An eye on currency

FX: The multi-tasker

Lynn Strongin Dodds reports on the strategies pension schemes are applying to currency, including hedging and return-seeking strategies, as pension schemes continue to allocate more to global equities

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Widening the net

Mesirow senior vice president, Katie Renouf, discusses FX cost-saving opportunities and the growing case for agency trading, as portfolios become more diverse across asset types and geographies

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Currency: The multi-tasker

Increased market volatility has sparked greater interest in return seeking currency strategies but hedging remains a significant part of currency strategy as pension schemes continue to allocate more to global equities particularly in the US

WRITTEN BY **LYNN STRONGIN DODDS,** A FREELANCE JOURNALIST

Currency management is not a new theme for European pension funds. They have been hedging their FX exposure to global equities over the past 20 years, but more recently alpha generating opportunities are back on the table as volatility has spiked.

It certainly has been a roller coaster ride since 2020, starting with the outbreak of Covid, followed by Russia's invasion of Ukraine, a mini banking crisis in the US and the more recent war in the Middle East. FX has been caught in the crossfire as interest rates have increased to curb stickier than expected inflation, while growth in the UK and on the continent has stalled. The prevailing view is that central banks will no longer move in tandem, opening the door for return-seeking prospects.

"Central bank policy differences influence interest rates, which in turn influence currencies," says Mesirow Currency Management managing director and senior strategist, Uto Shinohara. "The challenges lie in conditions where central bank policies are all in lockstep where there is less opportunity due to limited divergence, promoting sideways, non-trending environments. More recent divergence in policy between the Federal Reserve and European Central Bank (ECB) promote FX price movements."

"The US presidential election is another risk event on the horizon that can drive currencies, with ramifications affecting geopolitics and global economies," he adds. "These price swings reveal opportunity. The FX market is large and liquid, where the majority of market participants are not speculative but central banks and corporations trading FX as part of their operations, so less crowding."

Making predictions

One of the main issues, though, is predicting which central bank is likely to make the first interest rate cut move. This is not easy given that forecasts have vacillated over the past two years. For example, at the start of 2024, all bets were on the US, but expectations have been pushed back as inflation climbed to 3.7 per cent, which was higher than the 3.4 per cent consensus. As a result, analysts changed their outlook from the six to seven quarter-point rate cuts to perhaps one or two later in the year. In the options markets, many participants put a probability close to 20 per cent on the next move being a rate rise instead.

The European Central Bank (ECB), on the other hand, has been making noises about June, provided there are no nasty surprises in wage or price developments. The latest set of results show that things are going to plan with inflation unchanged in April from March at 2.4 per cent. Some policymakers though are more cautious, concerned over rising energy costs and the ongoing conflicts, which threaten to disrupt shipping and push up commodity prices.

ECB President, Christine Lagarde,

encapsulated the mixed sentiment by stating that eurozone inflation is likely to decline further, and interest rate cuts are on the horizon if its long-standing price growth criteria are met. However, "at the same time, the Governing Council is not pre-committing to a particular rate path", she said. "Risks to the inflation outlook are two-sided. Upside risks include heightened geopolitical tensions, as well as higher wage growth and more resilient profit margins than anticipated."

Reaping rewards

Despite the uncertainty, many schemes are adding currency to the portfolio to reap the rewards. As Russell Investments global head of solutions strategy, Van Luu notes, currency return-seeking strategies are a good diversifier because they are uncorrelated to equities and bonds. He points to 2022 when there was a big sell-off in both markets, and FX was one of the few asset classes that performed well for the first three quarters of that year.

"At the moment, with interest rate differentials staying stable we believe that the carry trade, which has done quite well, will continue to do so," he said.

One of the most popular is the yen carry trade, whereby investors cheaply borrow the Japanese currency to fund investments in higher-yielding assets, such as the US dollar. Although Bank of Japan recently intervened in the market after it plunged to a four-year low, analysts do not see interest waning in the yen/dollar trade until the Fed starts cutting rates.

Emerging markets

Emerging market (EM) currencies are also sparking interest, according to Luu.

"Investors did not look at emerging markets in the past because of the risk but now they are taking a closer look because of performance," he adds. "Our emerging market carry trades has risen 16 per cent over the year and they are still going strong. Some of the trades we are doing are going long on the Mexican peso and South African rand and short on some of the lower interest rate currencies, such as the Korean won and Thai baht."

