

The Case for Currency Overlay

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Overview of currency

Overview of Currency

- Internationally diversified portfolios have an equal exposure to currency as to assets
- Historically, currency risk is significant
- Expected return to currency is zero
- Currency return is not systematically related to asset return
- Currency is driven by different economic fundamentals than those that drive assets
- Currency markets are not efficient, and therefore can be managed actively to add long term return to international portfolios

Purchase of foreign assets requires equal purchase of currency

$$\text{Asset return} = \text{Local return} + \text{Currency return}$$

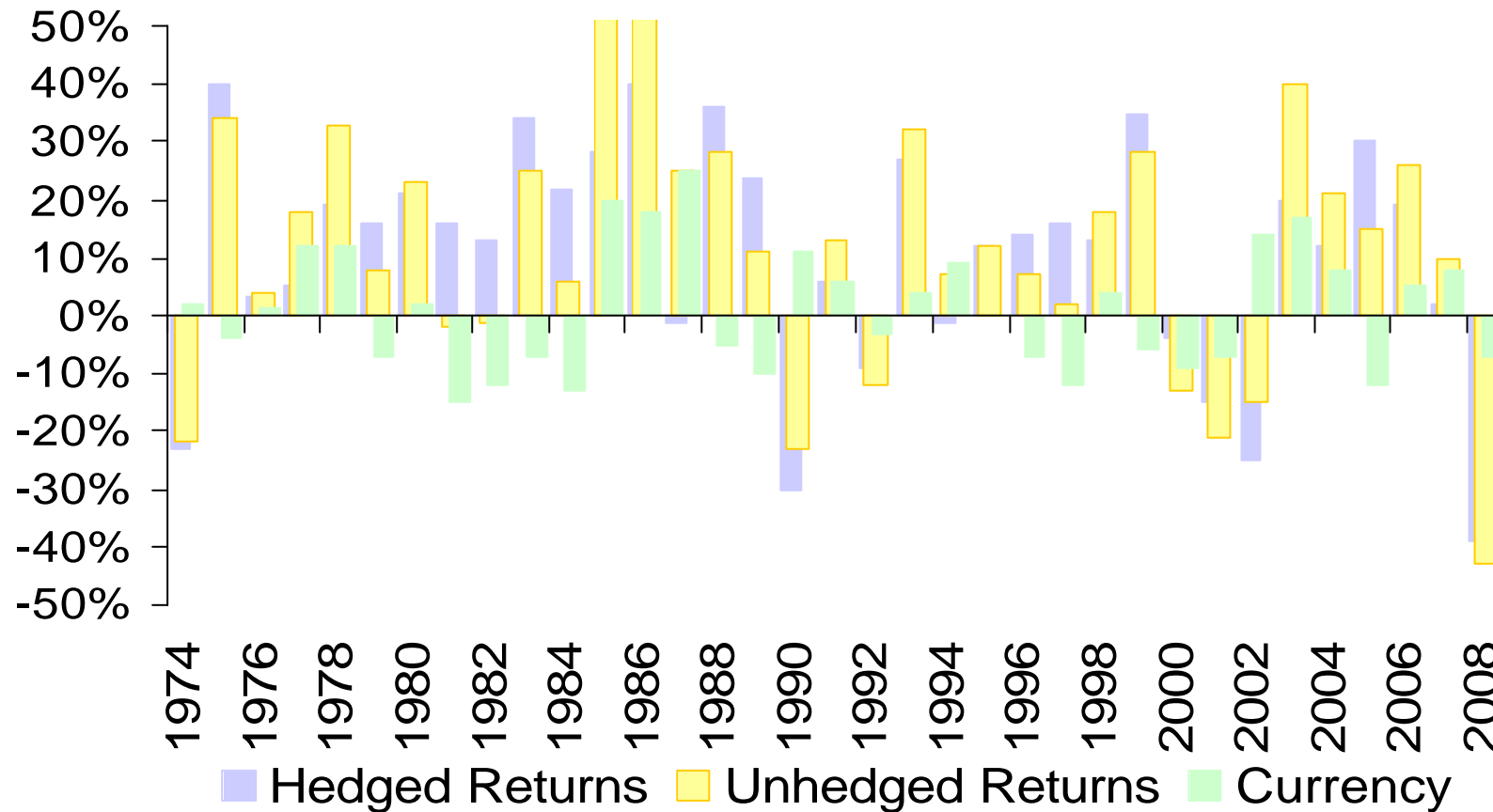
Example:	<u>Start</u>	<u>End</u>	<u>Return</u>
DAX in EUR	2557	2593	1.4%
EUR/USD	1.17	1.04	-11.1%
DAX in USD	2992	2697	-9.8%

