

Session 5: Currency: Refining the approach to foreign currency management

2023 Frontier Advisors Annual Conference

Chair:



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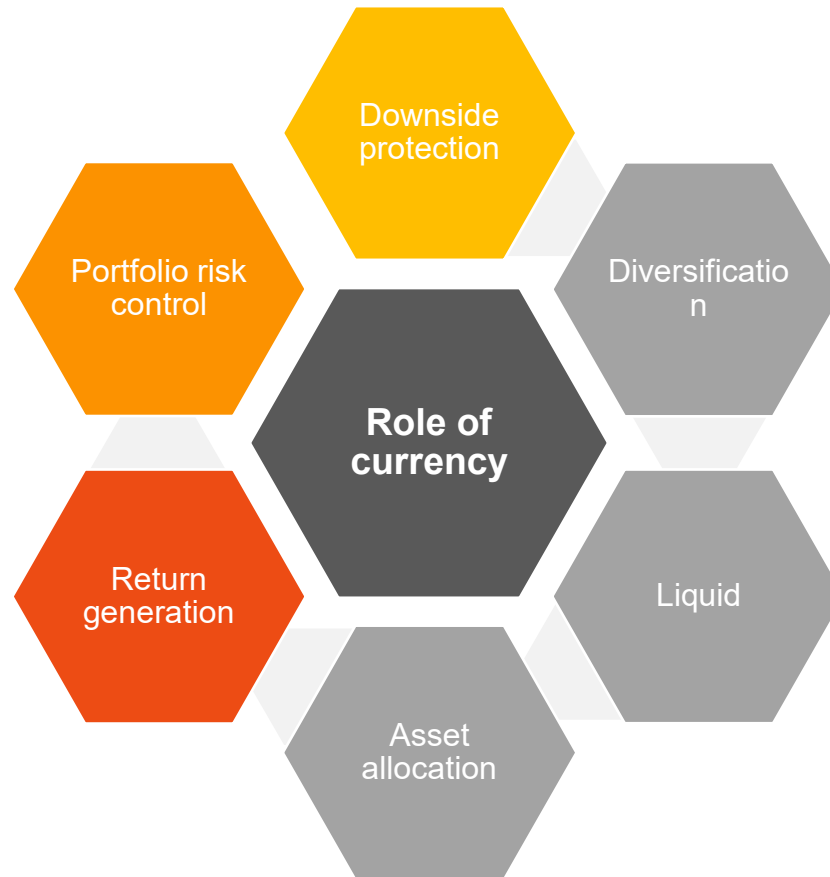


