

Passive currency hedging summary

Overview

We believe that passive hedging offers an efficient and cost-effective solution for managing currency risk. Insight Pareto's long-standing active approach to managing currency risk has driven the development of an integrated trading, risk management and reporting infrastructure, facilitating an institutional quality passive solution. We provide this valued service for institutions, either on a stand-alone basis or as a complement to an active currency strategy. Our philosophy and strategy is to reduce the foreign exchange risk from the client's international investments and limit trading costs.

Insight Pareto is a full service risk manager offering specialist currency risk management services for institutional clients for over 20 years. Currency hedging is closely aligned with a holistic view of managing risks across the entire investment portfolio, especially with increasing allocations outside the domestic market, and is a hallmark of the firm's evolution. Our passive mandates, which comprise a meaningful portion (approximately 20%) of our funds under management have the same level of oversight that our active clients enjoy, thus providing checks on currency exposures, interactive dialogue on currency markets and portfolio activities, and verification of performance reporting. Foreign exchange transactions are executed by a dedicated trading team located in London through the firm's leading-edge proprietary Currency Trading System, using a panel of independent high-quality counterparties. Insight Pareto's posture in the marketplace allows us to expect competitive pricing from our counterparties, and passive hedging clients may participate in the trade execution and efficiency benefits of our active currency management business for additional economies of scale regarding transaction costs. Similarly, centralizing foreign currency trading activity with one specialist manager for purposes of achieving net trade execution rather than trades by multiple underlying managers also helps mitigate the cost of implementation. Over the years, we have invested in systems and technological infrastructure to effectively manage large client mandates that require efficient trading and seamless operations for delivering foreign currency management services. Risk management is embedded in our entire operation and each step in the passive currency hedging service is subject to tight operational oversight. The passive hedging portfolios are managed by a highly experienced, stable team of currency investment professionals, including dedicated client portfolio managers assigned to each account for oversight and reporting to ensure a full service infrastructure and client experience.

Passive currency hedging implementation

Currency hedging is a risk management strategy that provides a way for investors to reduce the uncertainty in the value of overseas investments caused by exchange rate movements. Foreign investment is motivated by the desire to access higher returns and achieve greater portfolio diversification, but it also increases exposure to currency risk. Currency exposure differs from an asset exposure and is a separate source of volatility that offers no expected risk premium. The objective of a currency hedge is to remove this unrewarded risk, particularly if it represents a mismatch against future liabilities that are likely to be paid in the investor's base currency.

Currency hedging allows the currency allocation to be entirely separable from the asset allocation, without disrupting the underlying investments. Since currency exposure results from the domicile of the investment rather than the asset class to which it belongs, it is logical to consider currency risk management at the total portfolio level. The bulk of currency risk typically comes from developed market currencies, where theory suggests the expected return is zero. We are also happy to advise on the right approach to hedging emerging market currencies as appropriate.

A currency hedging program seeks to offer several advantages:

- A more efficient use of risk budget at the total portfolio level
- Access to the foreign asset risk premium, without the contamination of currency movements
- A reduction of volatility due to exchange rate moves by managing currency risk directly
- Protection against foreign currency devaluations impacting the base currency
- A low cost of implementation
- Protection of the base currency value of foreign investments for future liability payments

Passive hedges

Insight Pareto provides customized passive hedging applied to the currency exposures of a client's portfolio of international investments. Positions are rebalanced on a monthly frequency to ensure that the hedges remain in line with the underlying currency exposures. Based on our process, we have the capability to either fully replicate the developed market underlying exposures with the portfolio hedges or use a designated notional exposure applied against an international index. The foreign exchange market is the largest and most liquid of all financial markets. This means that transaction costs are very low in comparison with asset markets. Additionally, passive hedging clients may participate in the trade execution and efficiency benefits of our active currency management business for further economies of scale regarding transaction costs. The hedges are typically implemented using three month forward foreign exchange contracts, providing a favorable trade-off between turnover and implementation costs.