International returns significantly impacted by currency

International equity returns (1974-2008)

Source: MSCI data

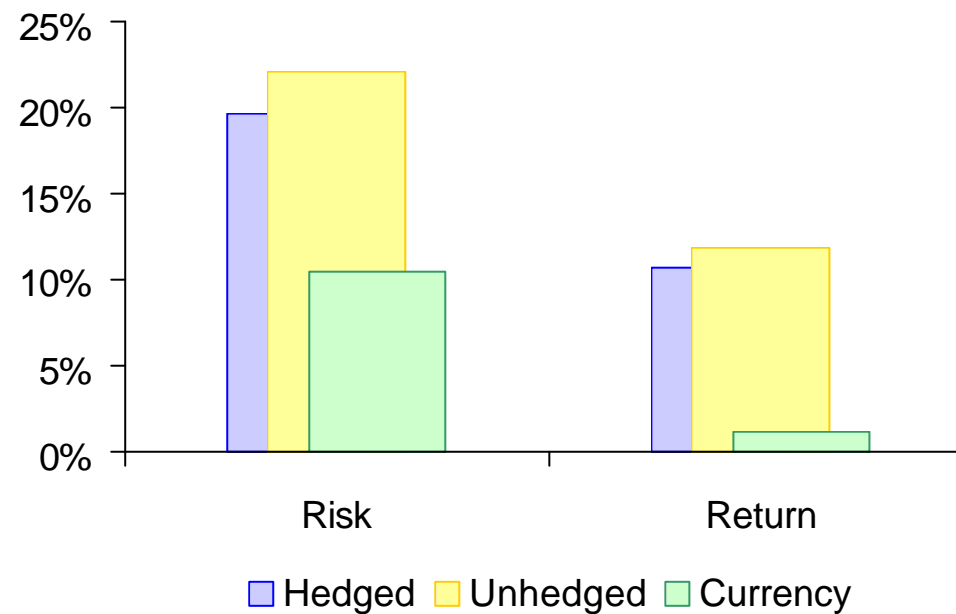
USD perspective



In the long run, currency has virtually no return, high risk, and low correlation with equity

International equity returns 1974-2008

Equity Summary Statistics



Hedged equity and currency correlation: -0.12

Currency markets are driven by different fundamentals than asset markets

Equity market drivers:

Local asset yields
Growth of corporate earnings
Dividend yields
Domestic growth

Bond market drivers:

Local monetary policy
Inflation expectations
Credit spread
Local real yields

Currency market drivers:

Relative price levels
Relative quality of traded goods
Relative expected return on assets

Plan sponsor issues

Three separate currency policy decisions are required of a plan sponsor

1. The amount of long-run, strategic, currency exposure in the portfolio

- Unhedged
- Partially hedged
- Fully hedged
- Option hedged

2. Active or passive currency management

3. Who is responsible for managing currency

- Underlying manager
- Specialist manager

Ignoring these decisions means they are taken by the asset manager

Decision 1: Strategic currency exposure

Total portfolio asset allocation methodology is appropriate
 There is no “one strategic policy fits all” – each portfolio is considered separately
 Currency denomination of expenditure basket defines zero risk

