



CURRENCY RISK MANAGEMENT AS A VALUE LEVER TO MANAGE FUND RETURNS

BACKGROUND

Fund managers have been targeting developing/emerging market assets for their growth potential, providing investors an alternative to the relative lower growth experienced in developed markets. This is evident from the flurry of activity related to fund raising targeting emerging market exposures in the past 5 years. For example, Emerging Markets-Focused Private Equity funds raised aggregate capital of USD272.3 billion during 2011-15¹.

Most international funds tend to use a G4 currency as the capital currency for the fund, mostly USD, while investments target non-G4 currencies, e.g. Asia Pacific currencies linked to the country of the underlying asset investment.

While assets in emerging markets, using local stock market indices as proxy, in the past decade generally experienced double digit annual growth based on investment periods of 7 to 10 years², annualised foreign currency returns generally experienced single digit depreciation. Currency risk management under those circumstances may not to be a major focus, likely due to the comfort derived from the significantly higher local asset returns as compared to the currency depreciation. Exhibit 1 below shows average annualized currency (vs USD) and select local stock market³ returns (in local currency terms) for investment periods that commenced between 7 and 10 years ago.

WHILE LOCAL ASSETS MAY GENERATE POSITIVE RETURNS,
CURRENCY RISK CAN DRAG THE OVERALL RETURN IN THE
CAPITAL CURRENCY DOWN, IF LEFT UNMANAGED.

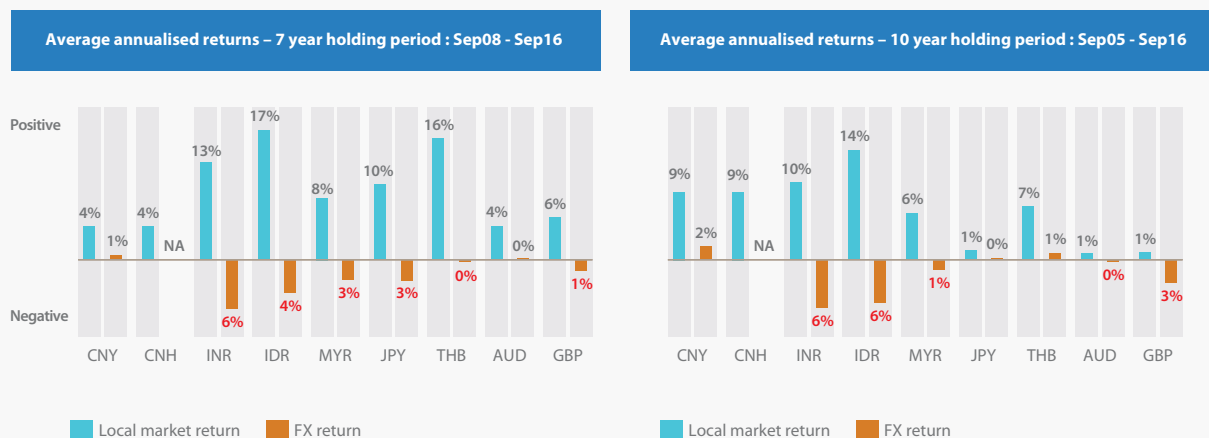
¹ Preqin Special Report: Private Equity in Emerging Markets (June 2016)

² Past performance is not indicative of future performance

³ Local stock market indices are the relevant stock market indices of China, India, Malaysia, Japan, Thailand, Australia and the United Kingdom.

EXHIBIT 1:

Average annualised holding period returns⁴ (7 and 10 years)



Source: Bloomberg (9 Sep 2016), ANZ Analysis

For example, considering a 10 year holding period for Indonesia, even though the Indonesian stock market returned on average ~14% p.a. in Indonesian Rupiah (IDR) terms, the overall return in USD terms was ~7% p.a., only half the local asset return, due to an average ~6% depreciation p.a. of IDR. *As such, while local assets may generate positive returns, currency risk can drag the overall return in the capital currency down, if left unmanaged.*

