INVESTMENT

Taking centre stage

Lynn Strongin Dodds **reveals why currency hedging should now be of growing importance within European pension fund investors' portfolios**

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To hedge or not to hedge has always been the question for pension funds with overseas investments, but the issue is firmly back on the agenda for European institutions as the euro has gained strength against other currencies over the past year and monetary policy is diverging.

As Millennium Global Investments managing director Charles Goodman says: "We may be coming to the end of a super low volatile period and asset allocations are slowly going to address this change. I think pension funds will spend more time and energy looking at unrewarded risks such as currency and how they can be optimised. Now that central banks are withdrawing support the potential returns from currency could be bigger in both absolute and relative terms."

Changing times

This is a marked change from two years ago when central banks were basically on the same policy page and interest rates were uniformly low. Today, the US Federal Reserve is gradually tightening and raising interest rates while the UK is following suit and for the first time in a decade increased rates by a quarter percentage point to 0.5 per cent. There could be further hikes over the next two years but decisions will depend on whether a Brexit deal is visible by mid-2018, unemployment remains low and global growth remains steady.

By contrast, the European Central Bank is staying the low interest rate course and analysts do not foresee any changes until 2019. It is instead focusing its efforts on unwinding quantitative easing and plans from January to halve its bond-buying programme from €60 billion to €30 biilion a month.

While these differing paths have an impact, they are not the only factors. Geopolitical risk has also reared its head over the two years, starting with the Swiss National Bank scrapping the euro peg after four years followed by the surprise election of Trump and the Brexit vote. More recently, FX markets have been shaken by the spate of European elections, the last one being in Germany in September as well as the unexpected Catalan independence vote. Brexit will continue to weigh heavily on sterling while the fortunes of the dollar will be subjected to the Trump administration's ability to pass any of its reforms, most notably the tax legislation currently making its way through Congress.

As for the euro, investment committee at Carmignac Sandra Crowl sounds a warning. "We believe that the *[euro]* currency will continue to trade in a higher trading range against the dollar and its trading partners' currencies will benefit from the eurozone's strong trade position, as well as the relative underweight position of institutional investors and reserve managers in the region," she says.

She adds that "while interest rate differentials haven't been the main driver of currency moves this year, the unprecedented reduction of over $2.5 billion worth of liquidity foreseen by central banks over the next two years will, at the very least, create volatility with currency markets".

A broader reach

In the past, European pension funds did not have to take into account these fluctuations because they were mainly invested in domestic assets. However, today, data from the

European Insurance and Occupational Pensions Authority (EIOPA) data shows that they have broadened their reach.
A typical pension fund has 25 per cent allocated to global equities, 25 per cent to global credit and 50 per cent to euro-denominated fixed income assets.

Based on the composition and assumptions that 50 per cent of the overseas exposure is linked to the dollar, numbers crunched by Willis Tower Watson reveal that a pension fund's return from unhedged overseas investments would have suffered 2.5 percentage points this year. By contrast a pension fund that was 50 per cent hedged would have only sacrificed 1.25 percentage points.

Putting it in index terms, Neuberger Berman head of currency management Ugo Lancioni notes that pension funds who hedged their currency risk against a euro benchmark would have made a 9.6 per cent gain September year to date but those that did not would have only eked out a mere 1.9 per cent return. "That is a huge gap and is the reason why the cost of hedging has become such a big topic," he adds. "Although, European investors can expect to pay around 200bps to hedge against the dollar, we think it still makes sense to do so."