Danica Hampton

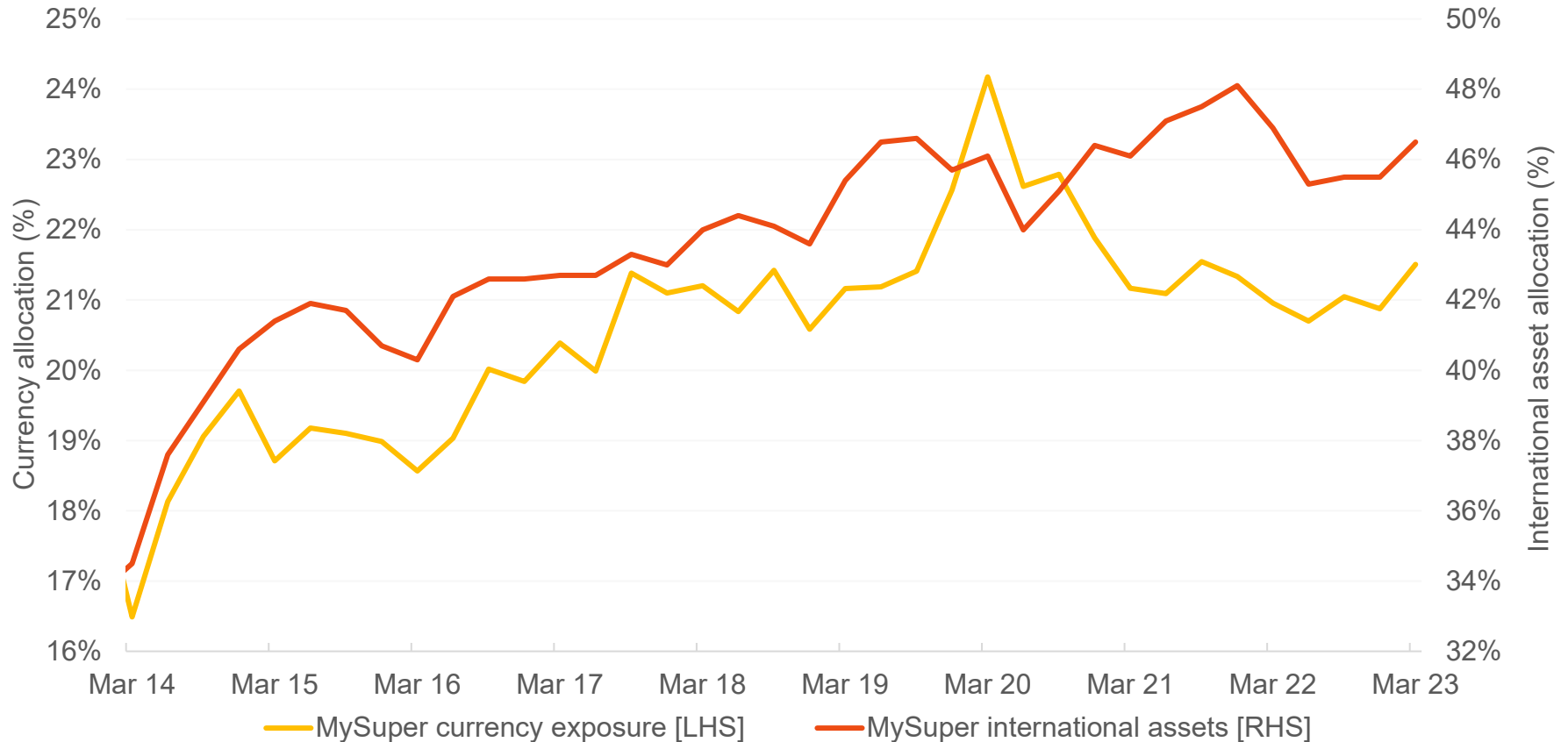
Head of Sales, Adrian
Lee and Partners

The role of foreign currency in a balanced portfolio

While the role of currency is multi-faceted, most Australian investors prioritise its defensive role.



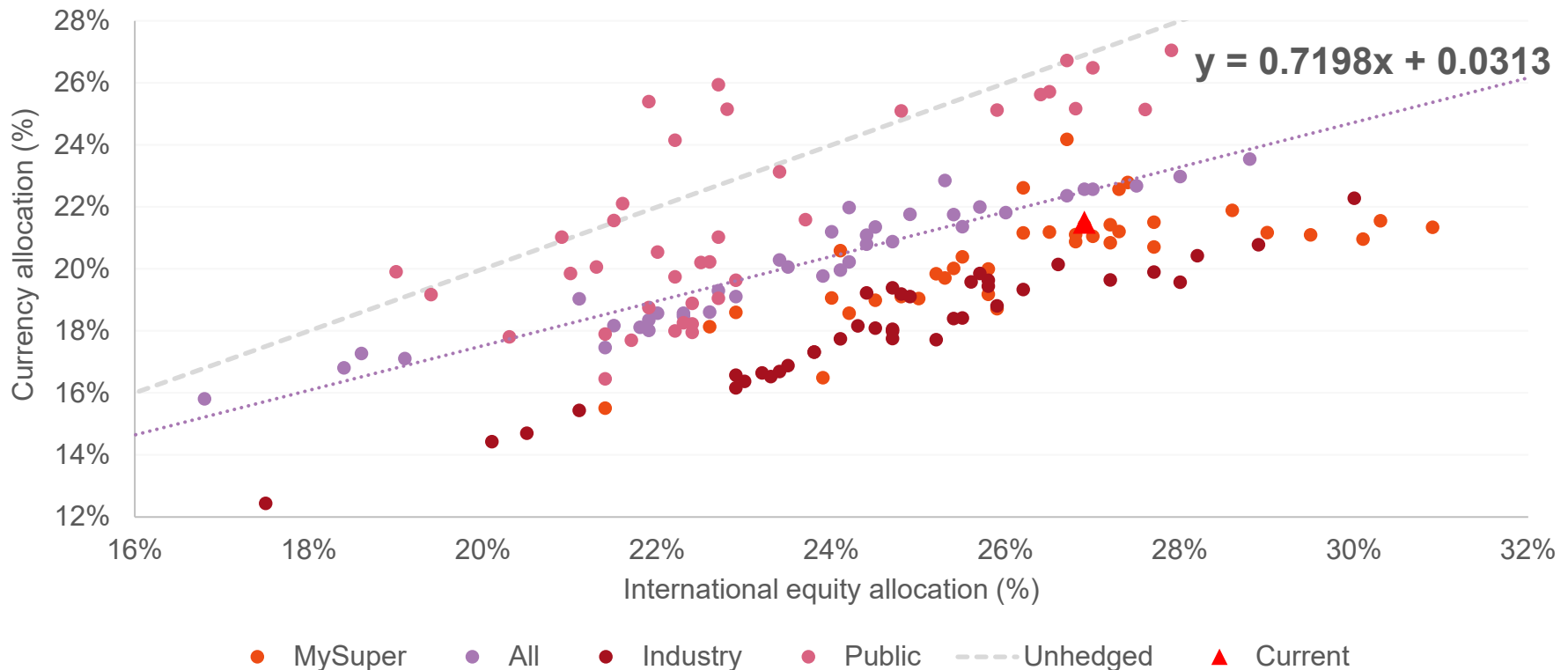
Portfolio level foreign currency exposures have increased over time



Source: Frontier Advisors, APRA. Quarterly asset allocation data from 2013 – March 2023