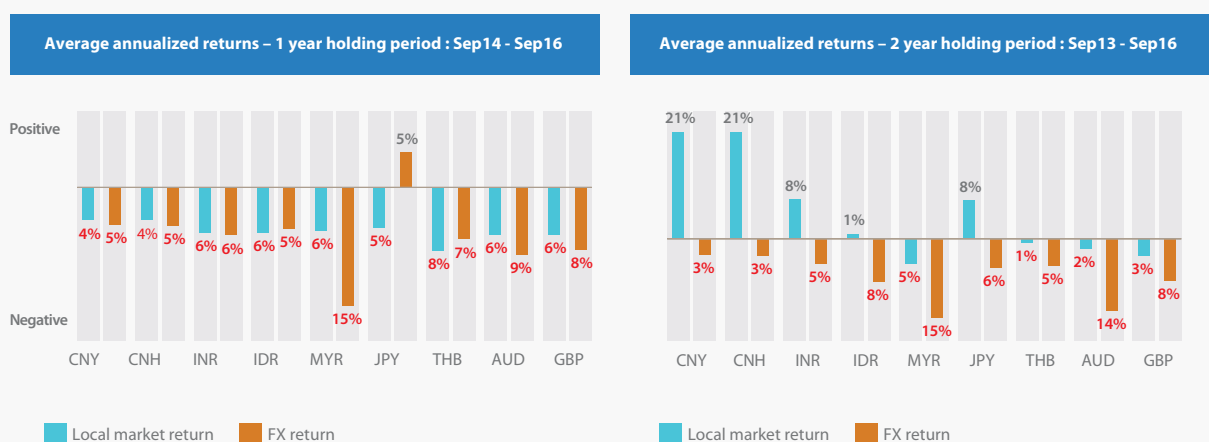
In recent years, currency risk management has become more topical for investors and fund managers. This is driven by generally low or negative local asset returns across the

world, combined with relative high depreciation of foreign currencies. In such circumstances, currency returns can dominate and drive the overall return in USD. Exhibit 2 shows average annualized currency and local stock market returns, again being a proxy for local asset returns, for investment periods that commenced 1 to 2 years ago.

Based on a 1 year holding period, negative local asset returns are exacerbated by currency depreciation, which were of similar magnitude to the returns, resulting in significantly worse asset returns in capital currency terms. For example, returns for the Malaysian stock index, expressed in USD,

EXHIBIT 2:

Average annualised holding period returns⁴ (1 and 2 years)



Source: Bloomberg (9 Sep 2016), ANZ Analysis

⁴ Returns are calculated based on the average of 365 observations, with each observation spanning the holding period. For example, the 10 year average annualized FX return for IDR is based on the average of: FX1 = IDR[9Sep16]/IDR[9Sep06], FX2 = IDR[8Sep16]/IDR[8Sep06], , FX365 = IDR[9Sep15]/IDR[9Sep05]. This approach ensures that returns are not biased by one specific entry date, rather it averages across each possible entry date over a 365 period for the given holding period.

EXHIBIT 3:
Major drivers of asset return in capital currency terms



would have been ~ (20)%, with the local market return at ~ (6)% and FX return of ~ (15)% dominating the asset return in USD. *The lesson from the past 2 years is that asset returns (in capital currency) in an environment of low or negative local asset returns, tend to be exacerbated by currency risk when left unmanaged.*

