Currency risk worth a closer look among alts

Experts advise hedging as alternatives’ share of portfolios gets bigger

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Currency risk might not be a pressing worry for pension funds right now, but the increasing popularity of alternatives in global markets is leading some to spend more time thinking about it.

While institutional investors are used to hedging currency or exchange-rate risk for fixed income and even parts of their international equity portfolios, private capital portfolios are a different story, said Kevin Lester, CEO of Validus Risk Management in London.

Validus reviewed the hedging policies of 50 U.K. local government pension funds and found that roughly half hedge some of the currency risk in their public equity portfolios, but none did it with private investments.

By contrast, the 171 billion Danish kroner ($27 billion) pension fund PenSam, Farum, Denmark, recently changed its foreign-exchange hedging strategy to accommodate a growing alternatives allocation outside Europe.

A few large U.S. pension funds, such as the $310.9 billion California State Teachers’ Retirement System, West Sacramento, have been hedging currency risk for a long time, Mr. Lester said. "European funds have started to do a lot more."

Validus specialist Bill Manahan said Canadian and Nordic pension funds in particular "are relatively aligned" with the risk, while in the U.K., "it might be third or fourth" on their list of priorities.

When Validus provides examples where more than half of expected returns "are being wiped out purely because of the currency risk, you really get their attention," Mr. Manahan said. Even for pension fund investors cognizant of currency risk, "when it comes to alternatives, we just haven't seen the same adoption of strategies. These kinds of growth spurts creep up on you, but it's getting tough to ignore," he said.

Without a fundamental shift in the way currencies behave, "currency risk is a small portion (of risk profiles) but there are some headwinds," said Matthew Maleri, Goldman Sachs Asset Management vice president in Norwalk, Conn. "Currency hedging introduces more complexity, and some costs associated with that exposure. It's the typical cost-benefit analysis."
For some pension funds, it may be easier to accept the risk, or push it down on the list of priorities. Others may seek currency-hedged share classes that address it, including specialized ETFs, or expect external fund managers to worry about it. Another option is bringing in a currency hedging overlay specialist.

Don't ignore it

One option not recommended is ignoring it. "Currency risk is a meaningful risk and it's one that you really need to manage over time," said Mark Davis, head of delegated portfolio management for EMEA at Willis Towers Watson PLC in London.

In the U.K., where pension sponsors are more likely to have outsourced to fiduciary managers like his firm, "it's a fundamental key risk that we are aware of and are monitoring on a day-to-day basis." Managers will take risks in other currencies "when we feel it's going to have a return benefit," he said.

"As portfolios become more complicated, governance becomes more important. If (pension fund) boards are thinking about making those shifts to increase diversity, they also need to think about the governance risks," Mr. Davis said.

Francesca Fornasari, head of currency solutions for London-based money manager Insight Investment, which manages more than $1 trillion in assets, said asset owners have some options. "If you are a very cash-rich institution, you don't worry too much," she said.

She likens currency hedging to insurance policies that a lot of clients want, despite the lack of gains. Still, she cautions, "currency risk can easily dominate if you don't control it. I don't think it is likely to go backwards. Foreign portfolios are a fact of daily life," she said.

That is standard advice these days, said Nikesh Patel, head of investment strategy at Dutch firm Kempen Capital Management NV with €86 billion ($102 billion) under management. He sees most U.K. and European pension funds domestically biased due to liability hedging needs, "so they are not as exposed to forex risk." In private equity, which is harder to sell if you need the cash, "you need to balance the exposure vs. the ability to hedge the exposure operationally," he said.

He expects emerging markets currency exposure to remain unhedged. "It is part of the investment story, and usually expensive to hedge," he said.

Using LDI, overlays

In the U.K., "most big pension funds do LDI and have an overlay account of cash or gilts" to deal with currency risk, said John Roe, head of multiasset funds at Legal & General Investment Management in London, with $1.83 trillion in assets. "The U.S. is earlier in the process. The more sophisticated (defined benefit plans) think about currency as an asset class," he said. "The risk is modeled into the decision in the first place."

That is the case for the $68 billion Maryland State Retirement & Pension System, Baltimore, said CIO Andrew Palmer. Historically the fund has modeled non-dollar investments including currency risk as part of underlying assumptions.
Managing currency risk can be prudent in some cases. For developed market currencies, "it's pretty easy to hedge," he said. With European stocks for example, "you can make money on the hedge through positive carry."

In private assets, where long life and higher expected returns mitigate short-term risks, some managers have incentive to manage currency risk instead of worrying about it, "and we are aligned. Long term, currency volatility gets smoothed out," Mr. Palmer said.

For emerging market currencies, the modeling expects long-term appreciation and because they have been historically expensive to hedge, the system generally accepts those risks, he said. Some of the volatility comes from currency, so "if the dollar starts to appreciate, we will hedge more and more."

"At the end of the day, we are going to get dollars back. It's part of the underlying assumptions that we have. Having a diversified portfolio of currencies is actually a diversifier. Some non-dollar exposure helps improve your risk profile. It adds different risks but you may have made a more efficient portfolio. The currency risk is an element of that," Mr. Palmer said.

Currency risk does appear more often now on the agenda of corporate pension funds, where risk "is ultimately underwritten by the corporation. It does depend on their strategies," said Nigel Sillis, client portfolio manager with Cardano Risk Management in London with $46 billion in assets under management. While getting information from managers can be problematic, "if it is a risk, it needs to be assimilated. A decision needs to be made."

Unless clients get clear information from managers, their currency exposure can be "murky" and exacerbated with alternatives, said Mike Moran, pension strategist with Goldman Sachs Asset Management in New York. But "I think it is always going to be pretty far down the list of things investors need to worry about."

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