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Currency risk: the neglected driver of investment returns

Mitigating currency risk in a volatile global economy has never been more important, argues Validus' **Kevin Lester**.

In his book 'The Most Important Thing' Howard Marks, co-founder of Oaktree Capital, writes: "When you boil it all down, it's the investor's job to intelligently bear risk for profit. Doing it well is what separates the best from the rest."

When it comes to international private debt investing, there are at least two core risks which require careful consideration: default risk and liquidity risk. The management of these risks represents the main competency of private debt managers. They are compensated for their skills in these areas, and the alpha they generate is derived directly from these two sources: the credit and illiquidity premiums embedded in the interest rates.

However, the contribution of a third risk factor to the investment risk of a portfolio can also be significant. That often-neglected factor is currency market volatility. This is important for three reasons:

1. private debt investors are not typically currency market experts;
2. currency risk is not a source of expected returns for fund managers;
3. currency volatility tends to be high relative to expected private debt returns.

Most private debt funds will have a target return of between 6 and 15 percent, whilst currency volatility can range from around 10 percent per annum in a 'normal' market environment, to well over 20 percent in the event of more extreme market conditions. Adverse currency volatility can easily wipe out the entire return of a fund, even if the underlying investments perform well.

There are a number of approaches which fund managers can take in order to 'intelligently bear' this specific risk factor. Perhaps the simplest involves understanding the magnitude of the risk up front, and attempting to price the risk into the transaction. However, as Mark Twain once observed: "Prophesy is a good line of business, but it is full of risks." As such, this 'measure and accept' approach will always rely on a certain amount of luck; it will, however, ensure that investments are made with some assessment of the potential currency impact.

A second approach is to allow investors to bear the currency risk directly, thereby removing the impact from fund returns. Dividing a fund into multiple currency subclasses (which may or may not be practical, depending on the geographic scope of the fund) can facilitate the achievement of this objective. This also allows fund investors to manage their aggregate currency risk as efficiently as possible.

However, there are often practical obstacles to this strategy. Certain investors may prefer to invest in their domestic currency for example (despite the obvious concern with this policy – namely that investment may be in a different currency from a fund's base currency, thereby obscuring rather than avoiding currency risk).

A third strategy is to tackle the risk head on by hedging. This requires a careful balancing of objectives and constraints, including risk tolerance, hedging costs, and liquidity (either in the form of credit lines or collateral). This approach will typically have an adverse effect on total expected return (which makes sense, as there is less risk), but will often allow the fund manager to gain more control over performance, as it removes a significant, but effectively random, risk driver. In addition, this approach often appeals to potential capital providers, thereby assisting the fundraising process.

Before 2008, the global economy had created an illusion of stability; a 'Great Moderation' characterised by stable economic growth, low inflation, and currency markets which tended to trade in observable ranges, with minimal market dislocations. In such an environment, the temptation to ignore the effects of currency risk on investment returns was high and perhaps led to complacency in some quarters. Clearly, the world has now changed. As unpredictable currency wars and large-scale monetary policy interventions begin to dominate the currency markets, the importance of controlling currency risk, whether through internal investment processes and fund structures, or through external hedging solutions, is likely to grow dramatically. ■

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