Record Currency Management chief investment officer, Dimitry Tikhonov, echoes these sentiments: "Exposures to EM currencies generate additional returns because they are exposed to faster growing economies. They also offer access to diverse economies which display different behaviours, with attractive interest and growth rates in some countries. However, you need a very disciplined approach to analysing these countries."

"CENTRAL BANK POLICY DIFFERENCES INFLUENCE INTEREST RATES, WHICH IN TURN INFLUENCE CURRENCIES"

This is particularly true with reverse carry trades, which are more complicated but have recently appeared on the investment radar screen given the returns have been as high as 9 per cent this year. This entails dollar bets funded by emerging market currencies such as the Chinese yuan, Thai baht, Malaysian ringgit and the Czech koruna.

Hedging strategies

Although there has been a renewed focus on alpha generation strategies, hedging remains an important part of the FX equation, especially as European pension funds have been whittling down their domestic exposure for the past 20 years. The approach to both depends on the country, its pension fund framework and national legislation. As Tikhonov points out, active FX management is popular in the Nordic region while Swiss pension funds tend to use a passive approach. Meanwhile, the UK and Germany are interested in both hedging and active management to generate additional returns. Most Swiss and German pension funds have a regulatory obligation to hedge a certain amount of FX risk.

RBC BlueBay Asset Management senior fixed-income portfolio manager, Kaspar Hence, agrees, adding: "European pension funds are highly regulated and are only allowed to take a certain amount of risk. In the FX space, most of this comes from their exposure to global equities. If you look at the typical global FX basket, the US dollar accounts for 40 per cent followed by 30 per cent in euros, 10-15 per cent in the Japanese yen, 10 per cent in China with the rest in other emerging market countries."

This year has been especially difficult due to the strength of the dollar. "With US investments making up the lion's share of international allocations, euro against US dollar has a meaningful influence on the portfolio," says Shinohara. "The swings can be large – euro weakened -20 per cent in 2021 through most of 2022, followed by an +18 per cent retracement into 2023."

The latest figures from the European Fund and Asset Management Association (EFAMA) shows that regardless of these challenges, US equities remain the favourite. This is not surprising not only due to the increased share of US companies in the world equity index, but also robust economic growth and the leading role of its technology companies.

INVESTMENT

Widening the net

As portfolios become more diverse across asset types and geographies, the need for FX cost-saving opportunities increases and the case for agency trading grows

The concept of centralised execution and FX netting is not new, for some time, asset owners have been well-informed of the scope to create cost savings and process efficiencies. The drivers have perhaps changed; counterparty risk and cost savings remain important, the evolving regulatory and reporting landscape, plus imminent US equities move to T+1, all play a role.

In this article, **Katie Renouf** – Senior Vice President on **Mesirow's** Global Investment Management Distribution team, based in London – explores how a rapidly evolving investment landscape, and subsequent FX netting opportunities, has led to increased interest in agency models.

When I think back to the start of my FX career, some 20 years ago, it's fair to say the industry has come a long way.

Wide margins, and a lack of transparency around price methodology and source, underpinned by basic documentation, were commonplace. This led to a fundamental lack of trust – forming the basis for a number of regulatory shifts, principally designed to create a fairer and more stable marketplace.

We have reached a point where competitive pricing is largely accessible to all - where counterparties and third-party providers are required to provide granular detail around pricing source and methodology.

However, when it comes to execution counterparty / liquidity providers, there remains scope for improvement. The FX price might look competitive on a single trade basis, but unless you are considering all FX exposures on a portfolio basis you are missing the full picture.

This is often the case when clients delegate FX to their administrator or custodian.

Each provider adheres to the best execution in context of the managed portfolio(s), but a lack of visibility to see the underlying client's full portfolio and FX exposures hampers order aggregation or netting opportunities.

Additionally, many custodians provide a principal-only execution model – meaning that clients face a single execution counterparty from both a risk and pricing perspective. Not only is this inefficient and expensive, but it can also create a "locked-in" element to the relationship – where FX revenue is used to balance underperforming revenue products such as global custody. This can make it very difficult to extract FX from the relationship in the future.

Having a specialist provider adopt a third-party "birds eye" view of all portfolios can be highly beneficial. By establishing an open architecture framework, connected to delegated managers and service providers, a fiduciary agent can achieve best execution across the asset owner's entire book.

