

WHY PLAN SPONSORS SHOULD HEDGE EMERGING MARKET INVESTMENTS?

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Introduction

A number of plan sponsors began to invest in emerging markets in the 1990s as the case for investing in high growth economies became more compelling. These markets were expected to provide higher than average returns, with some volatility, and were to provide diversification benefits because of the poor correlation with other asset class returns.

Coincident with the decision to invest in these markets was a currency decision to accept the exposure inherent in investing in these markets. Clients allowed these portfolios to be unhedged for any number of reasons including: (a) the allocations were too small to consider hedging; (b) the high real growth of these economies was expected to lead to an appreciation of the currency; (c) a number of currencies were pegged thereby negating the need to hedge; (d) the cost of hedging was too high as interest rates in these countries were higher than those in the developed markets; (e) the currency markets were illiquid; and (f) currency managers did not offer products that incorporated passive or active management in emerging markets.

As a former plan sponsor who participated in such a decision, I am pained by the attached Table 1 that shows that emerging equity markets delivered on the promise for high returns; the currency market however, did not play along. The key problem with emerging market currencies has been that they have experienced sharp declines in value over short periods – in other words, they have been susceptible to crises. These crises are often driven by internal economic imbalances that are unsustainable, contagion, or even a ratcheting back of risk tolerance of the average global investors. The recent experience with Turkey demonstrated that when investors perceived that a risk of crisis is high, the floodgates open leading to large depreciations in the local currency. Central banks may try to prevent such crises by purchasing local currency with US dollars, thereby depleting precious reserves or else raise interest rates to make the cost of flight or speculation very high. However, they are not successful once the seeds for a crisis have been sowed.

Currencies have consistently detracted value from emerging market equity investments

Country	Share in MSCI EM Index ¹	Annualized Return ²		
		Local Currency	USD	Currency
Latin America				
Brazil	10.80%	156.13%	18.67%	-137.47%
Chile	2.90	10.66	5.03	-5.63
Mexico	8.90	18.36	2.95	-15.41
Europe/Middle East/Africa				
Greece	5.40	24.80	15.75	-9.06
Israel	5.70	14.30	9.56	-4.75
South Africa	8.50	13.64	7.18	-6.46
Turkey	2.80	105.81	18.43	-87.38
Asia				
India	6.40	8.89	3.28	-5.61
Korea	10.40	2.50	-2.98	-5.48
Malaysia	5.60	4.07	-0.72	-4.80
Taiwan	16.30	8.88	5.31	-3.57

1) As of October 2000

2) December 1993-November 2000

Source: MSCI

Strategic Choices

Since these currencies have detracted value, and there is little cause to believe that the future is likely to be different, plan sponsors need to make some critical choices. One possibility would be to insist on fully hedged portfolios. While over the long-cycle these strategies may prove to be more attractive than being unhedged, currency hedging is expensive and leads to losses on the forward contracts used to achieve the hedge. This cost is shown in Table 2 as the interest rate differential between the base currency (US dollars or Euros) and the local currencies. Every time a forward contract matures and a depreciations has not occurred, the plan sponsor will need to provide cash to settle the currency contract. Most sponsors, unless they have long horizons, will usually terminate such programs before the crisis occurs, thereby losing twice.

A second, though unusual alternative is to achieve a partial strategic hedge in an innovative manner. Some researchers suggest that a good way to invest in emerging markets and diversify risk is to have 15% invested in emerging market debt (EMD) and 85% in emerging equity. Research has also shown that returns from debt and equity more closely related than those in developed markets. In addition, there is greater country diversification in these mixed benchmarks, better liquidity, lower volatility, higher income and a better risk-return trade-off. What previous research has not acknowledged is that the mixed benchmark is preferred not so much because of these diversification benefits, but because it provides a partial hedge against currency risk. In effect, since EMD is largely Brady-debt and denominated in US dollars, EMD continues to provide the credit risk of emerging markets, while providing the insurance of the translation effect from depreciating currencies. This “hedge” can be valuable against large translation effects as shown in Table 1.

Table 2: Interest rates and cost of hedging as of July 9, 2001

Currency	Local 1-Month Interest Rate (%)	Spot Rate (vs. USD)	Annualized Cost of Hedging (%)
US dollar	3.83%	NA	NA
Argentina peso	40.00%	0.996	36.17%
Brazilian real	18.16%	2.454	14.33%
Mexican peso	12.30%	9.178	8.47%
Turkish lira	77.03%	1,313,000	73.20%
South Africa rand	10.66%	8.23	6.83%
Taiwan dollar	11.46%	34.553	10.63%
South Korean won	6.05%	1296	2.23%

The third approach is to hedge the risk tactically using models that predict whether a currency is likely to experience a large depreciation or not. In effect, if the emerging market currency has a higher interest rate and is not likely to depreciate then no hedging is required. However, if the risk of crisis rises so that the expected currency loss exceeds the interest rate differential, then hedging is attractive. However, predicting crises is not a trivial task and hence currency managers are more inclined to over hedge than be late into the hedging decision. While some of these decisions may be costly, in a portfolio with over 10 emerging market currencies, this cost is minimized through the diversification provided across countries or through cross hedging. As a result, success in one country provides more than adequate alpha to offset other losses. By permitting cross-hedging, currency managers can offset the cost of hedging and potentially add significant excess returns.

Hedging emerging market risk is different from hedging developed market currencies for a number of reasons. These currency markets are less developed and less liquid. In many cases, instruments such as non-deliverable forwards (where the entire contract is settled in US dollars or Euros rather than in a local currency) or options need to be used. In addition, these programs cannot be run on the same size as developed currency programs (where the total notional size of all mandates in the industry is approximately USD 100 billion). It would be a challenge if emerging market overlay, given current market conditions, could support more than a few players for a total of USD 5 billion. Hence these services will only be available to a few sponsors or to many sponsors in sizes that are less than those of the underlying equity exposures. However, this is a risk that plan sponsors cannot ignore as demonstrated in Table 1 and over time markets will develop sufficiently to provide a more broadly distributed service.