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WEB EXCLUSIVES

Currency Debate: To Hedge or Not to Hedge

by Gregory J. Chrispin

Currency risk can no longer be ignored. This article discusses the issues surrounding currency risk in Canadian pension plans, and looks at ways of developing a currency policy that addresses and manages these risks. With the increasing opportunities available in global markets, this issue will take center stage in pension committees. Given the recent strength of the Canadian dollar, investors must understand the potential effects of currency movements and the elements to be considered in a currency policy.

The appreciation of the Canadian dollar against the U.S. currency started in December 2002. As a result, this sharp rise of the Canadian currency has had a significant dampening impact on global investment returns when expressed in Canadian dollars. The cumulative overperformance over a ten-year period of an unhedged Canadian investor in a Standard & Poors (S&P) 500® Index strategy reached a high of 35% by the end of 2001. This overperformance was completely eliminated in less than 18 months. Moreover, in the last ten years alone, an investor in the Morgan Stanley Capital International Europe, Asia and Far East (MSCI EAFE®) Index strategy would have incurred more than 20% currency impact to their portfolio returns on five separate occasions.

The elimination of the foreign property rule by the federal government will enable Canadian investors to fully participate in the international opportunities created by the global markets; however, while this increase in international diversification will undoubtedly improve the performance of most pension fund portfolios, it will also expose Canadian investors to an additional source of risk: currency risk.

For many plan sponsors, currency is an unfamiliar topic, but it is increasingly receiving a lot more attention. The objective of this article is to discuss the issues surrounding currency risk in Canadian pension plans, and to look at ways of developing a currency policy that addresses and manages these risks.

Strategic Decision to Manage Currency Risk

The first step in establishing a policy is to understand the impact of currency on the plan, both in terms of return and volatility. This, combined with the plan's risk and return objectives, will guide and help determine the appropriate degree of strategic hedging.

Currency exposure is typically derived from an investment in some underlying nondomestic asset class such as fixed income or equity, which does not provide any implicit or explicit return stream. For this reason, many investors have assumed that currency exposure has no real long-term expected return associated with it. This may be true over the very long term (20- to 25-year periods), but over shorter periods this is not the case. Our analysis shows that currency returns rarely fail to wash out over periods as long as five years, which implies that currency exposure can add substantially to interim volatility of international investment portfolios. Since most plans review strategic objectives in periods ranging from three to five years, this amounts to significant risk over horizons longer than most strategic time frames.

In fact, over the 30 years from 1974 to 2004, annualized rolling ten-year MSCI EAFE unhedged versus local monthly returns have fallen between +/− 1.00% in 18% of the observations. This would tend to support the view that over shorter term horizons, currency is not a "zero-sum" game.

Another significant by-product of establishing a currency management framework is that it creates a discipline allowing the separation of currency positions and underlying equity or bond positions. This has obvious benefits because it promotes a core competency approach where investment managers are focusing on what they do best, which should translate into a more meaningful performance evaluation. In other words, it limits situations where managers will attribute poor performance to unfavorable currency movements but claim superior investment management skills to positive currency moves.

In this context, the "do nothing" strategy, which has been the right one during the long period of depreciation of the Canadian dollar, may no longer be optimal. Our view is that whether managed passively, dynamically or actively, the currency risk can no longer be ignored.

Benchmark Issues and the Motivation for Hedging

For any plan with more than 15% invested internationally, the impact of currency volatility is significant and likely to increase in significance. This volatility has been beneficial in the past because returns have been generally positive and have been negatively correlated with equities. However, this may not be the case in the future and the level of strategic hedging in the benchmark must be considered.

There are several possible motivations to be taken into account when considering a currency policy:

- Avoiding losses due to adverse currency movements
- Minimizing overall portfolio risk
- Expressing a directional view on exchange-rate movements.

For plan sponsors that are strongly focused on the negative effects of currency exposure, or have been through a long period of base-currency strength, avoiding losses is perhaps the most obvious motivation. Such losses can be avoided by implementing a fully-hedged policy, but this approach is not without costs. In addition, the myopic avoidance of currency losses overlooks the fact that currency exposure can also be a diversifier in a portfolio context due to low or negative correlations between currency and asset returns of a given country.

