FIRST QUADRANT

Perspective

The Top Ten Excuses for Not Actively Managing Currency

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Currency may be one of the least understood sources of risk and return, at least amongst the most common investment exposures. As a result, it seems to have acquired one of the most developed lists of reasons why it should be ignored. We might call this list "The Top Ten Myths About Currency," since many of the reasons why investors choose to look the other way when it comes to currency aren't actually correct.

In an effort to address the broad list of issues, we've kept our comments here fairly brief. Many of these issues deserve to have entire papers written about them, and in the months ahead, we will do just that with several of them. Until then, here's the Top Ten list as we have heard it.

#1 It's a zero sum game – FX risk "washes out" over time

We don't disagree that the effect that currency returns have on investment returns does tend to wash out over time. Virtually anyone responsible for managing investments, however, doesn't have the luxury of being as patient as this would imply. Even if currency returns do wash out over the longest time horizons (e.g. 10 to 20 to 50 years), changes in exchange rates can have substantial impact on investment returns over long periods of time – periods as long as most policy decisions are intended for (e.g., 5 to 10 years).

I don't know any plan sponsors or fund managers who can afford to treat three to five year returns so casually as to not worry about the erosion that exchange rates may have on investment returns. Furthermore, for those who now take a risk-budgeting approach, taking unintentional and unmanaged risks where there is no expectation of reward is a waste of the precious risk available to budget to return enhancing activities.

And finally, in a market environment where the search for incremental return has grown increasingly more difficult, no one can afford to thoughtlessly discard potential sources of alpha. Many investment returns either "wash out over time" or "wash out on average." Active management broadly speaking washes out on average. For every basis point of excess return one investor captures, another necessarily loses the same basis point. Active management is, therefore, a zero sum game as well. Should it be ignored for that reason? Certainly not!

#2 Numerous academic studies have shown that Purchasing Power Parity doesn't work – at least not in the short run – and I can't wait 3-5 years for my investments to add value

This is a challenge presented to those who would seek to add value by actively managing currency exposures using economic fundamentals. The logic underlying this argument is seriously flawed. We would assume that the proponents of this argument fall vulnerable to an overly domestic orientation to financial assets, i.e., they think of foreign assets as one homogeneous bundle containing one currency risk, "foreign" currency. Currency decisions, from this perspective are one dimensional, and managing currency risk means determining how the currency risk should be split between the two risks, domestic currency and foreign currency. If one bases such a decision on Purchasing Power Parity, and one has to wait as long as 3-5 years for that decision to prove right, then yes, it's hard to add value over the investment horizons most investors really care about.

The fact of the matter is that foreign currencies do not represent one homogeneous bundle called "foreign currency." When you invest internationally, you take on a portfolio of currency risks, and currency decisions should treat these risks as a portfolio of separate risks rather than a homogeneous bundle. Now the use of economic fundamentals is no longer limited to a one-dimensional decision, but rather, it is now multidimensional. In a portfolio context, the right question to ask is, over what horizon does PPP add value in a *portfolio* context?

This should sound very familiar to anyone who has ever hired an equity manager who employs valuation as a part of her approach. We don't ask a value manager whether each asset in the portfolio will return to fair value in the next month, quarter, or even year. What we want to know is whether the portfolio of stocks will, *on average*, converge towards fair value. Some stocks will move away from fair value, while others will move towards fair value. The strategy is judged successful if the portfolio of decisions adds value, even if some percentage of the positions don't.

That's exactly what happens in a portfolio of currency exposures. A portfolio of currency exposures based on taking long positions that are "cheap" from a PPP perspective and taking short positions in currencies that are "expensive" may add value even on a monthly basis despite the fact that some of the currencies won't converge on fair value for years. We've long liked to point out that even the most naïve form of Purchasing Power Parity seems to work when applied in a portfolio approach to managing currencies. The Economist's "Big Mac Index," which identifies expensive currencies as those where the price of a McDonald's Big Mac is higher than the world average, has had an information ratio approaching 0.35 since it's inception. That's not bad!

#3 Currency markets are too liquid to be inefficient

It's easy to sympathize with this position. The currency markets trade between $1.0-$1.5 trillion a day. Transactions costs are measured in the low single digit basis points. One would assume that where liquidity is highest and transactions costs are lowest, that any opportunities for profit from trading in these markets would have been arbitraged away. Despite this, we find that there are inefficiencies left un-captured. How could this be?

Much of the currency trading does not have a profit motive, but is conducted for reasons related to trade in goods and services, the financing of mergers and acquisitions, direct foreign investment, and trade in publicly traded financial assets. Perhaps more important is the fact that currency is a relatively unexploited asset class as far as value added is concerned. Very few investors choose to exploit currencies as a source of value added – which is why there might be a need for a paper such as this!

