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WRITTEN BY MARISA KURK, CHIEF OPERATING OFFICER, CURRENCY MANAGEMENT

As we move into a more transparent and regulated world of FX, it is crucial that pension fund managers and their agents focus on achieving, measuring, and communicating best execution on FX transactions. While achieving best execution should always be a primary focus, measuring and communicating these results has become even more important under a new FX landscape. This article will explore the importance of best execution, outside factors that have shed additional light on this topic, key factors for achieving execution quality, and Transaction Cost Analysis (TCA) as a tool to measure and communicate execution results.

Regardless of asset class, fund managers and their agents should always remain focused on best execution; unfortunately, until the last few years the marketplace did not universally demand precision and communication in FX. Beginning in 2009, pension funds started to more carefully evaluate the performance of their custodial managers in executing their FX hedges. It was discovered that by allowing custody providers to have such extensive discretion over the timing and mechanisms of FX execution, the custodian was able to benefit, at the cost of pension funds, by providing unfavourable rates and wide spreads, and being the sole or primary recipient of trade volume. Over the next several years the unscrupulous execution methods of custodians dominated the headlines. Clients were at times provided prices on trades that were significantly different than the actual prices executed by the custodian, or the client's price would be as extreme as buying near the high or selling near the low of the day, depending on the direction of the trade. This was one of the key catalysts for an increased desire of transparency when transacting FX.

Furthermore, as global regulators began to focus more on risk and FX regulations post global financial crisis, additional light and scrutiny was shed on the topic of best execution in FX. Presently the Markets in Financial Instruments Directive (MiFID) states that firms "must take all reasonable steps to obtain the best possible result….." . The updated guidance of MiFID II, set to come into the marketplace as early as 2018, looks to strengthen the language and requirements for obtaining best execution. While the exact market requirements around the heightened fiduciary and regulatory obligations are still being scoped out, it is clear that the standards for achieving best execution will be set even higher.

Best execution is especially important in FX given the typical magnitude of hedge sizes. Let us examine a client that rolls €5 billion in three month maturity hedges, for an annual roll volume of €20 billion. If the execution price is off market by even one-tenth of a basis point, the client will incur €200,000 in hidden execution costs per year, for what is often approximately a tenth of a forward point. Accordingly it is imperative that every effort is made to keep this cost to an absolute minimum as the price of each trade will directly have an effect on the overall performance of the fund.

The following key factors outline some of the primary ways to help ensure best execution:

- **Trading desk experience:** A well rounded, experienced trading team is crucial in providing continual best execution practices. Whether it is dealing with extreme market events such as the SNB EURCHF 1.2000 floor removal, or more common daily situations such as executing a large order, an experienced FX focused trader is invaluable. A variety of backgrounds can further complement a trading team as well. For example, sell-side experience on the trading desk is a significant plus as it provides direct insight into the sell side methods and tactics, better preparing the desk to push back in order to achieve best execution for the fund.

- **Multiple pricing sources:** Obviously a trading desk must know exactly where the market is trading at all times to help ensure precise market pricing on each trade. To obtain this information, access to multiple pricing sources such as Bloomberg, Reuters, Currenex and other various ECN's is essential. In addition, the ability to reach out to multiple counterparties for indicative pricing provides important additional clarity on the actual market.
- **Multiple execution strategies:** A trading desk must have the ability to vary execution strategy depending on the deal to be completed. This may include utilising competitive and/or streaming pricing, having a large order execution methodology or taking into account time of trading day when planning execution.
- **Strong and broad counterparty relationships:** It is important to have strong working counterparty relationships with clear pricing expectations. Counterparties should recognise that excellent pricing leads to increased business, and less than excellent pricing leads to the opposite. Furthermore, the larger the counterparty roster, the greater flexibility available to the trading desk.
- **Large trading volume:** Trading desks with large currency volume have more impact and influence with the counterparty trading desks they execute against. Continual large trade volumes with a counterparty lead to a relationship that is important to the counterparty; typically resulting in high quality pricing.

Even after internally determining that best execution is being achieved, it is important to ensure it can also be documented. The established need for execution transparency has led to the popularity of TCA as a tool to fill this void. The basic elements of TCA are threefold. First, it captures key execution details including spot rate, forward points, execution timestamp, quantity, currency pair, and value date. Second, it selects the benchmark to be utilised for benchmarking; whether it be one data source or a more comprehensive multi-factor benchmark provided by a third party, it ensures spot and forward rates from an external data source are captured along with time stamps. Finally, TCA utilises a systematic process to calculate the costs arising from the difference between the executed rates and the benchmark rates. This analysis can be further broken down into various details such as spot costs, forward costs, costs by currency pair, time of day or order type.

While these basic elements of TCA are similar throughout the industry, variances in methodology may exist among currency managers. It may be possible for similar execution to have significantly different TCA results. Accordingly, before reviewing the TCA results, it is essential to understand the underlying methodology being employed, specifically the benchmark rate source, the application of the bid/ask spread, and the timestamping methodology. As previously stated, benchmarks can vary from a single data source to a more comprehensive multi-factor benchmark. A robust source of benchmark data will serve as a more accurate assessment of the transaction cost. Ideally, the benchmark data feed should include a high frequency of prices from multiple platforms. Next, when looking at bid/ask spreads, the most neutral benchmark will utilise the MIDPOINT rate, even though this rate is typically not an achievable execution price. Thus, utilising the bid or ask may artificially reduce displayed costs. Finally, it is important to understand that the method for applying timestamps will have a direct effect on the results. Ideally, timestamps should be generated and captured from an electronic trading platform. Importantly, timestamps should never be recorded after a trade was completed, as this can artificially influence the cost.

An additional consideration for TCA implementation is whether to conduct the analysis in-house, or use an outside TCA provider. While TCA can certainly be successfully analysed in-house, the desire for third party providers has grown significantly in recent years, as outside providers offer an independent analysis and an increased level of transparency. In addition, the benchmark rate source of third party providers is often much more robust than an in-house TCA. For these reasons the trend toward outside providers will likely continue to gain momentum in the coming years.

In summary, it is critical that best execution is sought and applied in all FX transactions, regardless of agent or method. Additional factors over the past several years such as public custodial shortcomings and new regulations have heightened the need to prove best execution is being achieved. Furthermore, TCA, and the trend toward third party TCA, has emerged as a useful tool to measure and communicate the quality of execution to the client. The combination of a highly experienced trading desk and a quality TCA process will ensure both best execution and clear communication of this achievement. ■

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INVESTMENT

Ripples in the currency market

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

WRITTEN BY LYNN STRONGIN DODDS, A FREELANCE JOURNALIST

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. ■