

ARE CURRENCY OVERLAY CLIENTS GETTING “SHORT-CHANGED”?
BY ARUN MURALIDHAR
MANAGING DIRECTOR, FX Concepts, Inc.¹

As the currency overlay industry has gathered over fifteen years of experience (e.g., FX Concepts was asked by a pension fund to manage currency exposures in 1987), it is useful to take stock of the industry and the products it offers to ask if client’s needs are being served. As a former client who implemented the currency overlay program for the World Bank in 1995, it is interesting that very little has changed by way of product offerings or number of firms offering such products (approximately 20 firms). To some extent, this may be the result of the fact that historically, naïve rules have been profitable (Strange 1998) and managers are hesitant to change their stripes. As the industry has changed, this note examines some new products that the asset management industry can offer to clients and the potential benefit to clients.

The objectives of pension and institutional clients can be broadly categorized as follows: (1) Standard hedging of foreign exposures to the base currency; (2) Utilizing currencies as an alpha strategy without leverage through standard hedges and cross hedging (Hersey and Ogunc 2000); and (3) Utilizing currencies as an alternative strategy with leverage - akin to a Hedge Fund program (Muralidhar 2002). These three objectives move from the most restrictive to the most relaxed set of objectives.

In addition, there are three products that can be offered to clients that can be categorized based on markets accessed; namely, (1) developed market currency management using forwards; (2) developed market currencies using forwards and options (to trade volatility); and (3) developed and emerging market currencies. These products range from those with limited scope (developed markets accounting for 11 currencies using only forwards) to offering the currency manager a wide-open scope through a multitude of markets (up to 24 currencies) and instruments (plain-vanilla forwards, non-deliverable forwards, plain-vanilla options and exotic options).

In this note, we compare the nine possible products that can be mapped to this 3-by-3 matrix in Table 1 and evaluate each bucket by three criteria: (a) number of managers offering these products; (b) reasonable alpha expectations based on research into these strategies; and (c) reasonable information ratio expectations. Table 1 demonstrates that while currency overlay has offered a reasonable return-risk ratio (information for the industry of 0.5), the industry is largely concentrated in the areas that offer clients the lowest alpha and the most limited return-risk ratio. As a result, clients may be “short-changed” and the rest of the note explores why this may be the case.

Some part of the stationarity in products is a supply and a demand problem. One of the possible reasons for the industry being focused on unlevered currency strategies using currency forwards only is that it was easy to develop simple variations of naïve rules to trade profitably. Currency managers exploited the fact that a significant portion of the

¹ Prior to FX Concepts, Arun was Head of Currency Research at JP Morgan Investment Management and before that Head of Investment Research at the World Bank.

currency market does not trade for profit and two naïve rules that have made money are the carry rule (i.e., buy the high interest rate currency and sell the low interest rate currency) and the trend rule (i.e., buy the currency that went up in the previous periods and sell the one that declined).² In addition, most pension clients have tended to be relatively risk-averse with respect to currency management and have not pushed managers until recently.

Two recent changes in the currency markets have put pressure on currency managers and caused clients to require new products: (1) interest rates differentials across currencies have narrowed thereby hurting the carry trade and the dollar has gone from a high interest rate currency to a low interest rate currency (see Figure 1), and (2) trends in markets are more episodic making returns from trend models lumpy. A number of Dutch, US and UK pension funds are now examining the use of options to trade volatility in an attempt to enhance return and diversify risk (Muralidhar and Neelakandan 2002). However, currency overlay managers have not traditionally hired staff with extensive experience in trading options³ and more critically, historical options-implied volatility data across currencies, strike prices, and maturities is not easy to come by. As a result, currency managers, in an industry where clients are heavily biased towards systematic programs, have been restricted from innovating in this area.

Emerging markets pose an interesting challenge both to clients and managers. Clients have not looked to emerging market currencies for either hedging risk of equity investments or sources of alpha. Initially, this was because emerging market allocations were too small (2-5% of total portfolios) and there was a sense that hedging emerging market currency risk is a losing proposition because of the high cost of hedging (as interest rates in emerging markets are higher than those in developed markets). However, with dramatic declines in emerging market currencies and declines in return expectations across all equity and bond markets, clients have had to look for every possible source of return. The high interest rates in emerging markets offer a unique opportunity for alpha if can be captured by programs that permit cross hedging in emerging markets. On the manager side, the models for purely hedging emerging market currencies require a leap in sophistication away from the naïve trend and carry models to models that evaluate the probability of crisis and given the relative paucity of demand, few managers have invested limited research resources to this endeavor. However, where the scope can be expanded to include all currency markets and cross hedging (with or without leverage), research has shown that clients can achieve attractive returns per unit of risk.

In summary, currency markets and instruments offer clients an interesting opportunity to achieve attractive risk-adjusted returns. However, clients will need to push the envelope with the currency managers to encourage managers to innovate (with the attraction of additional mandates). Similarly, currency managers will need to evaluate the efficacy of limiting their focus to the most limited mandates and whether additional resources need to be allocated to developing innovative currency programs to help clients.