Low risk tolerance Low domestic allocation Low currency return expectation		High risk tolerance High domestic allocation High currency return expectation
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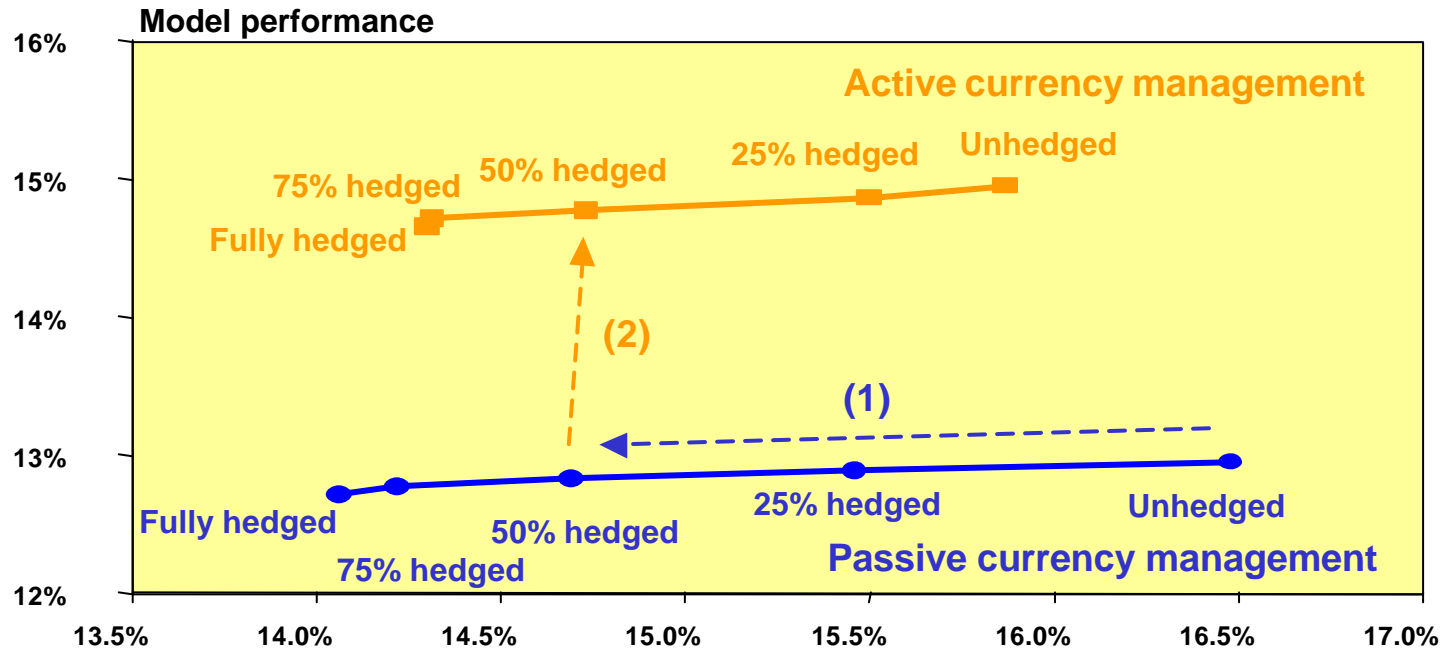
Fully hedged	75% hedged	50% hedged	25% hedged	Unhedged
<i>Dynamic hedging is equivalent over time to a fixed hedge ratio</i>				

Other issues:

- Hedge actual or actual to index
- Rebalancing frequency of actual and index
- Currency role of asset managers
- Cash flow implications
- Constraints to opportunity set for active management

If no decision is taken on strategic currency exposure the portfolio will be unhedged and managed by underlying manager.

