

Currency overlay winning recognition among plan sponsors and consultants

IN Asia and Europe, there has been a marked increase in interest in currency overlay among pension plans over the past 18 months. In Hong Kong, for instance, the HK\$1.2bn Hospital Authority Provident Fund Scheme – a leading performer domestically – has appointed Bankers Trust (Australia) and Pareto Partners as currency managers, and in the UK, William M Mercer reports having advised around six UK plans on strategic currency issues this year – one of which has now appointed a currency overlay manager. In Holland, ABP has just awarded a €1bn currency overlay mandate to Connecticut-based Bridgewater Associates, which manages \$20bn in currency overlay.

In the US too – where this product has its roots – interest has been slowly trending upwards. Consulting firms Hewitt Associates and Callan Associates report no discernible upswing, but Watson Wyatt reports “a definite upswing in interest” among its clients. Recently, Connecticut-based A.G. Bisset & Co., whose first client was the Prudential Insurance Company of America in 1988, was appointed by the Middlesex County Retirement System to manage a currency overlay of approximately \$35m. A.G. Bisset & Co. has also been given increased mandates from its existing clients this year based on good performance. Cambridge Associates was also appointed by the Middlesex County Retirement System last month to overlay approximately \$35m.

“Interest in this product is definitely spreading around the globe,” explains Harriett Richmond, head of JP Morgan’s Currency Group, which manages \$25bn in standalone currency overlay. “In the last 12 months, all of the major consultants have spent time with us getting performance data from us. There’s been a lot of interest from Asia and the UK marketplace is also beginning to think seriously about currency management,” Ms Richmond said.

Indicative of the increased attention to currency management globally, EM Warburg Pincus Inc. has invested in a new Dublin-based currency overlay company, Lee Overlay Partners Ltd, which was formed in April 1999. “The opportunity is massive,” explains Adrian Lee, president and chief investment officer of the new company who, until February 1999, was the MD of JP Morgan’s Currency Group.

“Interest is growing in Europe, Australia, Canada and the UK,” according to Mr Lee. “Only 2% of portfolios are overlaid at the moment, and with consultants increasingly recognising currency management as a logical

Currency management is a complicated and relatively new area. But increasingly, pension plans around the world are thinking seriously about it as a logical, specialist activity.

BRIAN KING

specialist activity, we think we’re going to be very successful.”

Heather Myers, Frank Russell’s head of global fixed income, takes a similar view. “There is a lot of client interest right now in currency management. Although it is still a relatively new asset class – which can’t be analysed in a traditional fashion – we’ve seen it become more established.”

Ms Myers is currently putting together a major research paper with Brian Meath – head of global equity at Frank Russell – and Janine

Baldrige – a senior Frank Russell consultant in Tacoma – looking at how much alpha currency managers can add. “Our study draws on the substantial performance data that we have collected from a lot of managers and our ongoing research over the last 10 years,” Ms Myers said.

Similarly, Watson Wyatt, which has been building a currency manager database over the past five months, is currently doing analysis, using their database, on whether there is any correlation between the hedge ratio and value added in currency management. “Our database covers 17 managers, and between 200 to 250 accounts are tracked on a monthly basis,” explains Atlanta-based consultant Jim Minnick. “We’re comparing the hedge ratio of various accounts and underlying benchmark’s hedge ratio to see what the most efficient hedge ratio for various mandates.” Watson Wyatt, which has been working with currency expert Brian Strange over the past few

months, believe monthly data will provide a “more complete picture” than presented by previous studies based on

quarterly data, because inter-quarterly currency swings can be quite significant.

Another consultancy firm which has become more proactive in this area is William M Mercer. In the past, Mercer would request performance data separately for each client assignment. Now, it has a developed currency manager database which is updated quarterly on an ongoing basis and has a rating system.

“It’s only in the last year that we have decided to be more proactive in raising currency as an issue with plan sponsors, particularly in the UK,” explains Bill Muysken, head of global manager research at William M Mercer. “We first started raising this issue with clients in Australia and New Zealand in 1992, but it was difficult. A lot of clients got confused about it and they often had strong, emotive views about it. On the other hand, those funds that did start using currency overlay managers are still using them – and wouldn’t live without them. I expect the use of currency overlay will snowball over time. Pension funds among our client base are definitely going for it.”

