managers will vary in their methodologies, they are all under pressure to reduce trading costs and detail their efforts under the impending MiFID II. The new regulations, coming into effect in 2018, imposes tougher best execution requirements on buyside firms, making them responsible to prove they are securing the best trading deals for their clients.

"Currency specialists are much more switched on how performance is being measured because alpha can be taken away by poor best execution," says Binny. "The problem is the definition of the market price is difficult in an over-the-counter market like FX. That is why we outsource the service to a third-party vendor, which not only can effectively measure our TCA but also allows us to demonstrate to our clients that we have achieved good prices."

Mesirow Financial also outsources its TCA to a third party. Its chief operating officer Marisa Kurk adds that "it is one thing to achieve best execution but another to document it. We use a firm that measures us against a more comprehensive benchmark and data points".

While regulatory pressures such as MiFID are an important driver, she notes the trend to look at different providers started four to five years ago due to the fallout from the scandals over poor pricing received from custodians. ■

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