Decision 2: Active versus passive currency management



- Passive currency management focuses exclusively on risk reduction through the choice of strategic hedge – moving along the blue line (1)
- Active currency management permits both risk reduction through the choice of strategic hedge **and** return enhancement through tactical hedges – moving up from the blue line to the gold line
- The case for managing currency actively is strong

Decision 2: Active versus passive currency management – the case for active

Theory:

Conditions for efficiency do not exist

- many buyers and sellers? NO
- common information? NO
- common objectives? NO
- absence of barriers to entry? NO

Academic evidence:

Several approaches have been shown to consistently produce abnormal returns

- differences in inflation (Jorion)
- differences in interest rates (Bilson)
- technicals (Sweeney)

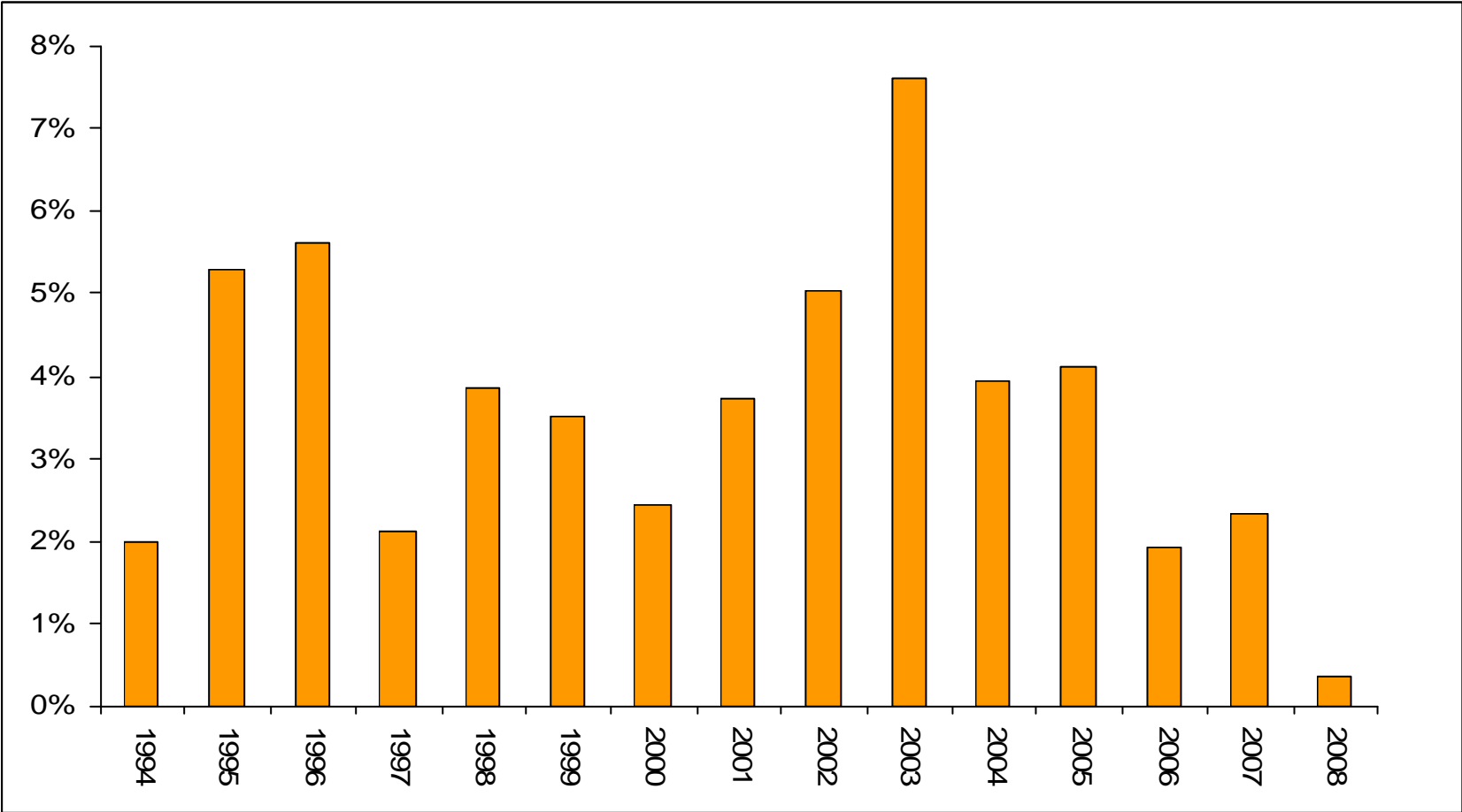
Proprietary evidence:

Lee Overlay Partners proprietary models show highly significant information ratios

Experienced manager track records show high excess return

Decision 2: Active versus passive – excess return from currency

Research evidence 1994 - 2008



Actual evidence of active currency management adding return

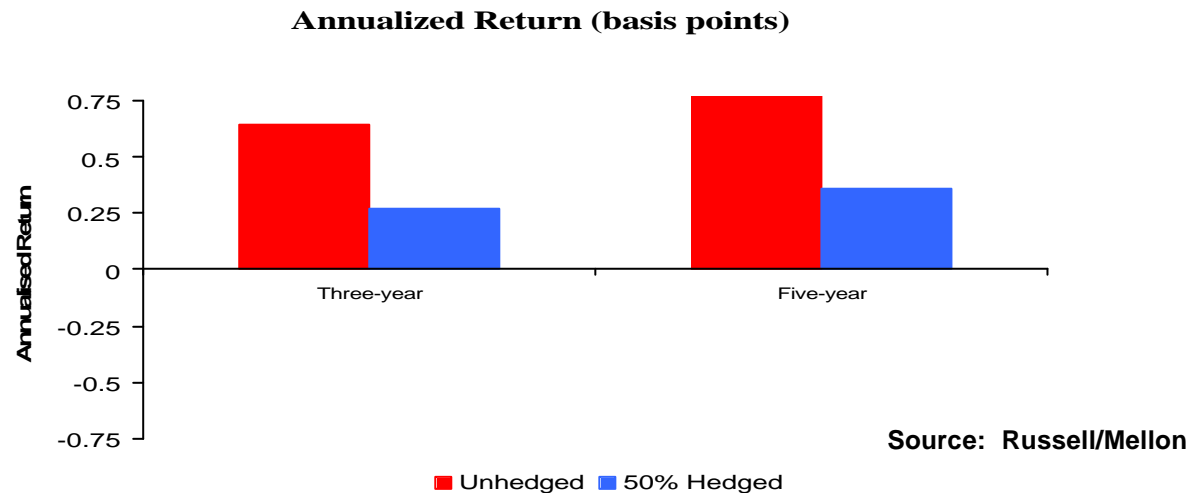
- *RogersCasey*

Sampled 21 different currency alpha managers covering 4,728 monthly data points and found that for the periods 3 years and 5 years ending 3rd quarter 2005 the managers produced an information ratio of .66 and 1.2 respectively.

“This up-to-date study renews faith in the hypothesis that the currency market contains ample inefficiencies that can be efficiently exploited for alpha via active management, as evidenced by the solid information and Sharpe ratios generated by this diverse group of managers over a large sample period.”

Taylor and Farstrup, ‘Active Currency Management: Arguments, Considerations, and Performance for Institutional Investors’, CRA RogersCasey, International Equity Research, Darien, CT

- *Russell/Mellon*



- *Mercer Investment Consulting* recommends active currency management

Decision 3. Who is responsible for managing currency? - the case for currency overlay

Assets and currencies are driven by different fundamentals and need to be managed separately

Currency is severely under managed by most international equity managers

- Traditionally, asset managers invest equally in assets and the associated currency
- Even the best asset managers are unlikely to be currency specialists as well