If there are inefficiencies to capture in the currency markets as we believe there to be, then this is a nearly ideal hunting ground for alpha! The greatest impediment to the capture of inefficiencies is transactions costs. In the equity area, for example, where transactions costs are far, far higher, it is not sufficient to simply identify market inefficiencies. One has to identify market inefficiencies that are large enough to be profitable after transactions costs. This means there is a distinct advantage for strategies where transactions costs are low.

#4 I'm already fully hedged

Being fully hedged means, as far as equity investing is concerned, that you're missing out on a useful source of diversification. Currency returns have a low correlation with equity returns and thus tend to lower the risk of associated with equities. With that said, we know that being 100% hedged is sub optimal. Fisher Black has provided the mathematical proof that optimal hedging lies somewhere in-between 0% hedged and 100% hedged, but cannot be found at the extremes.

We would also differentiate between the (passive) policy decision and the decision about whether to seek value added through the active management of currency exposures. The policy decision has no impact upon the potential for active currency management to add value from a pure investments point of view. Active management boils down to taking long and short positions relative to benchmark. What the benchmark is doesn't really matter all that much (it does matter, but less than is typically assumed).

In practice, however, many institutional funds are prohibited from taking net short positions in currencies, which means that an active manager would be prohibited from taking a bearish view on individual foreign currencies. The manager in such a case would only be able to add value when he had a bullish view on individual foreign currencies. This limits, of course, the potential for value added, but active management still remains an attractive option.

#5 Having some currency exposure diversifies my portfolio risk – I don't want to hedge that away

Good. This perspective has a sound foundation. Some currency exposure does tend to provide useful diversification properties. How much is optimal, however, and does the optimal exposure to foreign currencies change over time? Are there some foreign currency exposures that will not provide an attractive risk-reward ratio while other foreign currencies will? These are the questions that lead to a more focused active approach to taking advantage of the diversification properties that currency exposures provide.

#6 My foreign equity and bond managers already manage the currency risk

This presumes that equity and bond managers do a good job managing the currency risk. There are two reasons to question this assumption. First, the factors that drive currency markets are different from the factors that drive equity and fixed income markets. True, there are some common elements, but the differences are much larger than the commonalities. This argues for currency decisions to be treated separate from equity decisions. Few equity and bond managers do that.

Second, the antedotal evidence seems to suggest that equity and bond managers tend to suffer, not benefit, from their currency management decisions. This is not our work, so please don't take our word for it. The consulting community will have better evidence at their disposal than we could ever have.

#7 With the introduction of the euro it has become less important to manage currency risk

The impact that the creation of the euro in 1999 had on currency management was relatively insignificant, despite the fact that eleven currencies were replaced with one. This is a simple issue: the eleven currencies that disappeared were highly correlated to start with. This means that prior to unification, they behaved pretty much like one currency anyway. True, they didn't behave exactly alike, and this meant that were small risks to be managed between the currencies, and a small potential source of value added to be exploited, but they were just that – small.

From an active management perspective, what is required is that asset returns behave dissimilarly. If two assets behave too much alike, there can be little to no value to add in selecting between the two assets. This was largely the case with the eleven legacy currencies. The more meaningful opportunities were to be found by managing the yen vs. the dollar vs. the pound vs. any one of the legacy currencies. That hasn't changed with the launch of the euro.

#8 Currency is not an asset class

Investment management is the business of managing the trade off between risk and return. Currency represents both a risk to be managed and an opportunity to earn a return, possibly even an excess return. Whether or not currency is an "asset class" or not is, therefore, irrelevant to the decision about whether it should be managed. Fortunately, or unfortunately, because foreign assets usually come with currency exposure attached, one rarely has the luxury of avoiding the decision about what to do with it.

It would be fun to engage in a debate about whether assets that are"unproductive" such as currency, precious metals, or derivatives are rightly considered to be asset classes. Some would argue that the low correlation such assets have with other (productive) asset classes give them the right to be called and managed as distinct asset classes. This, we believe, is the principle reason that hedge funds are being referred to as a particular, and separate, class of assets. According to this metric, currency does qualify as an asset class, as it has a lowcorrelation with most other asset classes (fixed income would be the important exception).

The point, however, is that the semantics don't matter. What mattersis that currency presents a real risk and a real opportunity for return, and it, therefore, should be carefully and intentionally managed.

#9 I can't afford the additional risk

This is an interesting one. We're very supportive of the move towards risk budgeting that we've seen becoming more and more prevalent amongst funds today. Of particular importance in risk budgeting is the notion that active risk should be allocated to an array of independent and uncorrelated sources of alpha. Currency scores high on both its independence and on the uncorrelated nature of its alpha with other active management strategies – at least these two facts are true with respect to our own currency product. It is, therefore, one of the most attractive places to allocate any available risk from the risk budget if any is left.

#10 I don't understand currency

Of course not. With all of the existing misperceptions about currency and where currency fits into an investment portfolio, it is no surprise that people are confused about it. We hope that this short set of challenges to the conventional objections to currency management may begin to correct these misperceptions, and in the months ahead, we'll pursue these topics in further detail.

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