Currency hedges result in a stream of realized cash flows that are equal and opposite to the changes in value of the underlying foreign currencies. Depending on the level of hedging, these cash flows partially or fully offset the currency translation impact on the value of overseas investments.

As hedges approach maturity, they are closed and replaced by equivalent contracts with maturities three months further into the future. This roll-over process allows currency exposures to be hedged indefinitely, without disrupting the holdings of the underlying investments.

Passive currency hedging process

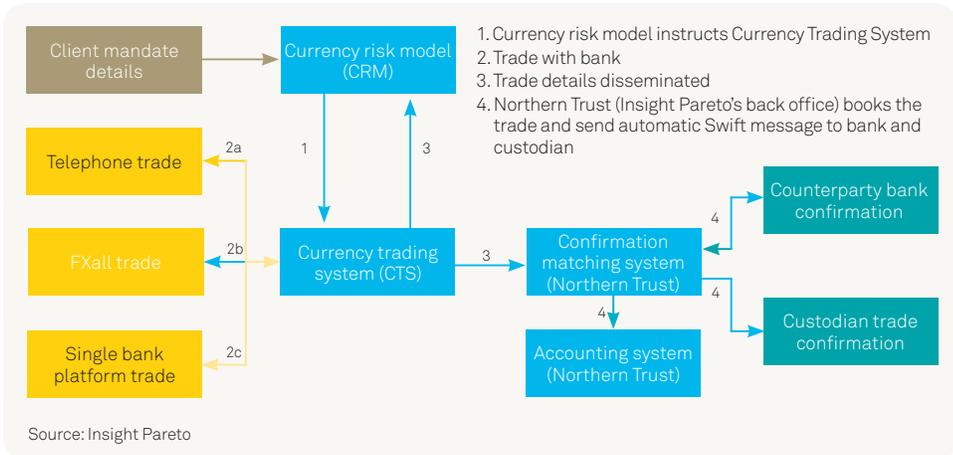
Currency Risk Management model

Insight Pareto's Currency Risk Management proprietary, quantitative model monitors the current level of hedges and calculates trades required to achieve and maintain the target hedge ratio on each currency pair. Trades are transmitted directly to the foreign exchange dealing desk, via the Currency Trading System, a leading-edge order management trading platform.

Monthly revaluation

Dedicated client portfolio managers in New York and in London are an important factor differentiating the Insight Pareto passive hedging service. Similarly, a critical component of the passive hedging process is periodic rebalancing, which assists in keeping the hedge activity closely tied with any changes in the underlying currency exposures. Insight Pareto's portfolio revaluation system manages the update of underlying currency exposures. These are derived from reports showing the client's international assets that are typically provided by the custodian in electronic form within seven to ten business days following month-end, depending on the appropriate reconciliation process for updating international investments. This system is able to download benchmark index weights and to adjust for index and exchange rate movements from different valuation points to combine data provided from a variety of sources. Intra-month, portfolio exposure amounts are typically fixed at their designated notional value within the passive hedging program. Once received, the updated exposures are checked and verified by a client portfolio manager in London against the prior month's currency exposures in the models to ensure that no significant changes have occurred that have not already been communicated to Insight Pareto, and the data is otherwise correct before being transferred directly to the Currency Risk Management model. If there are any notable discrepancies, the client portfolio manager in London would seek to revert to the client for double-checking of the information received prior to proceeding with the portfolio rebalancing. On the review date, we will adjust the portfolio back to the passive benchmark position. This review process is continuous throughout the passive hedging mandate.