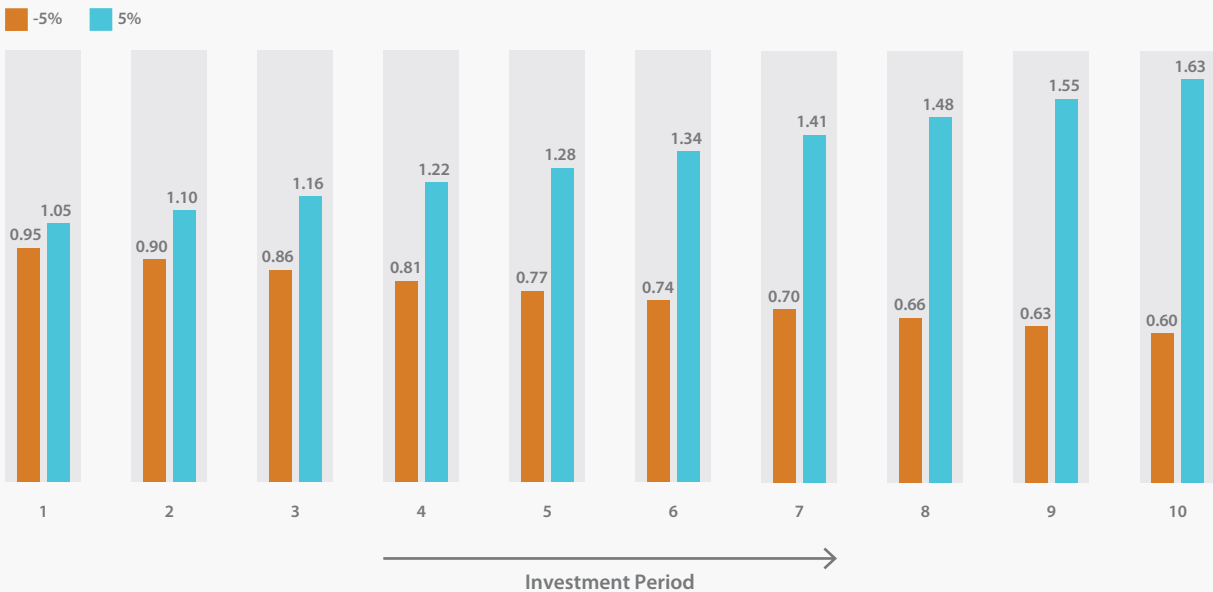
CURRENCY RISK A MAJOR DRIVER OF ASSET RETURNS EXPRESSED IN CAPITAL CURRENCY

To understand the impact of currency on asset returns expressed in the capital currency, we lay out the two major drivers in Exhibit 3. It is clear from the formula that currency

(FX) returns has a multiplier effect on asset returns (in capital currency terms). As such, depending on the magnitude of FX returns, currency could potentially significantly enhance or depress asset returns (in capital currency terms).

To illustrate the multiplier effect FX returns can have on the asset return (in capital currency), Exhibit 4 shows the impacts for different investment periods on the x-axis, where the bars show the impact for positive and negative FX returns of 5%. It is evident that even relative small FX returns of +/- 5% p.a. can significantly affect the overall returns in capital currency, particularly over longer investment periods.

EXHIBIT 4:
Multiplier impact from FX return on asset return (capital currency)



Source: ANZ Analysis

For example, over a 10 year holding period, negative FX returns of 5% p.a. can reduce the cumulative asset returns (in capital currency) by 40%, while positive FX returns of 5% p.a. can magnify asset returns (in capital currency) by 163%.

"Given the potential significant impact currency risk can have on fund returns, when targeting foreign assets, fund managers can use FX risk management as an additional lever to manage overall fund returns and ultimately, the quality of earnings of the fund manager itself", says Robert Tsang, Director in FIG Client Insights, ANZ.

The implication is that fund managers have an opportunity to generate value from both asset selection as well as proactive currency risk management. Currency risk management provides fund managers additional tools and flexibility to achieve target fund returns and corporate objectives. Further, given competitive pressures and evolution of investor expectations, some level of currency risk management capabilities could become a minimum requirement from investors going forward.

CURRENCY RISK MANAGEMENT CONSIDERATIONS⁵

When putting in place a Currency Risk management framework and process, it is helpful to consider five key areas, as illustrated in below exhibit.

- 1 **Objectives:** what objectives need to be addressed by currency risk management, e.g. maximizing fees, stabilising returns, etc.
- 2 **Targets:** based on the objectives, what are target measures, e.g. fund returns, annual fee income, currency risk appetite: how much volatility from FX do we find acceptable and how do we measure this, etc.
- 3 **Tools and set of strategies:** what tools and instruments are available to manage the currency risk, e.g. Forwards, options, etc; and what strategies can I consider, e.g. no hedging vs. combination of various tools available
- 4 **Scenarios and internal views:** what are the potential scenarios that could materialise, both based on internal views/convictions as well as external market information
- 5 **Impact and decisions:** for each of the scenarios defined, what is the impact on the targets based on differing strategies, and which strategy gives the most beneficial outcomes