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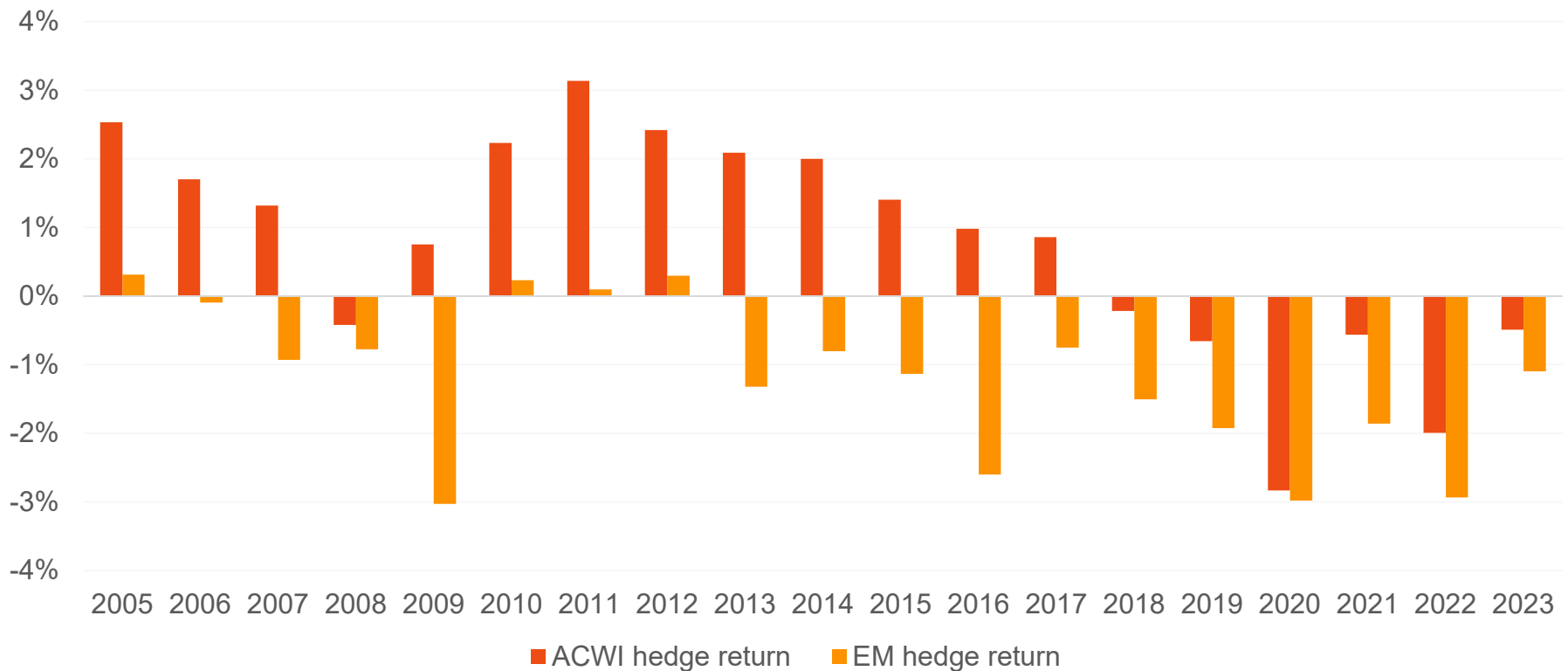
Hedge ratios on international equity appear somewhat constant over time at ~25-30%



Source: Frontier Advisors, APRA. Quarterly asset allocation data from 2013 – March 2023

