2018 CURRENCY ROUNDTABLE

WHY PLAN SPONSORS CAN'T AFFORD TO IGNORE CURRENCY

Ask the average plan sponsor in Canada about their approach to currency and you'll get a mixed bag of answers.

For many it's all about hedging risk – some choose to hedge their exposure to currency while others think that the ups and downs of currency fluctuations wash out over time. But for many, conversations about currency are beginning to move beyond just hedging and into alpha – the return-generating possibilities of currency in a pension portfolio. And given the macroeconomic backdrop and the level of uncertainty in global markets, it's probably a good thing that currency is getting more attention as plan sponsors look to position their portfolios for challenging times.

The 2018 Currency Management Roundtable discussed the shifting global economy and why currency should be top of mind for plan sponsors right now. Our expert panel examined why today's currency management solutions make sense for pension funds and how plan sponsors are using them to both manage risk and add returns over time.

EXPERT PANEL

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ROUNDTABLE SPONSORS

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STATE STREET GLOBAL ADVISORS

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HAS THE CONVERSATION ABOUT CURRENCY CHANGED IN THE LAST FEW YEARS?

ALAIN: In the 1990s and early 2000s, conventional wisdom for Canadian plans was to hedge about half of their foreign equity holdings. In the last 15 years or so, there has been a trend towards reducing the amount of currency hedging for foreign equity. This coincided with research showing that - since the late 90s - unhedged foreign exposure reduced equity risk, at least when defined as the annualized short-term standard deviation of returns. That idea is now being challenged – sure, being unhedged might be less risky over the short term, but if your time horizon is longer than two years, an unhedged portfolio has actually added to risk. Recently, I've had conversations with large long-horizon investors starting to question more critically the idea of being unhedged.

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VINCENT SICOTTE

VINCENT: The conversation has certainly become more sophisticated, particularly here in Canada. Plan sponsors and trustees have expanded their interest in currency over time, moving from very simple solutions like a passive overlay to more dynamic overlays with different hedge ratios. Now they are shifting to active strategies that could add a little bit of extra return.

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MICHAEL SAGER

VISHAL: Plan sponsors today are dealing with low interest rates, very high equity valuations and modest long-term return expectations. Investors are now more interested in learning about absolute return-focused strategies or liquid alternative strategies that can act as a diversifier – an uncorrelated source of alpha. As part of that, people want to learn more about the role currency can play in their strategic asset mix.

WITH RATES ON THE RISE AND THE THREAT OF TRADE WARS, IS THERE A MACRO-ECONOMIC RATIONALE FOR DEALING WITH CURRENCY RISK OR TAKING A MORE ACTIVE APPROACH?

JAMES: The last few years have been pretty good for long assets and volatility has been falling. Since currency managers make money when volatility rises, currency returns have been disappointing. Currency is where people go to vent – if there is a big crisis, the first place investors go is currency. Right now, we're facing a number of macroeconomic risks, which makes currency a good place to look for an added source of return. But currency isn't just about generating returns – it's also a risk that needs to be managed. A risk overlay is also important.

MICHAEL: Currency has traditionally been a diversifier as well. Since the beginning of the 2000s, we've become used to the negative correlation between equities and bonds as a source of portfolio diversification. That may be changing: we're now moving into a world where inflation may be a more relevant risk, and this could have implications for the correlation between equities and bonds. That makes it important to continue to search for additional sources of diversifying returns. In this context, active currency is particularly relevant.

MARK: If I were to rank the volatility of assets from low to high, I'd start with short-duration bonds at the low end and equities at the high end. Currency is somewhere in the middle. In a low interest rate, low return environment, pension plans that had previously used only currency to mitigate risk are now open to talking about alpha as well. Macroeconomic factors have played a role – plan sponsors are now pushed to find alpha in the corners.

ALAIN: I agree with Mark - every basis point counts. This is always important, and even more so in a low return environment. There are also several risks that are emerging. There's a common belief that during a market correction all correlations go to one – but it's not true for all assets, particularly for some currency. If we are headed to a market downturn, some currencies can provide meaningful protection.

VISHAL: An active manager can add value in the currency market even in an economic regime where rates are low and rising, and markets are priced very efficiently. It's still one of the few places where there is inefficiency – where there is significant discrepancy between the best and the worst performing currencies.