For this reason, many plan sponsors often prefer to describe minimizing overall portfolio risk as their primary motivation. By considering currency exposure as a natural part of overall portfolio exposure, one can frame the currency decision as minimizing overall portfolio risk, or making the overall asset allocation more efficient. Furthermore, the recent focus on liabilities in the context of plan asset allocation clearly has an important bearing on currency hedging policy. In particular, allowing for the risk and correlation characteristics of liabilities may result in a significantly different policy recommendation than that resulting from the consideration of assets alone.

Finally, the choice of a specific benchmark also has some impact on operations, because hedging programs generate realized profits and losses that need to be managed. Plans that have higher proportions of hedging will create larger cash flows. In the past this has been an area of great concern to plans, because the costs of continually investing and divesting in equities are high. There are now some simple low-cost solutions to this problem that should allow plans to select the most suitable benchmark without having to be concerned about this operational aspect.

The Partially Hedged Approach

The partially hedged policy has grown in popularity in recent years as plan sponsors have shied away from the strong philosophical views required to advocate either polar benchmark options (i.e., fully hedged or fully unhedged). Essentially, a partially-hedged benchmark is seen as a middle ground, bringing some of the benefits of risk-reduction while controlling costs, and minimizing the opportunity cost of incorrect benchmark selection. It is argued that a partially hedged stance is likely to be a better policy in the long term than either of the extremes. However, this does not necessarily imply the arbitrary choice of 50%, unless regret minimization is of primary importance.

Therefore, one of the questions that is often asked with regard to investments in international asset classes is: What should be the strategic level of currency hedging in my benchmark? Once a plan has decided upon the amount of strategic hedging on its international assets, the next step is to consider whether or not to use a passive, dynamic or active approach to manage those risks.

Passive Approach

The most conservative way to deal with currency risk is *passive hedging*. This approach seeks to remove some or all of the return volatility caused by the currency component of a foreign portfolio, while still allowing exposure to foreign stocks or bonds. By using this approach, investors can invest in nondomestic markets and avoid the potential losses due to a rising Canadian dollar currency. Currency overlay managers have been providing hedging services to manage this incidental currency exposure and have been making a stronger case in the recent past that currency should be viewed as a standalone asset class.

Here is in summary form the most important benefits of passive hedging:

- Can reduce total international portfolio risk
- Tight tracking
- Can be managed against a variety of base currencies and hedging benchmarks
- Can easily be integrated into existing international equity and bond mandates through an overlay framework
- Low transaction costs
- No additional investment required at startup.

Passive currency programs cover two types of service. The first type of hedging program involves hedging a fixed percentage of the foreign assets back into the base or domestic currency. The second type of passive program is often called neutralization hedging. This is a hedging program that eliminates the active currency positions that result from underlying equity managers taking active equity positions. For example, a manager may take an overweight position in U.S. equities. U.S. equities may outperform other markets, but if the U.S. dollar is weak at the same time, then the overweight dollar position will reduce the value added from the equity decision. The neutralization hedge will move the U.S. dollar exposure back to its benchmark level and therefore allow the portfolio to receive the full benefit of the equity decision without suffering from the adverse currency impact. Not only does this process eliminate any of the unintended currency position, it also reduces the active risk taken and therefore leads to more efficient use of active risk budgets.

Dynamic Strategic Hedging Approach

One of the reasons why investors have such difficulty determining a static hedge ratio is the inability to adjust to market conditions in the traditional framework, and implicitly, a fear of being wrong at some time in the currency cycle. Therefore, their implementation decision will be primarily driven by the level of valuation of their base currency at that very specific moment.

A *dynamic hedging strategy* should satisfy the concerns of such investors because it can adjust to the changing market conditions in order to dampen the effects of currency volatility. The objective would be to provide a long-term dynamic strategy to adjust hedge ratios over a currency cycle, as the exchange rate moves from levels of overvaluation to undervaluation or vice versa.