Historical currency hedging benefits have now become a cost

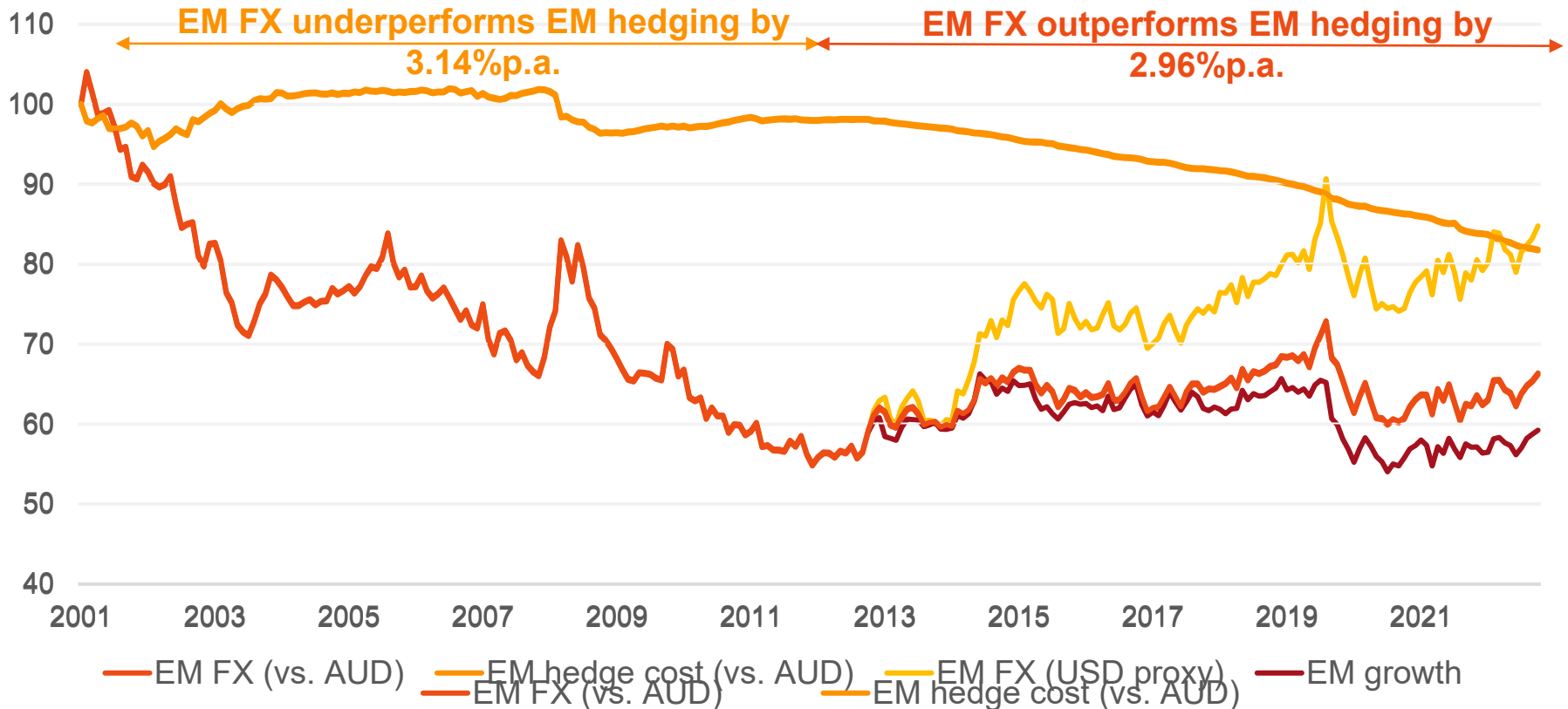
MSCI ACWI and MSCI EM annual hedging premium/(cost) by calendar year



Source: Frontier Advisors, Bloomberg. Returns derived from MSCI benchmark data to 31 May 2023.

Where to now for EM currency?

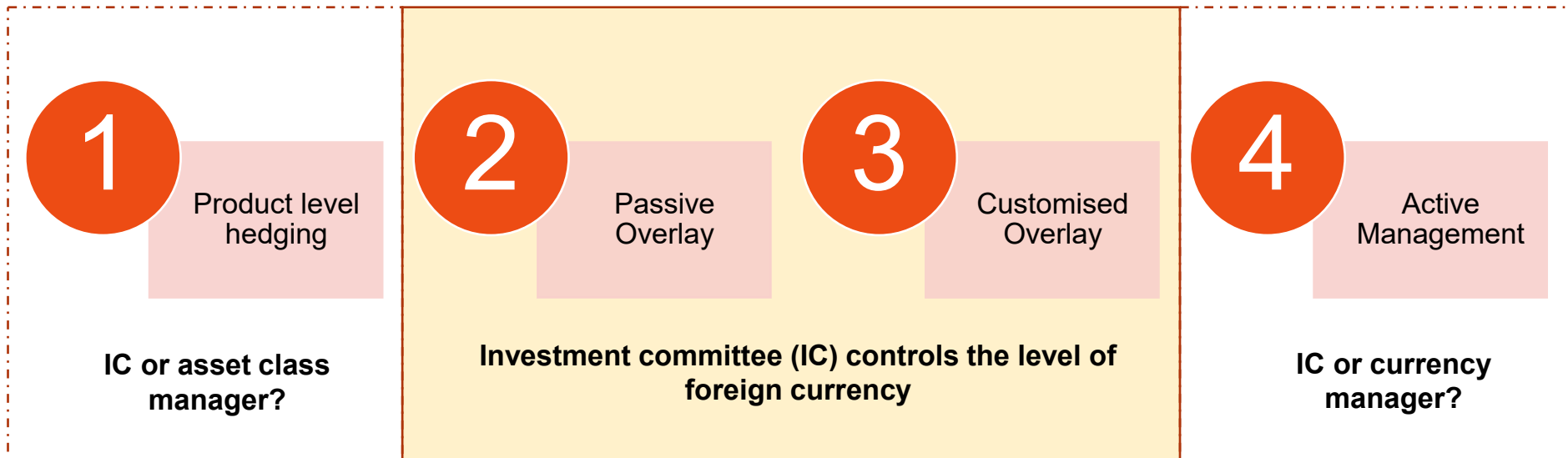
Performance dependent on structural regime



