

## INSIGHT

# THE EVOLUTION OF FX RISK MANAGEMENT FOR SPECIALTY FUNDS

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**HISTORY SHOWS IGNORING FX SHIFTS CAN PROVE COSTLY FOR FUND MANAGERS – AND IN 2018 THAT REMAINS TRUER THAN EVER, ESPECIALLY FOR SECTOR-SPECIFIC SPECIALTY FUNDS THAT ARE CONSIDERING MEDIUM TO LONG-TERM INVESTMENT DECISIONS AND THAT TRADITIONALLY RELY ON FORWARDS TO MANAGE FX RISK.**

Developing a measured and consistent hedging strategy should be a key priority for specialty funds this year and well beyond, given the expectation the Fed will continue to raise rates in the coming months, and the fluctuating outlook for many currencies.

Fund managers need look no further than sterling's performance in the three years to June 2017 (see graph below), when the sterling-dollar spot price varied by 10 percent a year. Sterling was in a steady depreciation against the dollar and resulted in an overall decline of 25% during the period. Any manager investing sterling in un-hedged dollar assets would struggle to make up that cumulative decline in AUM.

**Three Year Holding Period Scenario**



Source: Bloomberg

Ultimately, the right hedging strategy and solution will require fund managers to find a delicate balance between fund performance, currency risk and liquidity management.

## 1. CREDIT LINES AND COST MANAGEMENT

When it comes to managing FX risks in 2018, what should be top of mind for specialty funds?

For starters, managers need to understand that robust hedging programs require: (i) credit lines, which are necessary for hedging; (ii) unsecured collateral thresholds, which are relevant for liquidity purposes; and (iii) potential cash settlements related to the FX hedges. However, many fund managers struggle to obtain credit lines on short notice, and both credit lines and collateral thresholds take time to arrange. That means managers must plan well in advance so they aren't caught in a pinch following unexpected swings in currency valuations.

Secondly, specialty fund managers should commit to an investment ethos that actively guards against a false sense of security. The recent period of low FX volatility has allowed many managers to feel they have little reason to hedge. But if and when volatility does return, it could require substantial credit line increases or, if its effects mean the fund's currency exposure under a hedging contract exceeds its collateral thresholds, the need to put up cash. That could be problematic for specialty funds, many of which are traditionally illiquid.

Further, obtaining sufficient unsecured collateral thresholds would benefit the IRR of the fund as it would not need to have idle cash sitting in collateral accounts with bank counterparties to secure FX hedge exposures.

A third consideration should be achieving a firm grasp on the cost or potential cash settlements of hedging, particularly for managers based outside developed markets. Long-dated trades in Asia, for example, are relatively costly: a one-year dollar hedge in India might see the client paying away 5 percent purely on the basis of the forward curve; in China it could be 3-4 percent.

**Historical Holding Period FX Price Changes**



Source: Bloomberg, ANZ Analysis

Lastly, managers should structure their funds with a weather eye on the regulatory requirements of different jurisdictions, such as