One of the significant advantages of a dynamic strategy is the smoother return characteristics exhibited by the strategy, which could limit the downside risk of the static hedging model without sacrificing the upside. This approach offers an opportunity to add value over the long term from the currency exposures associated with global investing.

A dynamic hedging strategy will appeal to those pension funds that wish to control the unrewarded risk of unmanaged currency exposure, as well as those that seek to profit from the active management of these risks.

Active Currency Management

The case for *active management* of currencies is strong, and any plan that utilizes active equity or bond managers should seriously consider active currency management. The rationale behind any active management is that there are inefficiencies in the market that can be identified and capitalized upon. Active management can only add value if these inefficiencies exist as permanent features of the market and can be exploited without losing all of the value added, by way of transaction costs.

Currency markets fulfill these conditions particularly well. Unlike bond and equity markets, not all investors who buy currencies do so with the profit motive. Many investors invest to pursue other goals. For example central banks frequently seek to smooth volatile currency markets, while corporate treasurers need to lock in the value of overseas assets and avoid currency risk. These and other investors will continue to be participants in the future and therefore will contribute to keeping the market liquid but inefficient. These inefficiencies can be observed through predictable behavior such as trending and mean reversion of over/undervalued currencies. This enables skilled currency managers to identify and exploit enough of these predictable movements to be able to add value.

This leads to the conclusion that favorable conditions exist, which offer the opportunity for active currency management to add value. In addition, this should most definitely be entrusted to a specialist currency manager both to eliminate the currency losses from active equity managers, as well as to generate a separate source of value added.

Active programs are designed to add value through tactically changing the hedges around the benchmark levels. The objective of most programs is to increase hedges in times of base currency strength and reduce hedges when the base currency is weak. This allows the plan to avoid currency losses when foreign currencies are weak, but still benefit from currency gains when foreign currencies are strong. These programs can be implemented at almost any level of active risk, depending on client preference. In the past, most programs only allowed the currency manager to reduce or increase individual hedges up to the level of underlying assets in that currency. More recently, following research from overlay managers, some clients have recognized that their overlay programs could generate more value for the same amount of risk if these restrictions were relaxed.

A number of studies have been published in the last few years by the consulting community that have provided strong support for the active management of currency risk in global portfolios. Furthermore, currency experts have shown there are worthwhile risk-adjusted returns to be extracted from the foreign exchange markets.

Implementing an Overlay Program

The vast majority of overlay programs are implemented using forward foreign exchange contracts. The hedges are generally implemented through high-quality counterparties that are leading participants in the foreign exchange market. As mentioned earlier, the major operational issue to be considered when implementing an overlay program is the management of the cash flows from the maturing hedges. If the plan does not have strategic cash reserves through which the cash flows can be channelled, other solutions must be considered. If these flows are directed into and out of the underlying equity managers' portfolios, the costs of constantly buying and selling equities could be quite high.

However, there is a much simpler solution. The currency manager is funded with a cash pool at the start of the program representing approximately 6-7% of the assets being overlaid. This cash can come from an equity program, for example, from an S&P 500 allocation or domestic equities. The currency manager re-equitizes the cash by buying the appropriate futures contracts, and then uses the cash pool to pay and receive the profits and losses from the hedges. This is advantageous because it is a completely self-contained program, which keeps the cash fully exposed to the equity markets and does not disrupt the underlying managers. Each time there is a cash flow into or out of the pool, futures contracts are bought or sold to maintain 100% equitization. Full separate accounting can be provided for the equitized cash account to monitor its performance against its equity benchmark. The costs of managing this process are minimal because there is no extra management fee for the service and the transaction costs from trading in futures contracts are minimal.

Conclusion

It is important for investors to adopt the same discipline in their analysis of currency risk as they do for the management of other asset classes. With the increasing opportunities available in global markets, this issue will take center stage in pension committees. Given the recent strength of the Canadian dollar, it becomes clear that investors must understand the potential effects of currency movements and the elements to be considered in a currency policy. **B&C**

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