² For more advanced versions see Baz, Breedon, Naik and Peress (1999) and Reinert (2000).

³ This experience is important as trading options requires sophistication in trading direction of rates and volatility.

REFERENCES

Baz, J., F. Breedon, V. Naik and J. Peress (1999). Optimal Currency Portfolios: Trading on the Forward Bias. Lehman Brothers Analytical Research Series, October 1999.

Hersey, B. and K. Ogunc (2000). Designing Portable Alpha Engines. *Investments and Pensions Europe*, October.

Muralidhar, A. (2002). Currencies as a Perfect Long-Short Alternative Investment Strategy. *AIMA Newsletter*, April 2002, No. 51.

Muralidhar, A. and H. Neelakandan (2001). Options to Enhance Currency Overlay Programs. *FX Concepts Working Paper*, November.

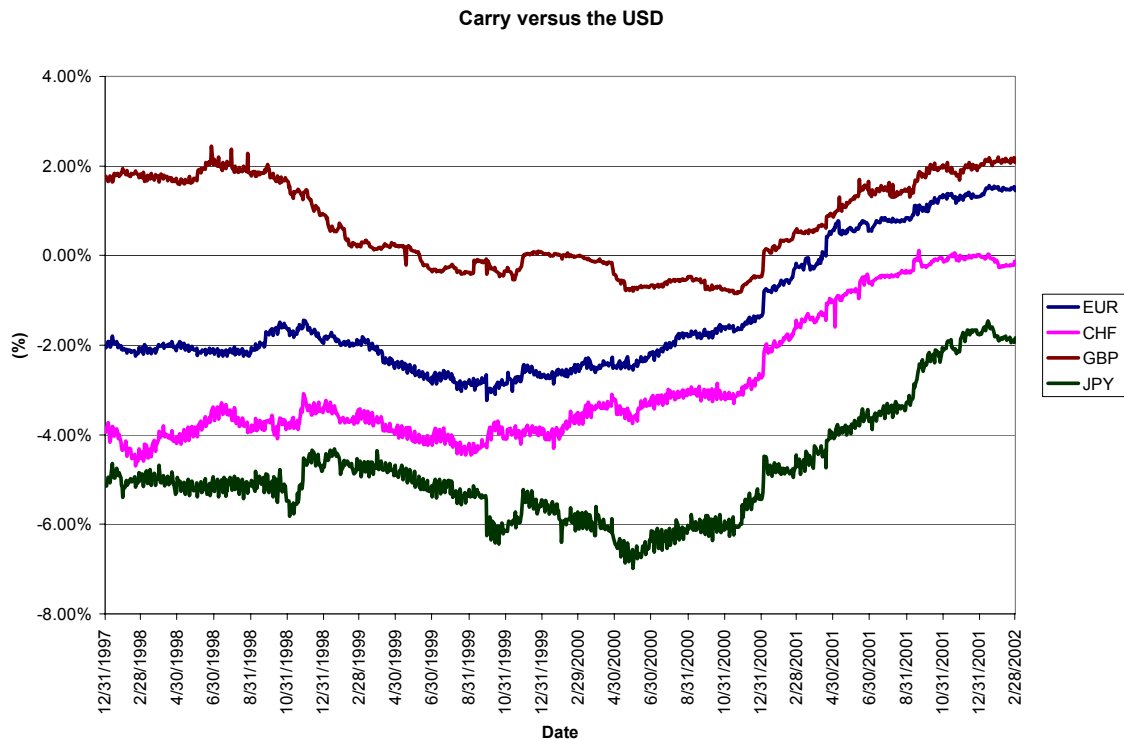
Reinert, T. F. (2000). Practical Active Currency Management for Global Equity Portfolios. *The Journal of Portfolio Management*, Summer 2000.

Strange, B. (1998). Currency Overlay Managers Show Consistency. Pensions and Investments, June 15, 1988.

Table 1: Clients' Objectives versus Markets and Instruments

	Developed Markets (forwards)	Developed Markets -Options Enhanced	Emerging Markets (deliverable and non-deliverable forwards)
Standard Overlay			
- No. of Managers	20	Less than 5	Less than 5
- Return Expectations	1-1.5%	1.75-2.25%	2-3%
- Information Ratio	0.4-0.5	0.6-0.8	0.8-1.0
Enhanced Overlay			
- No. of Managers	10-15	Less than 5	Less than 5
- Return Expectations	2-2.5%	2.5-3%	3.5-5%
- Information Ratio	0.5-0.7	0.7-0.9	1-1.25
Leveraged Products			
- No. of Managers	5-10 ⁴	Less than 5	Less than 5
- Return Expectations	10-15%	15-20%	20-25%
- Information Ratio	0.5-0.7	0.7-0.9	1.25-1.75

Figure 1: Interest rate differential versus the US dollar (1998-2002)



⁴ This list excludes pure CTAs and hedge funds that trade currencies and only includes overlay managers.