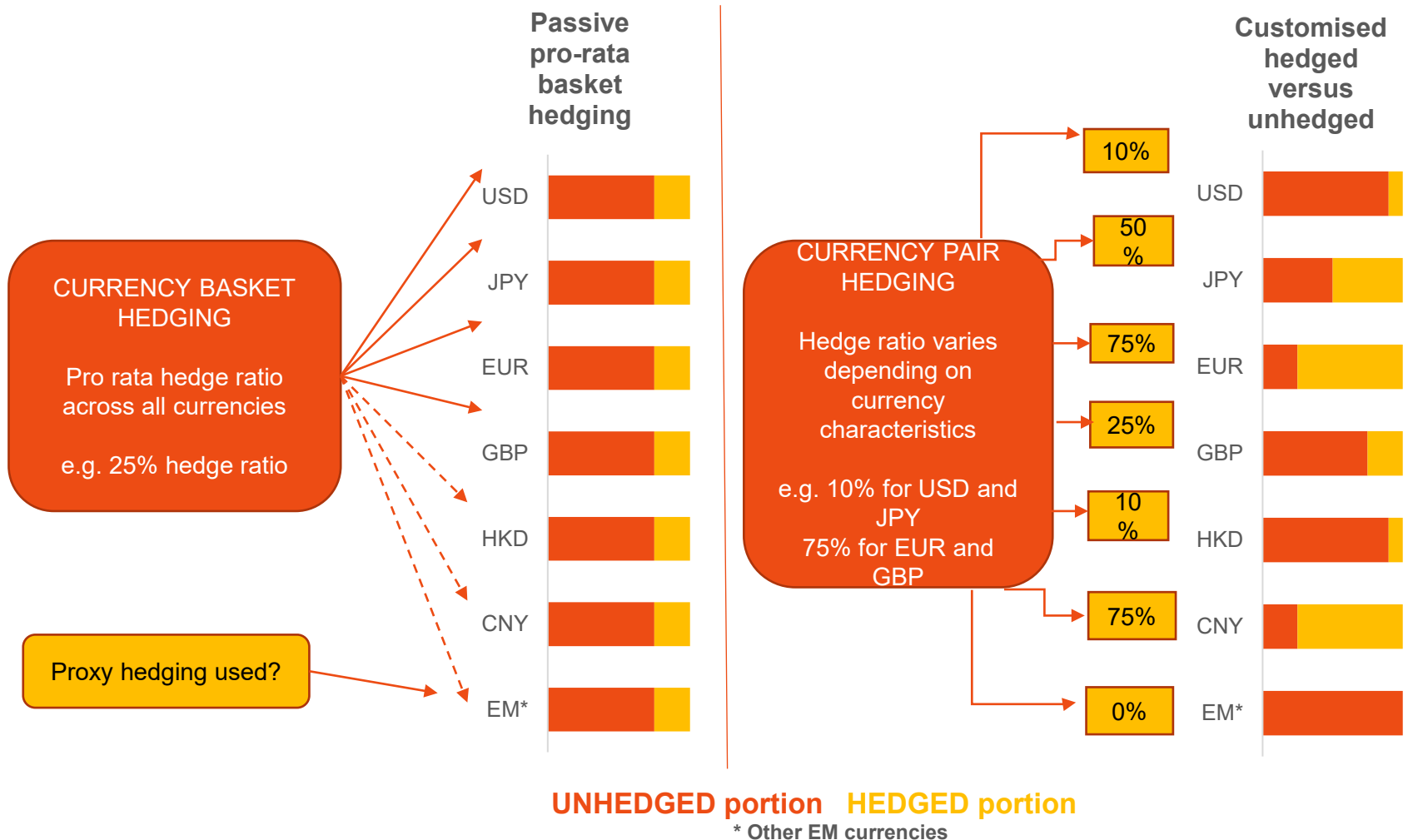
Frontier Advisors, Bloomberg. EM currency exposures represented by MSCI EM currency index. EM FX (USD proxy) basket composed of HKD, CNY, TWD, THB, SAR with static weights representative of the current MSCI EM currency benchmark. High growth EM FX basket composed of KRW, IDR, INR, BRL, MXN, ZAR. .

