Frontier Advisors

Why asset owners should consider a more flexible approach to foreign currency management

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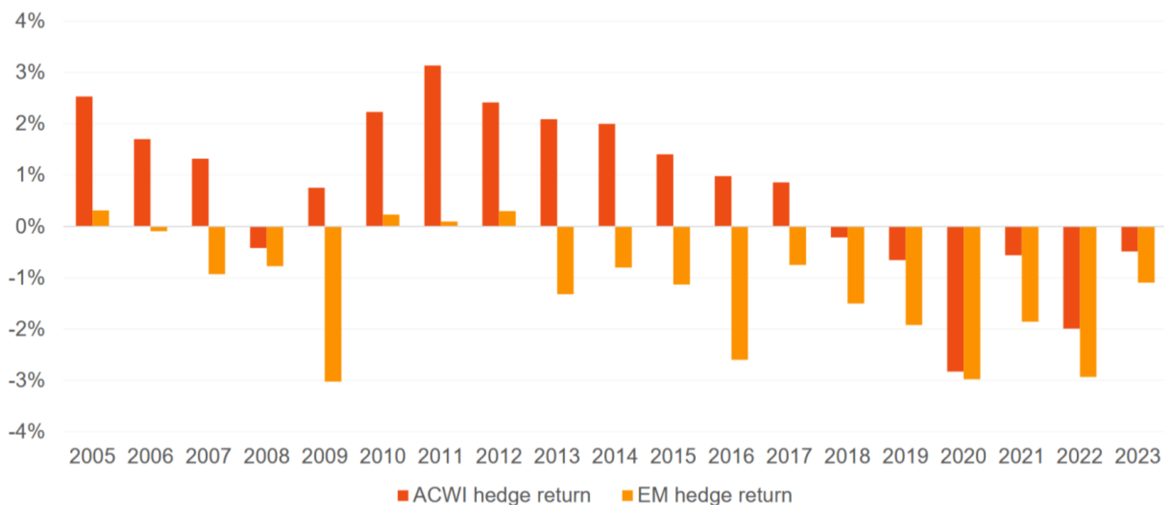
A more customised approach to foreign currency hedging can allow asset owners to extract more value given a change in market conditions.

Andrew Kemp, Head of Defensive Assets and Private Markets, Frontier Advisors, said most institutional investors had historically taken a passive approach to currency management, such as applying a 25% pro rata hedge ratio across a basket of currencies.

While that worked well in the past, today's higher interest rate environment had created more bifurcation between currencies, which meant a more active approach that can be tailored at the currency pair level had its merits.

“Having the flexibility in these portfolios is very powerful,” he said. “And the market environment just really lends itself to doing something which takes the good parts of the basket approach that we've used in the past and layers in the ability to target individual currency pair exposure.”

The foreign currency market environment has changed and historical currency hedging benefits had now become a cost, as shown in the graph below.



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

Kemp said US dollars, Hong Kong dollars, the Swiss franc and Japanese Yen held up as defensive currencies on a historical basis, but hedging costs and diversification levels of currencies now varied greatly.

“Now what we're faced with is hedging these currencies has quite a different cost from an interest rate differential standpoint. So can we sit back and afford to take the same basket approach across the board when we have these big deviations in different types of costs of currency?”

Danica Hampton, Head of Sales, Adrian Lee and Partners, said asset owners had to decide whether they were appointing an active currency manager to prioritise a risk management or alpha-seeking strategy. Either strategy typically involved an overlay or a total portfolio approach, with risk budgets around 2-3% a year.

“Everything can be customised. There is no one size fits all, whatever strategy you're trying to achieve with your fund; whatever thing that you're trying to get from your manager, can be done.”

Hampton said customised (active) hedging had been far more popular overseas than in Australia.

“If you look at US and European investors, they haven't had the benefit of the (Australian) interest rate differential for the last 20 years and so there's been a lot more use of active managers in general.”

Iain McMahon, Head of Bonds, Currency and Derivatives, Frontier Advisors, said the median active currency manager had delivered 65 basis points of alpha per year on a three-year timeframe, although more recent performance was higher again.

“A lot of the alpha has not been correlated to risky assets, which was probably one of the fallbacks or misconceptions historically, and it has not all been dependent on the direction of the US dollar.”

He also said an active currency investor should be agnostic between a smaller sized capital allocation in a high risk strategy versus a larger capital allocation to a low risk strategy. This distinction is largely a function of client preference and alignment with desired risk budget.