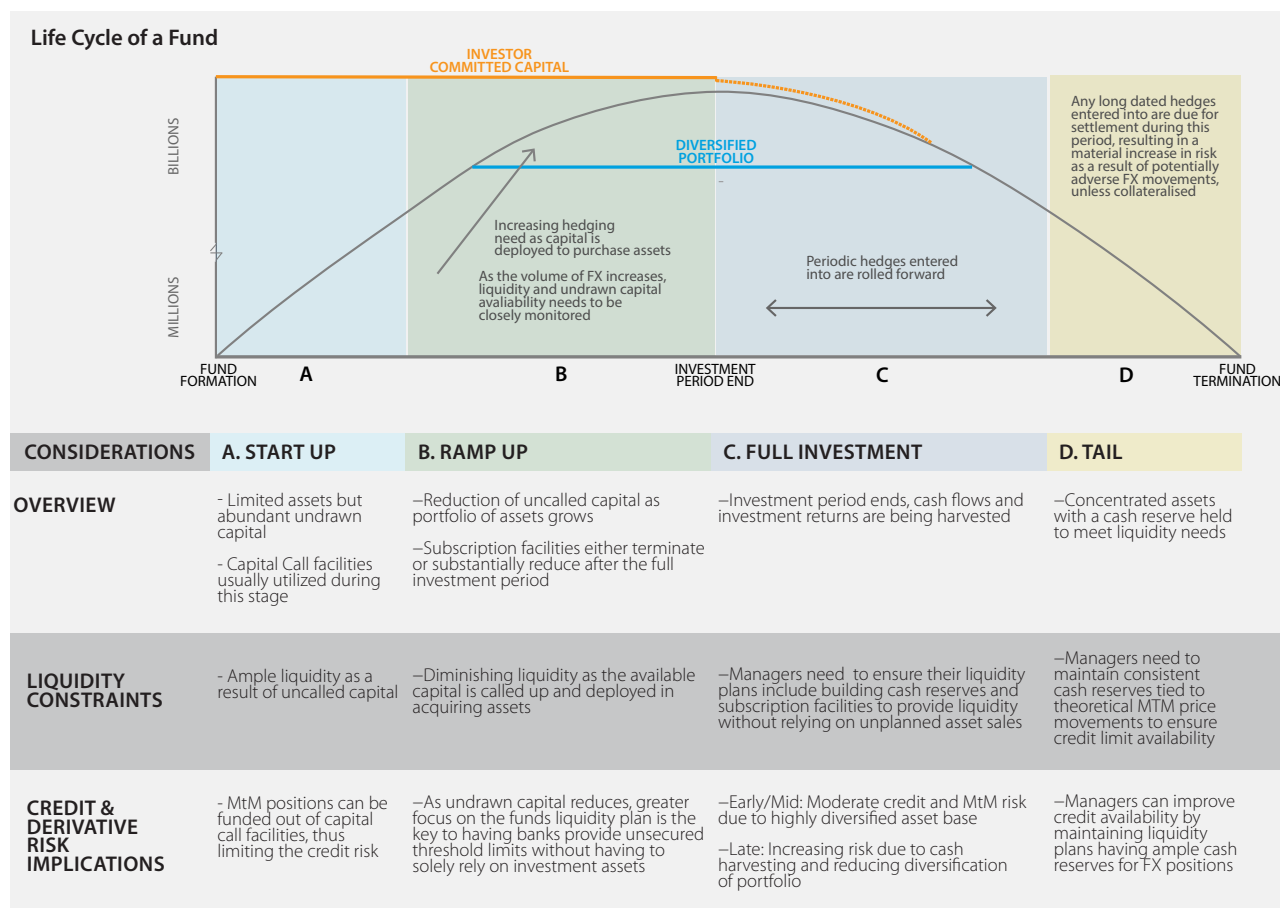
the rules on posting margin should a hedge move against the underlying asset. US and EU funds, for example, need to ensure they don't fall foul of the variation margin (VM) rules. One solution is structuring the fund to create an offshore hedging entity, which provides greater flexibility when using different solutions such as options and put-call spreads.

## 2. DEVISING A CONSISTENT STRATEGY

When determining a suitable hedging strategy based on the considerations above, managers must consider the fund's objective and its liquidity or cash settlement risk. For example, does the fund prioritise stable growth in the NAV in capital currency? Does it demand certainty of earnings? And how should it deal with liquidity or cash settlement risks?

Managers also need to keep in mind that a fund's liquidity and availability of capital will change over its lifecycle. As a fund moves towards full investment – and later into its tail phase – not only does its effective liquidity shrink, but a growing mark-to-market risk also brings exposure to fluctuations in the value of the underlying assets.

The consequence? The fund might need to provide cash margin or other types of security. That requires forward planning and knowing which hedging products would work best at which stage. As part of that the manager should consider setting up a hedging entity structure to ensure the fund benefits from the flexibility offered by various hedging products without having to post margin. In short, the manager should have a defined plan that incorporates unsecured thresholds to smooth out liquidity risk during the fund's lifecycle.