Foreign currency management – no one size fits all

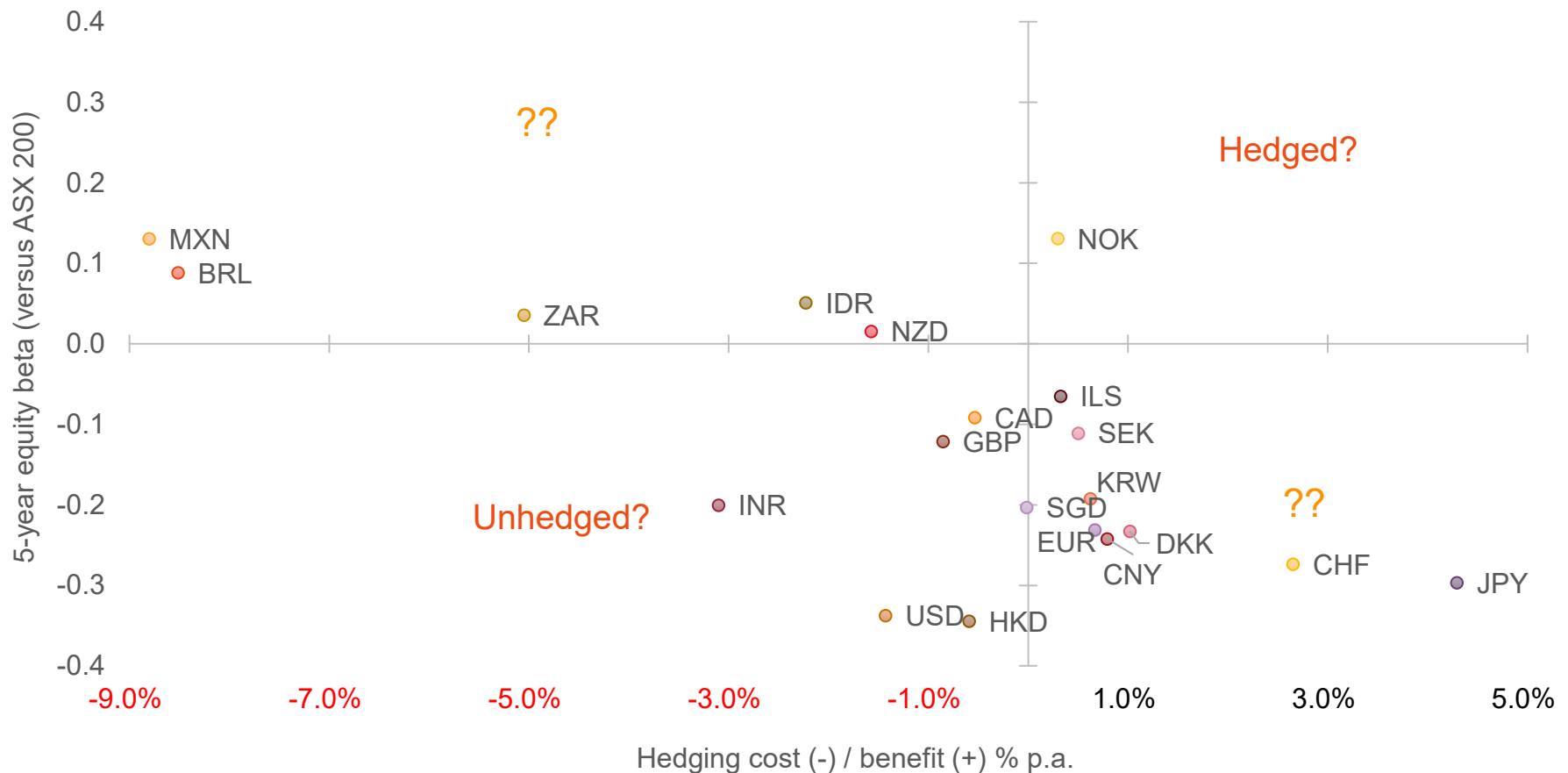
Which combination do you have?



What does customisation in foreign currency hedging look like?



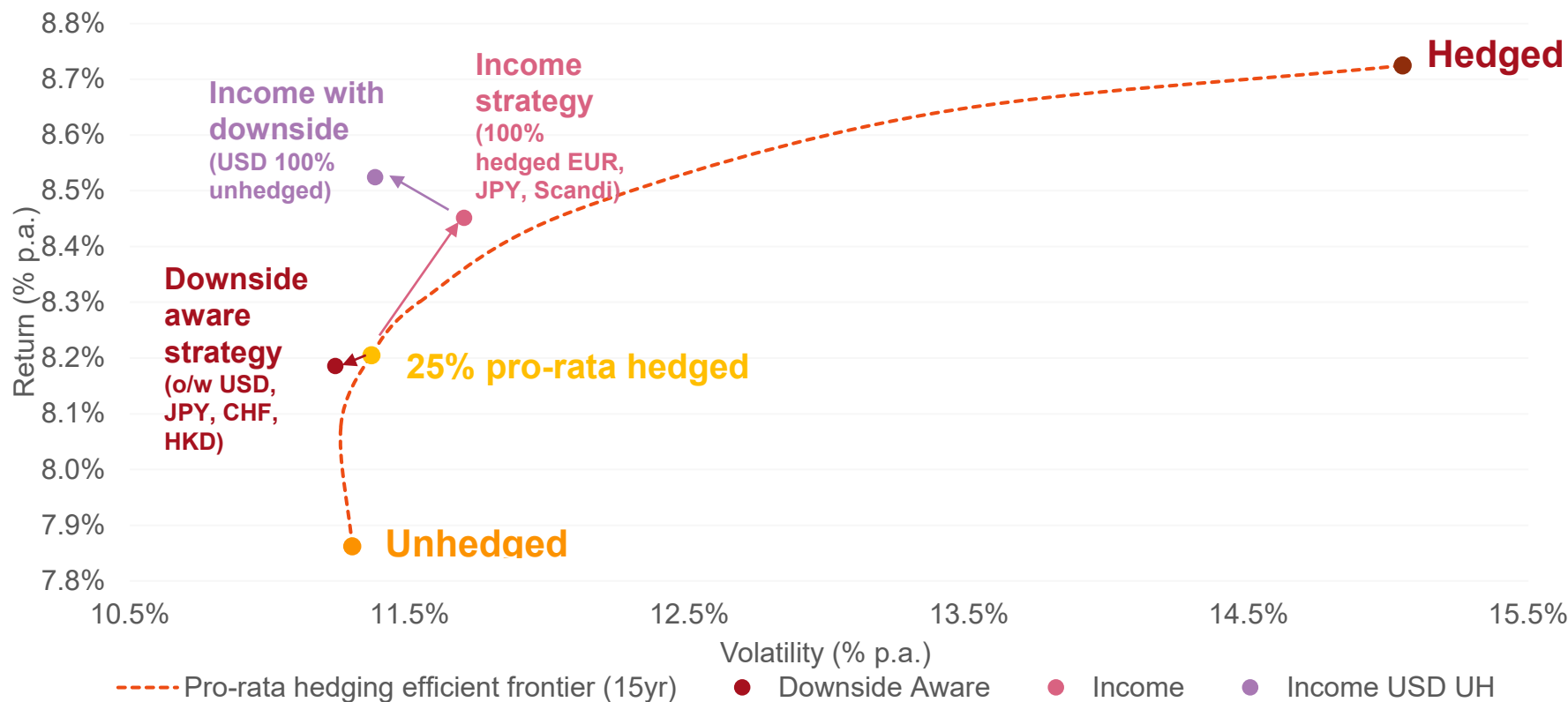
Why customise? Hedging costs and diversification levels vary greatly