Currency overlay – a logical specialist activity

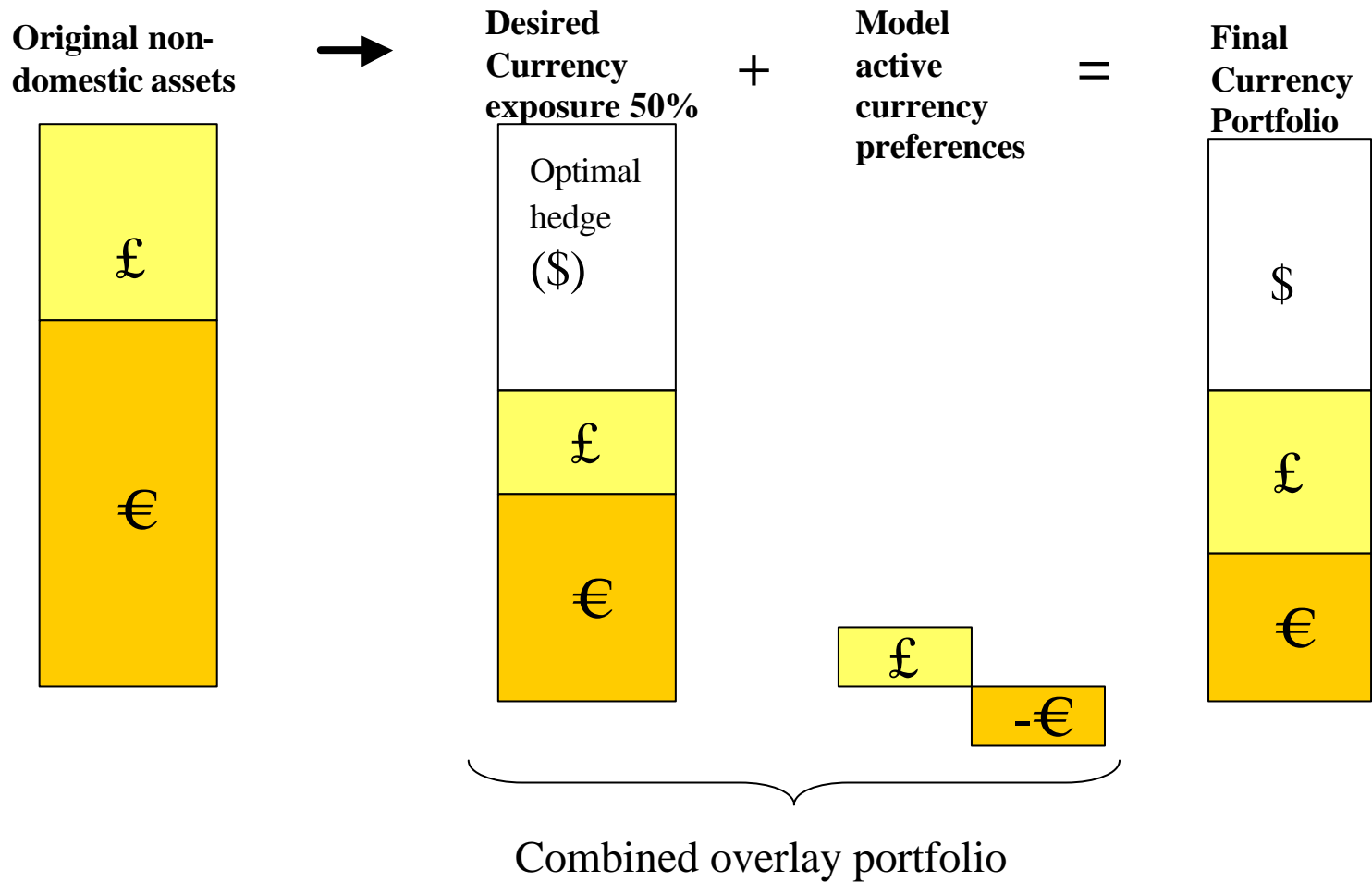
- Separates the two decisions and allows the “best of both worlds”
- Adds return from currency and controls currency risk
- Has no impact on underlying manager activity

The performance of all international portfolios is enhanced by the use of a currency overlay specialist

If no decision is taken on currency management, responsibility defaults to the underlying asset manager