DOES THE CURRENT GEOPOLITICAL ENVIRONMENT SUPPORT THE CASE FOR MORE FOCUSED CURRENCY MANAGEMENT?

VINCENT: As the world becomes a bit more unhinged or a bit more unpredictable, I think plan sponsors and boards are more receptive to conversations about currency. The impact of currency risk is very hard to estimate. In the past, currency was a difficult concept for the average board member to comprehend – but today board members feel more uncertain and uneasy with the level of currency risk in the plan.

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> JAMES BINNY

JAMES: The level of uncertainty has definitely increased. If we do end up in a world where international trade drops – and there is some evidence that the volume of trade is decreasing – then that is going to have an impact on the world economy. And, as I've mentioned, currency is the first place investors vent. That is going to have an impact on investor portfolios in all sorts of ways. You really need to manage those risks.

MICHAEL: At the same time, the bigger, more persistent political dislocations often lead to the best value opportunities. For a fundamental investor, high-frequency noise is often something to look through. But it can also sometimes be used to skew portfolios towards more attractively valued assets, including in active currency.

WHAT KINDS OF CHALLENGES ARE DB PLAN SPONSORS LOOKING TO SOLVE WITH CURRENCY MANAGEMENT?

ALAIN: Clearly, they want to use currency to increase their probability of success – typically means improving risk-adjusted returns on the asset side. But many don't feel they have the expertise in currencies, especially at the board level. They tend to be more comfortable overseeing broad asset allocation decisions or hiring equity managers for example – but for currencies they often don't have the same background or framework for thinking about them. There is also a lack of a standard approach. Some big and recognized plans here in Canada are fully hedged, some are fully unhedged, others are somewhere in between. Often, it feels like if a board could make currencies disappear, they would. The most gratifying conversations I have personally are when I can shift the perception around currencies from being an inconvenience to a valuable lever.

VINCENT: Canadian pension plans have an average of 37% allocated to international equities -- that is quite far away from where they were several years ago when the focus was more domestic. They've also gone beyond international equities and bonds – as many now have global investments in private equity, real estate and infrastructure. Currency exposure there is now a much bigger factor here – while pension plans are looking to these alternatives for return stability, the impact of currency exposure could be particularly high. That could impact their funded status over the short term.

MARK: There is a broad spectrum of people who think currency is an asset class and something they just don't want to touch. Vincent's point about exposure from private equity and real estate – that's a key point. Because some of that 37% is now being locked into private assets. In that case, hedging is key.

MICHAEL: Fixed income is also important from a currency management standpoint. On liability-driven investing [LDI] solutions, investors should look for opportunities to add at least some additional return. Adding a limited, active currency overlay on top of a core plus strategy can achieve this objective without adding significant risks to the LDI strategy.

SOME BELIEVE THAT CURRENCY RISK WASHES OUT OVER THE LONG TERM – THAT IT JUST MEAN REVERTS. IF THAT'S THE CASE, IS THERE A POINT TO CURRENCY HEDGING?

MARK: That's one of the big arguments with currency – that it's going to mean revert, so why should I bother? But if the currency reverts to the mean, it's also moving away from the mean for a prolonged period of time. The question becomes, why didn't you do something about it then? We recently surveyed some plans about currency and asked them what risks they are most afraid of in the event of a market shock. Currency risk was in the top four. If they are afraid of the negative impact of currency, then they should be hedged 100%.

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ALAIN: Yes, I often hear some people saying why bother hedging because currencies mean revert. I don't agree with the logic of this statement. From a long-term expected return standpoint, that's not a bad assumption, at least for developed market currencies. But this line of thought misses an important investment implication – if one believes there is mean reversion, that implies return predictability. If you believe this is true, then you should change the hedging ratio to take advantage of this mean aversion and, in the process, add incremental returns. This line of thinking also ignores the risk implications. Different exposures to different currencies lead to different risks, even if the expected long-term returns are the same.