Frontier Advisors, Bloomberg, May 2023. Hedging costs implied by (annualised) 3month deposit rates as at 31May2023.

Efficient frontier for MSCI ACWI with customised hedging approaches

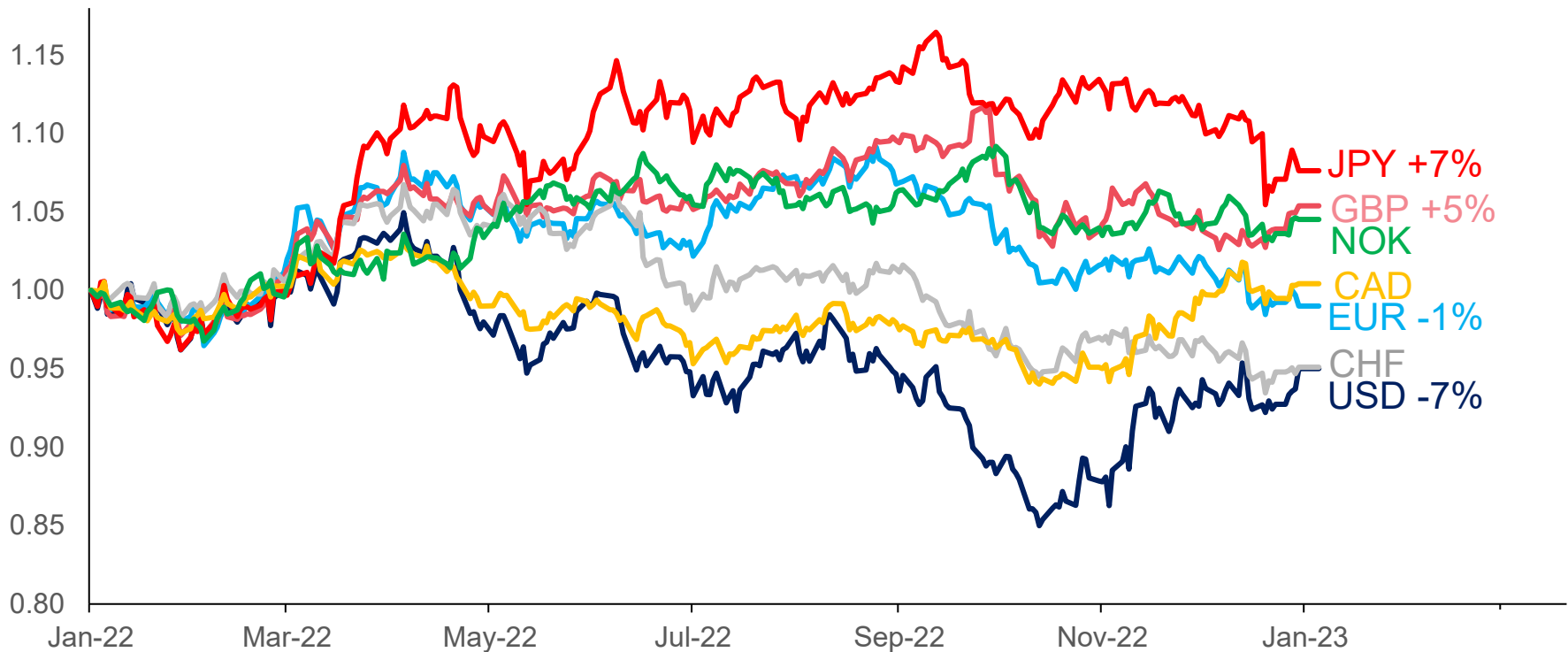
Improving risk return outcomes using a base hedge ratio (of 25%) and different mix of currencies



Source: Frontier Advisors, Bloomberg, based on monthly data from July 2005.

Why active? AUD crosses don't all move in the same direction

Performance of AUD crosses in 2022

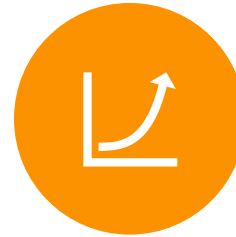


Source: Adrian Lee & Partners

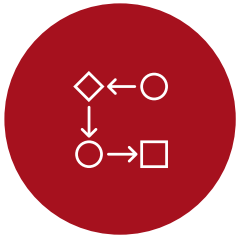
Implementation considerations for active foreign currency investors



What to hedge?
How do I think about my benchmark?