Arguably, the growing change in attitude towards currency management represents

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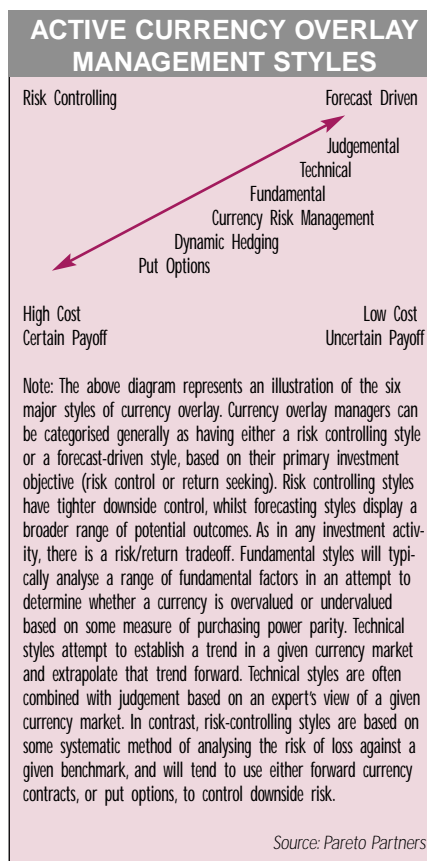
Adrian Lee, Lee Overlay Partners

something of a new era for practitioners in this area. Until fairly recently, several factors have hindered acceptance of active currency overlay as a specialist activity which can add value. These include:

- Poor marketing. Currency managers – and they admit this – have confused plan sponsors by delivering confusing messages as to what currency overlay is and what it can do. They muddled up the case for strategic hedging on the one hand with the activity of using forward contracts to add value. As Janet Becker-Wold, vice president of Callan Associates in Denver points out, “We see a lot of plans confused about this. Is it a risk device? Is it a return enhancing device? It really is both.”
- Insufficient research, which has left doubt about the ability of currency managers to consistently add value – if at all. A Goldman Sachs & Co and Rogers, Casey & Associates survey in 1996, for instance, pointed out that there were no widely available databases of currency overlay management results. It was difficult for consultants to be convinced themselves or to convince clients. True, a number of consultants have tried to raise this issue with clients – although a less generous interpretation from certain practitioners is that some consultants simply sat on the fence, arguing they were “client driven”;
- Academic disagreements – which still exist – between the world’s top thinkers on topics such as the extent to which FX movements can be forecast over one to three years (See box entitled Currency Styles). However, these differences shouldn’t be overemphasised – there are a number of different, legitimate currency management styles with different objectives. As Mercer’s Bill Muysken points out, the differences between currency managers in terms of the approach they use “aren’t as wide as they first seem”. Ronald Layard-Liesching, director of research at Pareto Partners, puts it this way: “Half of the disagreements are real. Half are definitional – using language with different meanings”;
- Relatively few practitioners whom consultants felt they could recommend; and
- The inherent complexity of the subject. Pareto Partners, for instance, advises pension funds to be prepared to spend one year investigating currency overlay before making any decisions.

Today, there remains considerable debate about this subject. There are no set reporting standards for currency management. There are also various implementation issues. In fact, as Jim Minnick, a consultant with Watson Wyatt in Atlanta points out, there is no succinct, definitive answer to the question: Can currency management add value? That said, however, a number of fairly recent developments have prompted greater attention to and acceptance of currency management as a logical, specialist activity. These include:

- Research published in June 1998 by curren-



cy expert Brian Strange showing that pension plans can consistently count on overlay managers to add value over a benchmark. Mr Strange, now director of institutional client services with Key Asset Management (\$75bn) in Cleveland, Ohio, looked at 152 institutional accounts (one-third non-US and two-thirds US) over 1,783 quarters and found that “the value added was positive relative to the benchmark return at a lower risk to the currency benchmarks given”. Expressed differently, on a cumulative basis, currency overlay managers were successful with 80% of the accounts they managed and success seemed more consistent in recent years. In addition, risk reduction occurred for all holding periods. Apart from Mr Strange’s empirical evidence, recent academic theory and other data showing fairly consistent added value by practitioners have argued that currency is a manageable part of international return. Admittedly, there were criticisms of Mr Strange’s work – such as survivor bias and reporting bias – and there are still a lot of industry professionals who aren’t yet convinced that you can add value. Yet, as John Taylor, chairman and CEO of FX Concepts in New York points out, “those (pension plans) in the know are continuing to expand their existing exposure to managed currency.” This claim is borne out by Pareto Partners, which says that between 30% and 50% of new business is from existing clients. According to Mr

Taylor, good performance has been a strong argument in their favour: “Why try to add alpha in the large cap US equity arena when no more than 30% of the managers beat the indices in an average year, when you can add alpha in currency where 80% of the managers beat the benchmark by a wide margin?”