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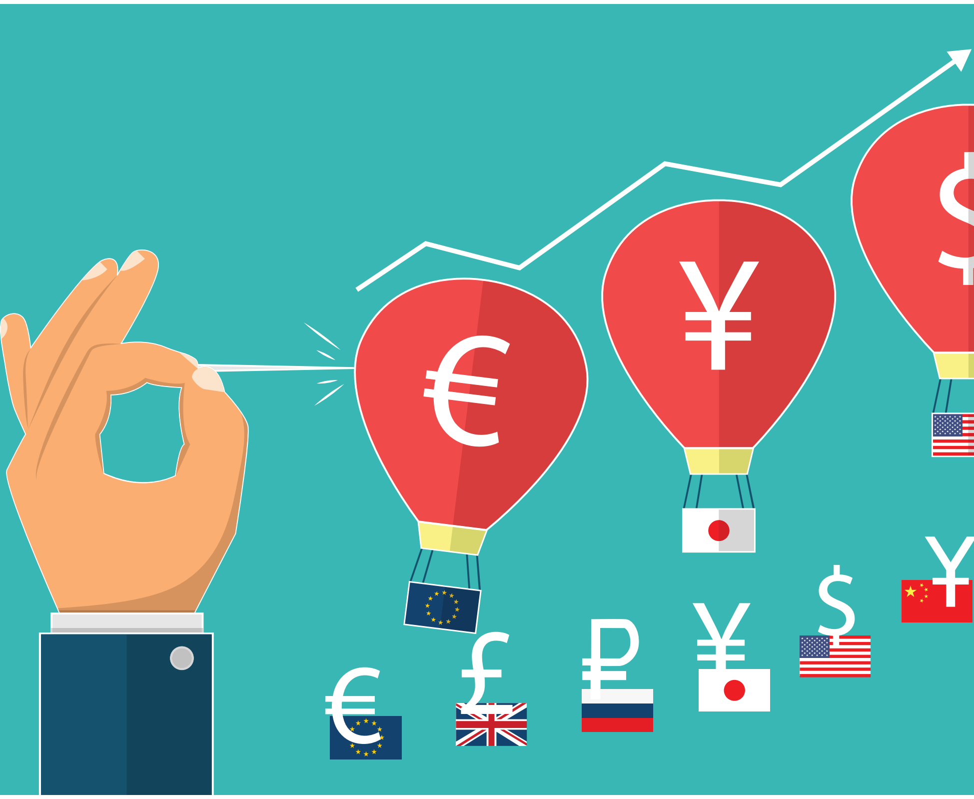
Willis Towers Watson head of smart beta Phil Tindall echoes these sentiments. He says: "We advise clients to hedge a significant part of their currency exposure – for example 70 per cent – where it is a material part of portfolio risk, although individual client circumstances vary of course."

He adds that the reason funds may not hedge is because they do not have much exposure to non-domestic assets and when they do de-risk they buy bonds. "For those that do hedge, what we typically see is the larger schemes will have separate segregated mandates with an overlay to manage FX exposures across the portfolio, while the smaller investors will make use of pooled funds that have a FX hedge



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built into the underlying structure," Tindall explains.

Strategies

As for the type of strategy to adopt, Russell Investments Van Luu believes that 50 per cent is a good percentage because it reduces the unrewarded currency risk of the international exposures but also leaves enough on the table to allow FX to be a diversifier. "If a fund keeps some dollar exposure for example, then if there another financial crisis and the dollar rises and equites fall, this could be beneficial because it will have a low correlation to the equities market," he adds.

Record Currency Management chief executive James Wood-Collins also explains that the strategy an institution puts in place may differ depending on its objectives and the asset class. "If you are going down the strategic route of wanting to reduce volatility over the long term then the hedging strategy you adopt may differ than if you are taking a more tactical view on the direction of a particular currency," he adds. "Also, the proportional reduction of volatility is greater in fixed income than equities. This is because bonds in nature are low in volatility and so the incremental contribution of FX risk is that much greater."

As for which instruments to use, FX forward and to a lesser extent currency options tend to be the favourites because "both are liquid and can be traded through exchange-traded markets electronically or with investment banks' foreign exchange-trading desks in the over-the-counter (OTC) market," says Crowl. "OTC trading offers the benefit of matching precise dates for settlement while currency options offer the possibility or contingency of gaining the intrinsic value of the rise or fall of the underlying position, as well as the leverage earned through buying or selling volatility."

Many market participants also see the benefit of adopting a more active approach in order to enhance returns, reduce cashflow drawdowns and mitigate the risks. As Edmond de Rothschild Asset Management global head of overlay management Benjamin Dubois says: "Dynamic strategies can improve performance because they reduce volatility and reduce the impact the currency will have on the portfolio, but they also take advantage of any opportunities to participate in risk currency appreciation."

Crowl also notes that while historically bond managers have been more active currency hedgers, value can also be created from an equity investor's point of view by hedging against a fall in the foreign currency in respect of the home currency. "Active management of foreign currency risk has indeed been required in 2017 where the euro has appreciated by 15 per cent against the dollar and around 8 per cent against its trade weighted basket of currencies," she adds. ■