Risk management or return seeking? Constraints?



Tied to underlying assets?
How closely?

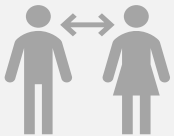


Risk budget – 1% or 3%

Ways global investors use active currency managers



One manager that does everything passive and active.



Two active managers (with complimentary styles) – one of those active managers does the passive hedging.



A separate currency manager for passive hedging.
2-4 active managers to extract all possible styles of currency alpha.

Most active currency managers include at least one these four factors



CARRY



VALUATION



MOMENTUM

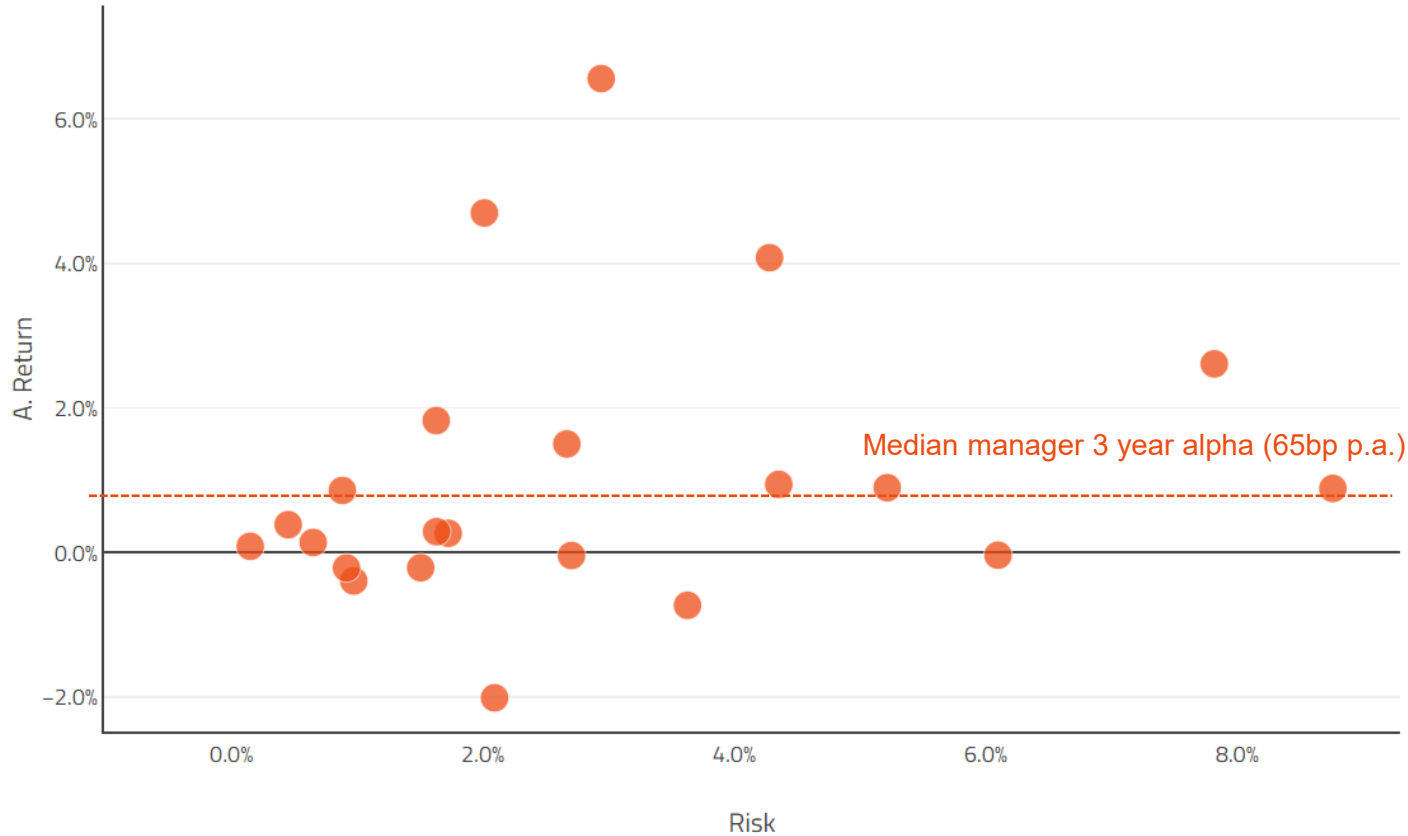


VOLATILITY



Return potential of active currency management

Positive alpha in the incumbent market regime (3-year lookback)



Source: eVestment, Frontier Advisors PTY LTD
Report Date: Mar 2023

Key takeaways

Extracting more value from foreign currency management

- The foreign currency market environment has changed.
- Passive basket currency hedging has served us well but has its limitations to deal with the current market backdrop.
- Investors should consider flexible customised foreign currency hedging solutions to help align outcomes with objectives and improve portfolio flexibility.
- Active management in foreign currency has yielded positive return outcomes in recent years which have been uncorrelated to risky assets.



Thank you for joining us.

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