

Hedging Currency Risk

John E. Murray, Managing Director, BNY Mellon, Global Markets, explains how the bank is meeting changing client demands for currency hedging.

What particular trends have you detected recently in the asset management sector?

Perhaps the most important trend in this market over recent years has been the widespread adoption by investment managers of the UCITS fund structuring regime to expand the distribution of their fund products to a larger market.

The advent of the European regulation known as UCITS, or Undertakings for Collective Investment in Transferable Securities, has meant that funds compliant with UCITS may now be sold in any European market.

The benefits in terms of cost and ease of distribution are significant. No longer must fund managers spend time and money adhering to local fund regulations in individual countries. Instead they are now able to consolidate disparate funds, offered across a variety of local markets, into a single fund. Under UCITS, a fund domiciled in Dublin or Luxembourg may be structured for distribution throughout Europe and even further afield to Asia, where the UCITS label provides investors with an important endorsement.

The UCITS structure thereby significantly reduces the costs associated with the distribution of new funds and vastly simplifies new fund launches.

The appeal of UCITS is further enhanced by its flexibility. The structure now permits the use of a wider variety of investment instruments, such as derivatives, and a greater range of investment practices, such as shorting, with which portfolio managers can manage risk and increase return. This greater flexibility increases the range of investment strategies available to conventional managers under UCITS, and has increased the appeal of the structure to alternative asset managers, such as hedge funds. The latter group are increasingly employing the UCITS structure to gain access to a wider market, and they are now launching a range of ETF and long-short strategies within the UCITS wrapper.

In this way, the new UCITS funds represent the confluence of performance and distribution: performance because they provide greater flexibility to the portfolio manager in constructing the portfolio, via short positions as well as derivatives, and distribution because they provide the means to distribute a single fund across a number of local markets.

And at no stage over recent years, have these twin benefits been as valuable to investment managers as they are now. Significant investment losses and widespread



“Share class hedging is at the nexus of what drives fund managers: performance and distribution”

redemptions over the last two years have precipitated a considerable decrease in assets under management on the part of large sections of the industry. Managers are employing the flexibility of the UCITS structure to enhance performance, and its distribution benefits to increase their asset gathering by expanding the range of markets into which funds can be sold.

What are the implications of the growing popularity of UCITS funds when it comes to asset servicing?

To facilitate this wider distribution footprint, investment managers must work hard to cater to the needs of a diverse group of investors across a wider range of countries. At the heart of this customisation lies the need to offer multiple fund share classes, each corresponding to the home currency of the investor, so that investors may invest in a foreign fund via a local currency share class.

This raises the question of whether such alternate currency share classes should be hedged against the fund’s base currency, or whether they should be

unhedged. While there are some investors who actively seek the currency risk provided by investing in a fund whose assets are invested in a currency other than their own, many wish for that currency risk to be hedged for them by the provision of a fully hedged alternate share class. Share class hedging provides these investors with the confidence that the performance of their investments will track closely the performance of the underlying fund, regardless of the movement of the respective exchange rates.

Through discussions with our clients we have found that in order to meet the requirements of their investors in this area, many investment managers prefer fully to outsource the responsibility of administering share class hedging. This removes from them the administratively burdensome process of operating a high quality currency hedging program, allowing them to concentrate on their core competency of managing the fund.

How, specifically, are you satisfying growing demands on the part of your investment management clients for an outsourced currency hedging solution for these alternate share classes?

The extensive experience of BNY Mellon across fund services, asset management, custody and FX, means that we have a unique insight into how to meet the needs of these clients for an end-to-end outsourced solution. Our Currency Hedge Administration service provides a highly flexible, technology-based, currency hedge administration capability.

At the heart of this Currency Hedge Administration sits iHedge, a proprietary web-based service to conduct hedge administration for share-class hedging programs, the intent of which is to insulate funds' investors from currency risk on cross-border investments. iHedge employs NAVs and subscription and redemption data, combined with currently outstanding hedge positions, to calculate the trade requirements necessary to maintain hedges at the target level specified by the investment manager.

We also offer arrangements with fully transparent benchmark pricing alternatives to allow clients to understand all costs associated with outsourcing their hedging program.

Beyond the investment management community, what requirements are you seeing from asset owners such as pension funds? How do they view the role of foreign exchange in portfolios and how does this define the demands that they are currently making of you?

Among pension plans and other institutional asset owners we are seeing a similar demand for our outsourced currency hedge administration program. But here the demand drivers are different, focussing around a shift from active to passive currency risk management on the part of portfolio managers, in response to recent market conditions.

Historically, currency overlay managers were successful in demonstrating to plan sponsors that actively managed currency overlay programs could be a valuable source of alpha for their portfolios. Among this investor segment, this created a bias towards viewing currency exposure as a means to enhance returns, rather than as a risk that needed to be hedged.

However, widespread asset losses in 2008 and 2009, and the continuing high volatility FX environment,

including the recent stress in the Eurozone and the notable pressure on Greece, has caused pension funds to evaluate carefully the costs of these active currency strategies against the returns they were generating.

This has prompted consultants to the pension industry to recommend converting active overlay programs to passive currency overlay arrangements, in order to cut costs and reduce the influence of currency fluctuations on long-term portfolio returns. Pension plans have, in response, moved from a position of seeing currency exposure as a source of additional alpha, to a position that regards it as a risk that needs to be identified and controlled. They have therefore replaced strategies that pursue returns from FX exposure via active management, with passive management strategies seeking to minimise the disruption of currency fluctuations on portfolio performance and the liquidity requirements of investors.

This non-discretionary systemic approach has also been characterised by clients wishing to change the duration of their hedging strategies. Whereas previously, managers' horizons for currency hedging

"Passive portfolio hedging programs are cost effective and reduce the impact of currency fluctuation on long term portfolio returns"

extended ahead around three months, the need to accommodate greater liquidity demands has meant that a one-month horizon is now typical. During this horizon the client will typically require that the hedge stay at all times as close to the desired target level as possible to minimise short-term risk.

How are you meeting these changing demands from portfolio managers?

This move to passive currency strategies has again played to our strengths at BNY Mellon. Utilizing iHedge, our Currency Hedge Administration service can be employed to manage portfolio hedging programs for clients, as well as to support currency hedging for alternate share classes.

Portfolio managers are requiring us to implement a comprehensive passive management strategy with which to dampen the effect of currency fluctuations on portfolio returns. Again the outsourcing route enables them to offload the difficult operational challenges to BNY Mellon, a firm with the focus, expertise and capacity to perform this function to a high standard, and we are finding that most of our clients prefer to take this route.

An additional benefit for these clients is BNY Mellon's strong credit rating. Since hedging programs are established, in large part, through forward trades, there is a meaningful counterparty risk inherent in such trades. Our strong credit rating provides clients comfort that the other side of their trade is sound.

The net effect of these benefits is that by adopting our fully outsourced currency hedging solutions, clients give themselves the freedom to focus on their core portfolio management competencies, at a time when difficult trading conditions have placed them under considerable scrutiny. ■