VINCENT: Mean reversion does happen – it's just that the timeframe needed varies from one currency to the next. If you look at the MSCI World Index in Canadian dollar terms, it could be 10 years, it could be five years. And you could see a 40%, 50% or 80% increase in market value during a 10-year period. Then in the following years, you could see a 50% negative performance – all due to currency. If you're a board member making a call to hedge or not hedge currency, then you're making a call that will have a very long-term impact on the portfolio.

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JAMES: Board turnover can be problematic. For example, a plan might have a 20-year time horizon, but foreign currencies suddenly fall 20%. One board might have decided not to hedge but a new board could react to the sudden loss by hedging the lot. And of course, that's absolutely the wrong moment. Currencies could then rise for five years – a new board might be in place and determine that the losses on those hedges aren't worth it and decide to get rid of them. Again, at the wrong point in the cycle. If you commit to being unhedged over 20 years, you've got to remember that.

VISHAL: If you're living in a country where the currency appreciates when markets are doing well, being unhedged or having a low strategic hedge ratio can reduce risk and provide some diversification. However, what might be considered an optimal hedge ratio changes over time and it's different for every currency. It always needs to be monitored.

SO, IS THERE AN OPTIMAL HEDGE RATIO FOR CURRENCY?

ALAIN: Yes, but it is specific to each plan. It should be a function of the plan's relative aversion to four risks – absolute return risk, relative risk, currency risk and liquidity risk. And of course, it depends as I said earlier on the investment horizon. From a Canadian perspective, the shorter the horizon, the more unhedged one should be.

MARK: Our job is to make this simple for the plan sponsor. They need to understand that, in the long run, there are going to be some times when they're going to lose money on hedges and there will be some times when being unhedged would have been better.

MICHAEL: I think investors have to be comfortable with the risks they're going to be taking. To Mark's point, we have to realize that passive currency hedging ultimately gives you a different sort of risk; cash flow risk instead of currency risk. Are you more comfortable with one risk or the other? Plans should seek to implement an optimal currency hedge ratio, although they should also realize there is no single optimal passive hedge ratio for all investors over all investment horizons.

JAMES: You can't look at currency in isolation. I would argue that there may be a long-run optimal hedge ratio – we could come up with some average. But within that, over shorter time horizons, there are different optimal levels. It comes back to the value and the mean reversion. When your currency is being very overvalued, it's much more likely to reverse and go the other way.

So, at that point, the risks of being unhedged or fully hedged are not the same. If your currency is very strong and is likely to weaken, then foreign currencies are likely to go up. That means your optimal hedge ratio over this next period is much more likely to be much lower.

WHAT ARE THE ADVANTAGES OF TAKING AN ACTIVE APPROACH TO CURRENCY – AND DO CANADIAN PLANS TYPICALLY DO THIS?

VINCENT: It is getting more popular with plans. Having a combination of active management and hedging is ideal – it lets you shift your portfolio over time. You not only protect your assets, but you can actually generate some added value at a time when investors are looking for extra return wherever they can find it.

MARK: I prefer a dynamic approach over an active one with set targets. In that case, the client and manager both agree that there will be variation in the optimal approach.

JAMES: You always need to manage the risk of currency exposure – that could be static or dynamic. And it's also possible to use currency to add value, which is active. But those are two different things.

AND TWO DIFFERENT DECISIONS?

JAMES: Yes, two different decisions. It's important to get people to separate them; otherwise, it's hard to measure success. If you haven't defined your objective, you don't know whether you've met it.

VINCENT: The size of the plan also matters. Implementing a hedging program, given the bespoke nature, can be difficult for smaller plans. For them, accessing very specific strategies can be prohibitive from a cost perspective.

HOW DO CURRENCY RETURNS COMPARE TO OTHER ASSETS?

ALAIN: If you're taking a passive approach, then the long-term expected return is about zero. From a dynamic standpoint, however, our research shows that over the last 20 years, simply leaving undervalued currency unhedged and hedging overvalued currencies provided a risk-adjusted return similar to the equity market, except that the returns were uncorrelated. Of course, one can do much more than changing the hedging ratio based on the valuation.

So, a passive hedge might not bring returns, but a thoughtful, dynamic approach could add meaningful returns at the total fund level.

WHICH MARKETS AND CURRENCIES SHOULD BE PART OF AN ACTIVE CURRENCY MANAGEMENT APPROACH? AND SHOULD EMERGING MARKETS BE PART OF THE STRATEGY?

