

The new weapons of mass performance

Active currency management can add value in managing risk and producing returns

BY MAXIME TESSIER

Trying to convince global bond managers or treasurers of large multinational corporations that currency returns need be actively managed is like preaching to the converted. It is much harder to convince global equity managers or - worse still - managers of balanced funds and investment consultants about the merits of active currency management. Yet they would do well to heed the call for active currency management: the simple truth is that exchange rates now account for a significant share of portfolio returns and risk, whether we are talking about a portfolio of bonds, equities or a balanced portfolio.

Recognizing this reality is half the battle. The other half consists in understanding that active currency management, whether it consists in hedging or overlay, can help reduce overall portfolio risk but it can also transform existing risk into additional returns. As for any asset class, this is by no means easy. However, several investment consultants now concede, albeit sometimes grudgingly, that active currency managers can be successful at managing risk and yielding additional returns, just as any good active fixed-income manager or good active equity manager. The challenge, as always, only resides in choosing the managers who will add value and in avoiding the ones that will subtract value.

Getting the facts straight

Let's consider the following facts. Over the past 75 years, U.S. markets have



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yielded the following annual returns, net of consumer price inflation: cash 0.5%; government bonds 2.5%; equities 6%. This works out to 4.5% for most balanced portfolio (this is before any additional returns accruing to active management). Now consider that major currencies have fluctuated by an average of 12% per year in the past decade. It quickly becomes obvious, even to the casual observer, that if this environment prevails going forward, exchange rate fluctuations

can make the difference between positive and negative portfolio returns.

The first myth about currencies is that they do not matter at all. Chart 1 illustrates the historic difference in the monthly returns between the best and worst market over the past decade. For global equities, these relative returns have averaged 10% per month. For currencies, the average is 5%. For bonds, it has been much less and has declined to as low as 2% over the past few years. From a global asset allocation point of view, this means that the equity decision has the potential to explain about 60% of returns, currencies 30% and bonds 10%.

Chart 2 shows the volatility of those relative returns. Over the past decade, the monthly volatility of relative equity returns (i.e. the return of one country's stock market versus another's) has been 4.5%. For currencies, it has been 3% and about 1.5% for bonds. In summary, the risk stemming from currencies is about two-thirds of the equity risk, and double the risk stemming from bonds.

The bottom line is that whether we look at currencies from a return or from a risk perspective, their impact is significant: the impact of currencies on returns is slightly less than the impact of equities but clearly more than the impact of bonds. Therefore, if investors choose to actively manage the returns and risks of equities and bonds, why should they not actively manage the returns and risks of currencies?

The second myth about currencies is that they are correlated with the relative performance of underlying assets.

Chart 1 - Average Monthly Return Dispersion
(Difference Between Best and Worst)

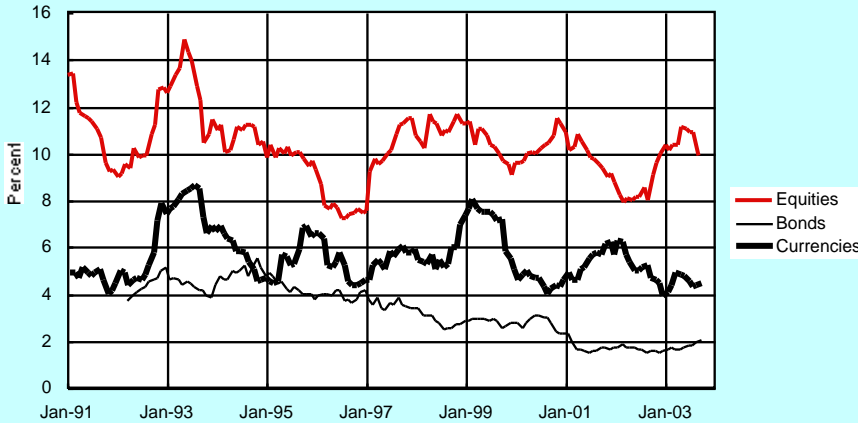
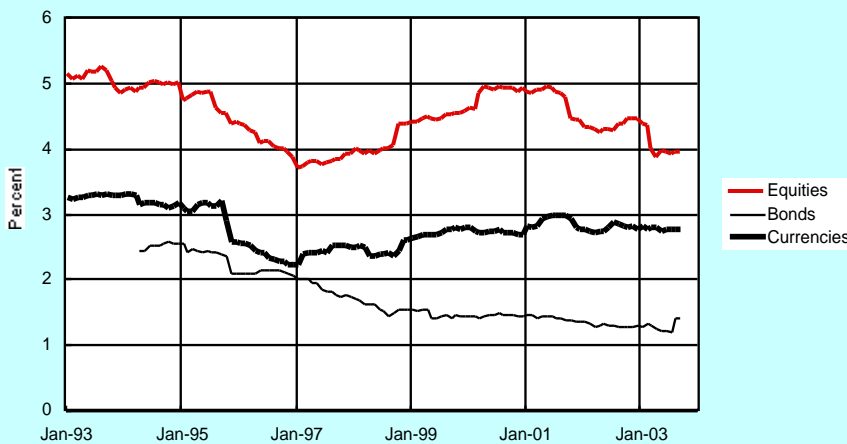


