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Currency hedging: the benefits of a tactical approach

A considered approach to currency hedging can help managers boost returns, writes **Kevin Lester,** co-founder of Risk Management Validus.

Currency volatility can have a significant impact (both negative and positive) on the returns of private debt fund managers, a reality which has been brought home on many occasions in the recent past, from the global financial crisis in 2008, to the more recent emerging market crisis of 2013. As a result, currency hedging is a generally well accepted component of the private debt manager's mandate.

Traditionally, the hedging of fund level currency risk has been done in a relatively mechanical fashion, with the "three month rolling" strategy traditionally being the most common approach within the private debt community. This mechanical approach to currency hedging does offer a number of advantages, as it does enable the fund to effectively hedge the exposure to movements in the spot rate, while minimizing counterparty credit exposure and limiting explicit hedging costs (typically less than 0.15 percent).

Nonetheless, this approach also presents certain problems. The fund remains exposed to changes in the currency term structure (interest rate), and the cost of hedging may be increased due to the higher number of transactions. However, the biggest problem with a mechanical rolling strategy is that the fund may be exposed to a potentially material level of liquidity risk. If the underlying currency strengthens, the fund will take a hit on two levels:

1. The fund will sacrifice the currency benefit it would otherwise receive (an opportunity cost); and
2. The fund will have to allocate capital to fund the negative mark-to-market hedging positions (this then becomes 'dead' capital, and carries a true (quantifiable) economic cost).

In an attempt to address these issues, there is an increasing trend amongst fund managers to develop a more tactical approach to currency hedging. Speaking at a recent conference in Hong Kong, Binay Chandgothia, portfolio manager at Principal Global Investors commented: "If you are looking to hedge out the forex risk from a fixed-income portfolio, you have to be a bit more tactical – this is especially true with high volatility currencies because otherwise most of the carry goes away. . ."

The main objective of adopting a tactical approach to currency hedging is to reduce the cost of hedging, in terms of the explicit costs, the implicit (op portunity) costs, or both. Direct hedging costs may be reduced by minimizing or capping the amount of collateral required to fund the hedging program, reducing the number of transactions, and / or exploiting market conditions, such as beneficial interest rate differentials. The potential opportunity cost of hedging may be reduced through the appropriate selection of hedging instrument (i.e. incorporating optionality into the hedging program) or calibrating the hedge ratio to optimize the balance between risk reduction and opportunity cost reduction.

When it comes to designing a tactical hedging strategy for a private debt fund (or investor), there are two quite different approaches which may be taken. Firstly, there is the opportunistic approach, which involves a careful assessment of market conditions (e.g. volatility, interest rate differentials), and constructing a hedging programme best designed to exploit these conditions.

For example, current market conditions are extremely favourable for US dollar-denominated funds with exposure to the euro, due to extremely low option prices and beneficial interest differentials, particularly in longer-dated durations, which may be used to effectively subsidize the cost of options. For more risk aggressive investors, the predictive school of currency hedging involves assessing market momentum and / or market factors to help calibrate the hedging programme, and is more directional in scope.

Whether an opportunistic approach or a predictive approach is taken, there are three key factors which must be in place before a tactical currency hedging programme is considered: (1) the necessary infrastructure (e.g. adequate hedging lines); (2) the analysis necessary to design and select an optimal hedging strategy (e.g. the cost of potentially tying up cash in unproductive collateral can be compared against the cost of an alternative option-based hedging approach); and (3) the market intelligence necessary to assess market conditions, and how they may be most effectively exploited.

Employed appropriately, a tactical currency hedging strategy can turn FX risk management from a necessary burden to a true source of competitive advantage for the private debt fund investor. ■

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