MICHAEL: You need to look as broadly as possible, and that includes both developed and emerging market currencies. Liquidity is high across a wide number of currencies, facilitating use of a broad investment universe. The more you constrain the investment universe, the fewer opportunities you have to add value. Emerging market currencies represent an essential part of an active strategy.

ALAIN: I agree with Michael – adding more currencies is better than limiting the universe. We recently compared a basket of G10 currencies with one that included 12 more liquid emerging market currencies. Based on the same models and construction, adding emerging markets doubled the risk-adjusted return, just by moving from G10 to a broad universe. It makes sense provided the pension committee is comfortable – you always need to stay within their comfort level.

JAMES: There can certainly be opportunities for active returns from emerging markets; we mostly look at the opportunities between emerging currencies but there are often opportunities in emerging markets overall. For instance, our models currently show emerging market currencies are on average relatively cheap. However, they could get cheaper and they will be volatile – but that's where the opportunities arise.

WHEN DOESN'T IT MAKE SENSE TO HEDGE CURRENCY?

MARK: In DC plans, it doesn't make sense when employees are picking from individual funds and not model portfolios – it's very hard to look holistically at their portfolio. And it may not be right in an LDI portfolio focused on liability-matching.

MICHAEL: I wouldn't rule out DC plans – adding an active currency overlay to a DC program, or as part of a balanced offering within a DC program, makes a lot of sense, and it represents another potential return lever. This also applies to LDI mandates – I think there is an opportunity to add some active overlays there, too, including active currency, to generate additional return.

VINCENT: When you look at the DC market, most participants will use the default option and then be stunned by how little they have at the end of the day. If you're looking at a pension plan with a target date default option that has a glide path, I think there is a lot of room to implement currency management. However, if you're looking at plans where investors pick the funds, you need to do a lot of work to educate them. Overall, I think we have a lot of work to do as an industry in helping DC plan members understand what they're really being faced with in their pension, and where they're going to end up 20, 30, 40 years from now.

HOW SHOULD PLAN SPONSORS ASSESS INDIVIDUAL MANAGERS WHO CLAIM TO HEDGE CURRENCY AS PART OF THE PRODUCT?

MARK: First of all, you have to find out what their hedging approach looks like and then compare that to what a currency manager does. Also, it's very important to make sure that their reporting isn't skewed by the currency results.

VINCENT: You have to view currency holistically. You can't just look at individual managers. They may be taking offsetting positions – so you might do well, but when you combine everything together it could be over-diversified and reduce the impact of those calls. A currency manager is more effective overall than as part of individual strategies.

JAMES: The fact that they have currency hedging at all is a big first step, however. Considering whether or not to hedge is a very important strategic decision. It's better than just closing your eyes and hoping the currency risk is going to go away.

VINCENT: I agree – I am happy if I can walk out of a meeting with a board and know that they will be making a decision on currency, even if it's to remain unhedged.

JAMES: At least they've considered it.

WHERE SHOULD CURRENCY FIT IN A PENSION PORTFOLIO? CAN IT BE USED TO HEDGE LIABILITIES OR JUST AS A RETURN-SEEKING ASSET?

ALAIN: From an LDI perspective, it can help minimize volatility. And on the return-seeking side, it can contribute to both risk reduction and return generation.

VISHAL: If you have a pension plan with short-term liabilities and expected cash outflows in Canadian dollars, it makes sense to hedge the currency exposure of foreign assets. To Alain's point, that would make it a fit for LDI-type portfolios. That being said, given the diversification benefits of currency, it is also a good fit as an absolute return strategy as part of a pension portfolio's liquid alternative allocation.

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MICHAEL: Over the last 10 years, we've seen the need to truly diversify portfolios. We've talked about equity/bond correlations and how reliable they may be going forward. Finding truly diversified – and liquid – alternative sources of active return is important. I think that's where active currency fits, as one of those liquid alternative diversifiers.

JAMES: If you've got international holdings, you've got currency. You might choose not to manage it, but as we just said that is an explicit decision. So as soon as you've got an international holding, you've got a decision to make about currency. Ignoring it doesn't mean the risk has gone away.