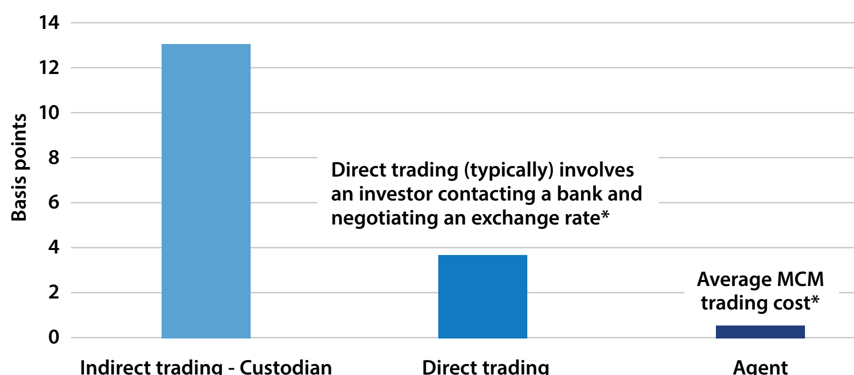
This is particularly topical when we consider the ongoing shift from defined benefit to defined contribution, underlying portfolios are becoming increasingly diverse from both an asset and geography standpoint. Assuming that delegated managers are being used, at least some of the time, this has potential to create an ever-increasing number of siloed currency exposures.

Let's consider an example, Asset Owner A wishes to increase their global equity exposure and re- duce their global bond book, keeping base currencies in GBP for simplicity.

The equities manager liquidates a portion of their portfolio, realising multi-currency cashflows back to GBP, all of which require FX. At the time of writing, the non-GBP exposure of the MSCI World index is more than 96%.

The bond manager also implements the increase to their portfolio accordingly. Currently, the GBP component of the Bloomberg Global Aggregate Bond Index is just

AVERAGE TRADE COST



over 4%.

Whilst both managers could be achieving strong FX execution and pricing terms on an individual basis, their inability to see the other's activity results in far greater FX volumes than needed.

Whilst the currency composition of each index is not identical, applying netting to both portfolios could reduce the execution figure significantly.

Furthermore, the compressed ticket size(s) reduces market impact, typically resulting in tighter spreads.

If you scale up this concept across an ever-increasing number of sub-funds and asset classes, the argument for netting becomes increasingly compelling.

FX execution cost savings generated through an agency provider netting solution can exceed 30% in some cases.

The above scenario could be further complicated by the forthcoming US equities move to T+1; many managers have yet to establish FX trading processes that accommodate this.

The compressed timeframe for settlement means that they may have to act upon unmatched trade estimates – creating enhanced risk of error – or, alternatively, maintain long USD positions to provide liquidity to settle late trades. Neither of these options are particularly efficient from a risk, process or return perspective.

There will also be a marked impact on the huge proportion of managers who settle their trades via CLS. CLS deadlines cannot accommodate the move to T+1, meaning that gross settlement will lead to clients having to maintain larger USD cash reserves.

Again, using a third party agent can be beneficial in this situation. By taking a cross-portfolio view on currency exposure, the agent condenses the net execution figure as far as possible. This compresses not only cost but also counterparty risk, and potentially reduces the USD balance level that needs to be maintained.

Where long USD overnight positions need to be held, Mesirow's cash equitization service can reduce portfolio performance drag. We sweep residual balances into index-linked futures, generating a return far closer to the portfolio benchmark than holding cash.

Many clients are not set up to trade futures, so the cost of implementing this themselves prevents it from being a viable option. Through our strong market positioning, we have access to more competitive pricing terms than many clients can access.

There are asset owners that already centralise their FX execution in-house. Granted, for those names, some of the points highlighted above are not relevant. They are already achieving an efficient level of FX trade netting.

However, the process of establishing and maintaining a broker execution panel is problematic. There are numerous legal documents and credit facilities to consider, combined with the cost and risk aspect of undertaking the process in-house. An FX back office that historically required 2-3 FTE's is now likely to require more.

Furthermore, there is always a critical mass – where volumes become sizeable enough for in-house management to appear the more attractive option. However, due to the points mentioned above and the subsequent cost base increase, this figure now looks a lot higher than in previous years.

One final angle to consider is regulatory reporting. For example, recent changes to EMIR reporting requirements ("EMIR refit") increased the number of reported fields per trade from 129 to 203. Many clients choose to delegate this task, and by reducing the total number of trades, the cost base is reduced accordingly.

Whilst evolving regulation is integral to protecting the interests of market participants, it requires constant monitoring and resource; making it preferable to delegate this element to a third-party FX provider.

To learn more about Mesirow's Fiduciary FX capabilities, contact:
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