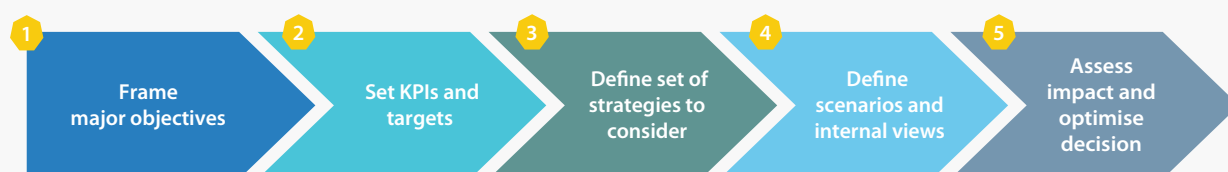
Once the abovementioned has been established, it will be easier for portfolio managers and support functions to align on risk management objectives and specific steps and actions to consider, and to monitor and track actual outcomes against targets, and where necessary, adjust the risk management decisions.

HEDGING TRANSACTION CONSIDERATIONS

Regarding execution of currency risk hedging transactions, it is important for the fund manager to consider the hedging rationale, the uncertainty of the asset value or timing of valuations, available financial resources for transaction settlements, the creditworthiness of your counterparty as well as the fund managers/fund entity own credit standing.

- **Hedging rationale:** is the fund aiming to hedge at a fund portfolio level or at the individual asset level? Is the aim to hedge the fund value or is the aim to hedge cashflows from the asset or debt at the asset level? Suitability of hedging tools depends on the hedging rationale: e.g. if a fund is looking for tail risk protection on the NAV of the fund, currency options could be more suitable as compared to forwards, as one would be able to define the protection level, e.g. 25% depreciation of the currency, rather than agreeing on a market determined forward price today.
- **Uncertainty of asset value/timing of valuations:** it is important to determine the expected asset valuations over time, as well as which timing the fund cares about, to ensure these are matched with the values, tenors and timing of the hedging tools. For example, if a fund comprises assets with observable prices, and valuations are reported on a quarterly basis, hedging instrument tenors could be matched to the reporting periods.
- **Available financial resources:** ensure there are sufficient cash reserves or expected cashflow streams to settle potential FX hedging transaction obligations. For example, while FX forwards tend to be favoured given no upfront cash layout, it does introduce risk to the fund, as at maturity, settlement obligations are uncertain and could surpass available cash reserves. *"You do not want to end up in a position where the asset and currency have appreciated, while the hedging transaction obligation results in substantial cash requirements forcing you to either raise capital or worst case, sell the asset, just to service the hedging transaction"* says Nick Angove, Head of FIG FX Advisory, ANZ.

EXHIBIT 5:
Major risk management considerations



⁵ It is the fund manager's responsibility to evaluate suitability of hedging strategies and the impact it has on its financial objectives.

- **Credit risk considerations:** consider highly rated counterparties to mitigate credit risk to the fund from hedging transactions, particularly in cases of long dated hedges. Further, hedging capacity of bank counterparties is typically driven by the credit standing of the fund's entity. In unsecured transactions, typically credit limits are based on

the size and quality of the fund or the investor committed capital base (for private equity or specialty funds). Low creditworthiness of fund entities could affect credit limits and credit charges that are incorporated in to the hedging transaction prices.

SHARING OUR INDUSTRY INTELLIGENCE WITH CLIENTS

Currency risk has been front of mind for investors and fund managers in the past year given persistent bouts of market volatility experienced throughout the world. Further, subdued global growth and uncertain outlook of global/regional economies and markets are making currency risk management an important tool that provides fund managers with an additional lever to manage fund returns.

ANZ has been actively engaged in currency risk management discussions and activities with global, regional and local fund managers targeting foreign assets. ANZ's engagement ranges from sharing currency risk practices of banks and funds, who have historically managed this type of risk, and how the fund management industry can apply such tools and lessons learnt; impact assessment of hedging strategies to executing hedging transactions for clients. *"These are exciting times for fund managers. Whilst currency risk can be seen as a potential drag on fund returns, building capabilities to manage this risk could be seen as an opportunity to strengthen the fund manager's value proposition in the current market environment"*, says Mark Harding, Head of FIG South East Asia, ANZ.



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ANZ HAS BEEN ACTIVELY ENGAGED
IN CURRENCY RISK MANAGEMENT
DISCUSSIONS AND ACTIVITIES WITH
GLOBAL, REGIONAL AND LOCAL
FUND MANAGERS TARGETING
FOREIGN ASSETS.



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