Trade execution process



Currency trading system

Our dedicated trading team is based in London with significant experience in foreign exchange markets, derivative instruments and trading applications, allowing us to optimize trading activity with the goal of achieving the best result for our clients. The trading team utilizes the Currency Trading System to achieve the best possible results for trade execution, with built-in pre-trade compliance checks. Rebalancing trades are typically executed at rates based on the London 4pm fixing with a panel of core counterparty banks who are constantly monitored for execution capabilities and credit quality. Competitive quotes are requested for roll-over trades. Straight-through processing ensures that trades are confirmed with the counterparty bank and transmitted to the client's custodian via electronic SWIFT messages. A diagram of the trade execution process is included above.

Settlement

For institutional investors, currency hedging mandates are commonly implemented on an unfunded basis. In this case, cash flows occur when forward hedging contracts reach maturity (typically four times per year). Advance notice (typically 7-10 days) is provided to inform clients of forthcoming settlements and there is flexibility to coordinate cash flow settlements suited to the client's needs regarding timing.

As the regulatory environment evolves, attention has been placed on the level of unrealized gains and losses associated with financial derivatives. Although not yet a regulatory requirement, we are also able to offer clients the ability to margin currency hedging accounts against a pool of collateral, thereby further reducing counterparty exposure risk.

Reporting

Our dedicated team of client portfolio managers assigned to each account oversees the reporting and client interface for the passive hedging program. Monthly reports include a portfolio valuation, monthly and cumulative performance data, hedge ratios, and details of the outstanding exposure to each counterparty bank. Information is presented graphically where appropriate and is sent to clients in electronic format. Insight Pareto is also able to provide detailed transaction cost analysis on a periodic basis to review the implementation costs of maintaining the passive hedging program. We also assist clients in meeting regulatory reporting requirements in the appropriate jurisdictions governing the trading activity. The local client portfolio manager for each account is also responsible for managing day-to-day interaction on the program, communicating on currency markets and portfolio activities, coordinating periodic client visits and opportunities for investment board and/or staff education on currency, ensuring a full-service Insight Pareto client experience.

Risk management

Forward foreign exchange contracts are over the counter (OTC) agreements executed with independent, leading foreign exchange banking counterparties; they are not exchange traded derivatives. Insight Pareto maintains a panel of recommended counterparty banks and the firm's Counterparty Credit Committee is charged with the initial and ongoing responsibility of identifying permissible counterparties and assessing counterparty risk.

Clients benefit from the reassurance of trading arrangements established under an umbrella agency International Swaps and Derivatives Association (ISDA) terms letter where necessary. The terms have been negotiated between the firm and each of the counterparty banks to minimize the administrative exercise of clients negotiating trading terms with counterparty banks individually. Clients can select some or all of the approved counterparties consistent with ensuring that sufficient relationships are maintained relative to the size of the passive hedging program. We can also implement the program based on existing client documentation already in place for trading other derivatives where appropriate.

Exposure to foreign exchange counterparties is managed within the Currency Trading System, where client-specified constraints are encoded at the individual account level, alongside our internal prudential limits. These constraints form part of the automatic pre-trade compliance module.

Insight Pareto closely monitors trade execution. We record the rate of execution of every trade relative to the prevailing market, taking account of the amount executed. Proprietary tools have been developed to analyze the effectiveness of trade execution, the results of which can be reported periodically to clients.

We strongly recommend that clients arrange for their custodians to settle foreign exchange contracts using Continuous Linked Settlement (CLS) where applicable. This is the industry standard payment versus payment matching system, which has the benefit of reducing daylight settlement risk and seeking to ensure that neither party is left exposed on a failure to deliver proceeds associated with the forward contract settlement.

For further mitigation of counterparty risk, clients may wish to take advantage of margining foreign exchange contracts against a pool of collateral.

For further information please contact:

Carl Mastroianni, CFA
Senior Vice President,
Client Portfolio Management

Carl.Mastroianni@insightinvestment.com
(212) 527-1817

Vincent Fontana, CFA
Assistant Vice President,
Client Portfolio Management

Vincent.Fontana@insightinvestment.com
(212) 527-1811

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