Chart 2 - Average Volatility of Monthly Relative Returns



Accordingly, their return and risk can simply be managed as part of these same underlying assets. This belief is based on the intuition that because capital flows usually chase the best performing markets, the stock or bond markets that out-perform should draw in more capital. Those capital inflows should in turn force up the value of currencies.

Chart 3 shows the monthly correlation between bond returns and currency returns over the past decade. On average, this correlation has been very low (-0.1). For each month, we also show the highest and lowest correlations among different markets; this is the gray band around the thick line. You will note that this range

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has been fairly narrow and has been declining considerably, from plus or minus 0.5 in the early 1990's to 0.1 to -0.4 recently. In other words, government bond returns and currency returns are

completely un-correlated.

One argument that may explain this apparent lack of connection between bond returns and currency returns is that equity and equity-linked cross-border capital flows have been dominant. This was certainly true in the late 1990's, although the equity bear market has reversed this trend since 2000. Assuming that in the future equity flows will again be dominant, it may be more relevant to look at the correlation between equity returns and currency returns.

Chart 4 shows the monthly correlation between equity returns and currency returns over the past decade. Again, we note that it is not only very low (and negative) but that the dispersion is just as narrow as it is for bonds.

Our conclusion is that currencies march to their own beat. We recognize that cross-border capital flows probably impact currencies in the short term. However, empirical evidence is unambiguous: there is no apparent link between equity or bond market performance, and currency fluctuations.

Charts 1 to 4 together could yield the following conclusion: in a global balanced portfolio, currencies can account for about one third of total returns and half of total risk. Because currency returns are not correlated to those of the underlying assets, they can just as easily bolster or detract from portfolio returns with little or no increase in overall portfolio risk.

How about the longer term? If one looks at quarterly or annual returns and risk, the conclusions are much the same, but with different orders of magnitude: currency returns remain significant, somewhere between stocks and bonds, and are un-correlated with the return of the underlying assets. For example, the correlation between currency and equity market annual returns has averaged -0.2 over the past decade, ranging from 0.2 to -0.4. The range of correlations is slightly higher for currencies versus bonds (-0.4 to 0.5), but the average remains low and insignificant as well at 0.2.

Finding optimal solutions

Finding the right solution will depend on many variables. This section provides a