### 3. LOOKING BEYOND FORWARDS

Hedges, which are typically an offset to the performance of the underlying asset, can be categorised as either committed hedges or uncommitted hedges. The former provide committed financial obligations, such as FX forwards, cross-currency swaps or sold FX options; the latter are suitable as insurance for tail risks, such as bought FX options.

Forwards are more efficient than options when a manager has a strong view that the foreign currency will weaken, as in this scenario they provide better earnings and cash settlement (liquidity) outcomes. However, should the fund manager's view be proven wrong - i.e. the foreign currency strengthens instead of weakening - the manager would then be exposed to the risk of insufficient liquidity to pay the cash settlement under the forward contract.

As such, where managers do not have directional views, options can be a more efficient approach: the upfront "currency insurance" premium can be budgeted based on available liquidity, while the hedge provides upside participation in case the foreign currency strengthens, while protecting against potential weakening.

If stable growth in the NAV in capital currency terms is a priority, or if earnings certainty is required, a forward might be used. However, although forwards protect from the downside, they require paying away any potential upside. In terms of settlement risk, both the cash outlay and the payoff would be subject to future market conditions.

Part of a manager's liquidity plan could be to use something other than just FX forwards, such as options structures, and put-call spreads to manage the risk but still position themselves for upside potential.

Bought options provide certainty in terms of cost; however, the payoff is unclear. These are more efficient when there is uncertainty over a foreign currency's movement. Also, they limit cash outlay, provide protection from downside risk to earnings, allow the benefit from foreign currency appreciation, and boost NAV.

Market conditions such as implied volatility and current forward points are also important in determining the relative cost of options and cost-benefit of forwards respectively. Managers should also weigh how the suitability of FX hedging techniques will vary depending on whether currency pairs are accretive or dilutive, and their impact on risk and liquidity.

Finally, managers should ensure that any hedge takes into account the terms of the underlying investment. Using short-dated options or short-dated forwards on long-dated assets will see, in the first instance, a fund paying multiple fees on renewal or, in the second, being exposed to repeated unknown liquidity events. That might or might not prove suitable for the fund's circumstances, but this ought to be considered.

#### The Cost Of Switching Strategies

It is better to stick with a consistent hedging strategy rather than switching mid-stream, because doing that can bring extra costs. Take, for example, Company X, which buys an option at a cost of 2 percent to match its LTV ratio. One year later, after the market has moved in Company X's favor, the option expires worthless.

The following year Company X decides not to re-hedge its LTV using an option, and instead uses a one-year FX forward. That means deferring the cost - which is now unknown - but, in the immediate term, saving 2 percent. Unfortunately this time the market moves against the company, and the settlement cost of the forward is 5 percent of the notional value of the trade.

In this instance Company X would have been significantly better off using an option for year two as that would have been both cheaper and ensured a fixed settlement risk.

Of course, these are not the only solutions. One alternative is to use a "natural hedge", which involves aligning the currencies of the investment commitments with those of the investments in to the underlying assets; that leaves the currency risk management with the portfolio company. Another is to remain unhedged: i.e. do nothing on the currency exposures of the fund, and use the FX spot market to convert currencies when needed; the downside is that doing so leaves all FX risk with the fund.

### 4. FINDING THE RIGHT BALANCE

Ultimately the choice of hedging solution comes down to balancing the fund's performance targets, investment currency exposures and its scarce liquidity to drive the best outcomes for their funds. For example, while using bought options means paying away an upfront premium, using forwards means no upfront cost but the possibility of incurring a large cash settlement in excess of the fund's liquidity down the road.

It is worth noting that funds in different parts of the world face different challenges, so what works for a specialty fund manager in Australia won't necessarily work for one in the US or Europe.

Although every hedge carries a cost, not hedging can end up proving much more expensive.