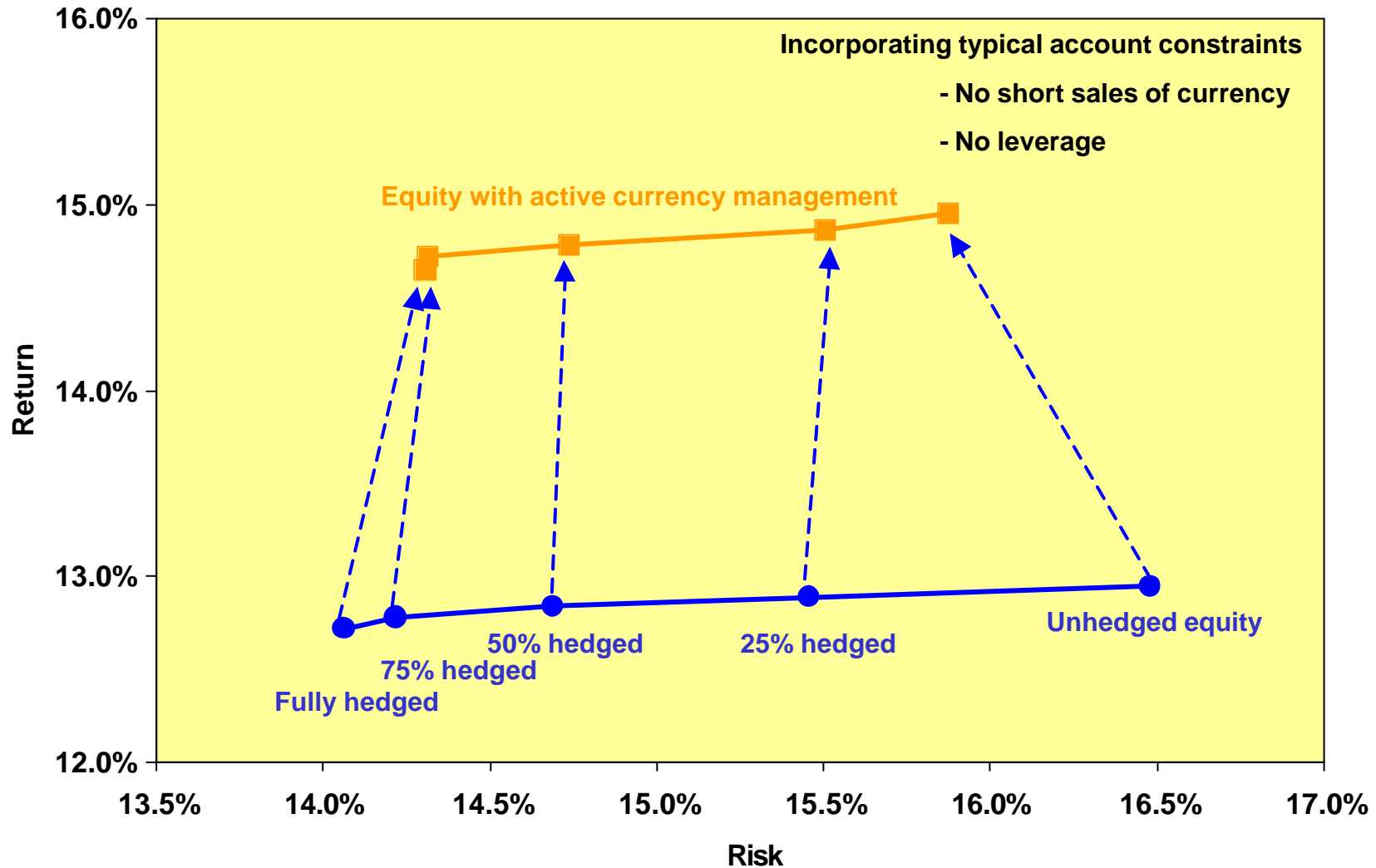
How currency overlay works

Hypothetical example – US\$ based Fund



Active currency overlay management – increases return and lowers risk

Research Evidence



Benefits of currency overlay

- Higher return and lower volatility from currency
- Clear delegation of responsibility to a specialist
- Better execution
- Better credit risk distribution
- Better performance measurement