Chart 3 - Correlation of Monthly Percent Returns
Bond versus Currency

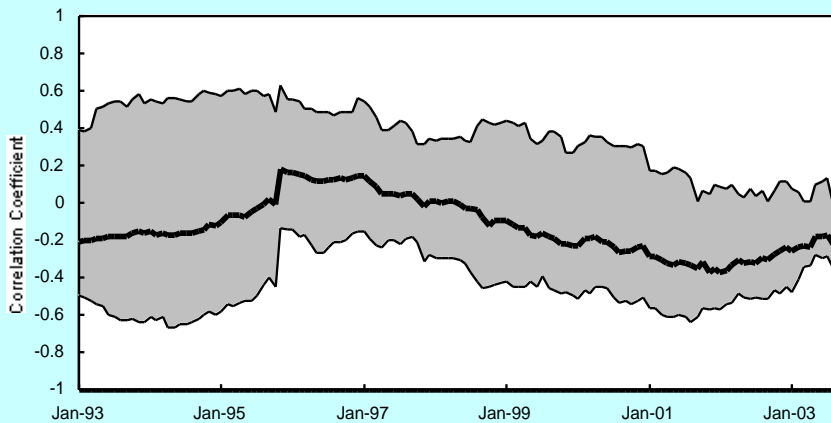
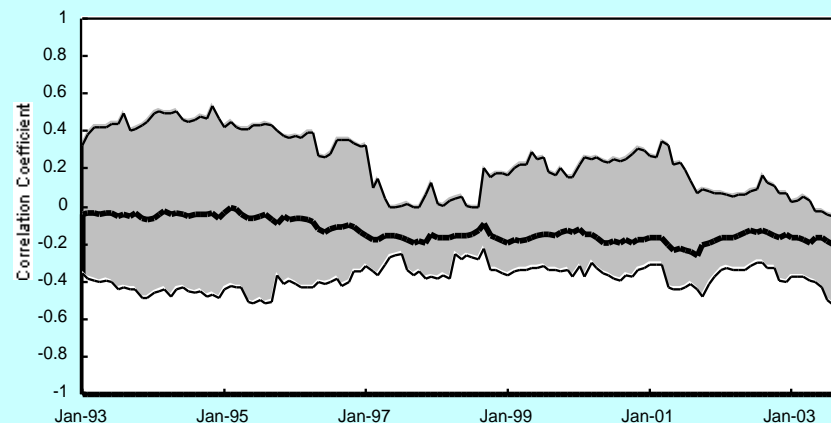


Chart 4 - Correlation of Monthly Percent Returns
Equity versus Currency



quick run-down, based on the assumption that investors are trying to achieve the most optimal return.

The ostrich solution

Hedging away all foreign currency exposure is akin to the ostrich sticking its head in the sand. If the risk and the opportunities are not recognized, it is easy to pretend they do not exist. This certainly reduces the risk relative to a domestic benchmark, and it avoids the embarrassing situation when an investment committee has to explain why its fund did poorly because a significant foreign exchange loss was incurred. However, it does not necessarily reduce portfolio risk or boost overall returns on an absolute basis.

The first step

The starting point for currency management is the adoption of an independent currency benchmark. Just because 20% of a portfolio may be invested in country X does not mean that exposure to country X's currency should also be 20%. Passive hedging - as in setting a fixed hedging ratio somewhere between 0% and 100% (often this ends up being about 50%) - is often used to improve the portfolio's overall return/risk profile. However, in a passive mandate, it is not so much that risks and returns could be improved, but rather they are shifted. Adopting a fixed hedging ratio of, say, 50% is akin to reducing exposure to foreign stocks or bonds by half.

The second step

The next decision is to set the limits of the currency manager's discretion to deviate from this currency benchmark. In asset management parlance, this is the amount of portfolio active risk that will be assigned to this activity. The difference between hedging and overlay is not one of risk. Some active hedging mandates can entail huge risk while many overlay programs could be quite conservative. The difference between hedging and overlay is in the performance: for the same amount of risk, the overlay manager will be more successful than the hedging manager. Hedging limits the breadth or number of decisions and thus the potential value added. In technical terms, this means that a manager's information ratio will be lower for hedging than for overlay.

Learning to dance

Overlay is becoming an increasingly accepted portfolio management approach to reduce currency risk while generating excess returns. Funds with significant currency risk exposures need to assign part of their active risk budget to currency management, otherwise the total return of these funds could fall to the bottom of their peer group ranking.

The other important decision is choosing the right dance partner. Client-specific experience plays a big role. For dollar-based investors, it was easy to be simply hedging away foreign currency exposures in the latter half of the 1990's, as the dollar appreciated against a wide range of currencies. However, the experience of the past two years of declining dollar constitutes a rude wake-up call. Allocating some of the active risk budget to currency management will be even more imperative as we enter a low absolute return world, because a bad currency decision - or no decision at all - could make the difference between a positive year or a negative year. ■

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