- Increased international equity exposures over the past decade. According to Fred Bisset, chairman and CEO of A.G. Bisset & Co., international exposures (outside the US dollar) for US pension plans have risen to more than \$600bn from just \$25bn in 1985. However, less than 10% of this currency exposure is being actively managed, says Mr Bisset. According to Ronald Layard-Liesching, director of research at Pareto Partners, which manages \$25bn in third-party currency overlay, big US plans now have up to 25% of their assets invested internationally.
- Client satisfaction with currency managers. According to Ms Myers, currency managers have been performing quite well. JP Morgan points out, for instance, that for its longest running 14 active overlay accounts globally, average annualised excess returns over a period of between four and 10 years have averaged just over 1.5% (0.8% to 3.3%). In three of the 14 accounts, there was increased risk, but a reduction in risk in 11 cases, according to Ms Richmond. According to Mercer’s Mr Muysken, their research has shown that over the last decade, some clients gained by hedging and some clients lost, but in most cases, risk levels would have decreased – even by partial hedging. Similarly, Mr Liesching argues that currency overlay has grown because “live results” have met the twin objectives of protecting the domestic currency value of international investments and, where possible, enhancing returns. “Sophisticated funds realise that the currency overlay returns are true incremental returns to the fund. The overlay manager is reducing a pre-existing, unrewarded risk that the fund already has – and in the process is able to add value.”
- Pension plans have become bigger and more sophisticated. In a low inflation environment, pension plans are looking for new ways in which to enhance investment returns without significantly increasing risk.
- The advent of the euro. According to Mercer’s Mr Muysken, the introduction of the euro has cut the cost of hedging. Whereas historically hedging costs for the US, Japan and Germany have ranged from 10bp to 30bp, for countries like Spain and Italy it could be 50bp or higher.
- Particularly in the case of UK pension plans, currency hedging helps reduce risks borne by these funds without breaching Minimum Funding Requirement (MFR) regulations. “The MFR is definitely driving demand in the UK,” says Les Halpin, chief executive of Windsor-based Record Treasury Management, which manages \$5bn in currency overlay.

- More currency overlay managers and longer track records. Mercer points out, for instance, that of the 27 currency overlay managers on its database, there are now seven or eight which they could recommend to clients. Five years ago, these figures would have been half their present level.

- A growing appreciation of the fact that currency markets are, in fact, inefficient markets, and represent an opportune environment for adding value. Connecticut-based Bridgewater Associates (see *Global Pensions*, June edition), for example, has data highlighting the extent of the systematic losses associated with US, German and Japanese central bank forex interventions. "Inefficiencies are created in the currency market because all of the players in the currency market do not share the same objective or skill set," explains Rob Zink, Director, Portfolio Strategy at Bridgewater. "Many major participants in this market have objectives other than maximising return and also have limited expertise regarding currency management."

Currently, market penetration of currency overlay products is small. A minuscule \$80bn of pension funds' cross-border currency risk globally is managed by currency overlay managers, according to Mr Strange. However, the potential for growth in this area is "enormous", Mr Strange says. "We think pension plans will gradually catch on. I'm surprised it's taken 10 years for something to happen."

Inexorably, the argument for currency management is gathering steam. One of the major arguments is the materiality of currency exposure to total fund returns. Pareto's Mr Liesching argues that international investing represents the single most important step a pension plan can take to enhance its risk/return profile, and that for a US pension fund investing in international equities, over half the total dollar return in an average 12 month period (positive or negative) is the result of foreign currency movements. However, currency risk exposure is most often not effectively managed by international equity managers. International equity managers, Mr Liesching argues, "do not take significant currency positions and show no evidence of consistent value added when they do take currency positions. Because of business risk implications, it is rare to see – even among top-down equity managers – an aggregate currency hedge of over 25% of the total foreign exposure."

Of course, there is much discussion going on about how pension plans should approach a neutral hedging position – according to Brian Hersey, investment director of Watson Wyatt in Atlanta, this has up until now only been looked at in an asset-only framework, without taking liabilities into consideration (Watson Wyatt is doing research on this) – and also the best way to go about implementing an active overlay programme, but Pareto and oth-



Ron Liesching, Pareto Partners

ers have put forward strong arguments – accepted by Mercer and others – that currency exposure per se cannot be ignored.

"No-one who has either examined the academic literature or experienced a 40% fall in the dollar value of Japanese assets in a three-year period believes that 'currencies wash out over time'," says Mr Liesching. "The statement 'currencies wash out over time' is meaningless. From what level will the currencies 'wash out'?"

Another argument relates to the nature of currency exposure. Pareto points out that the currency market has no memory or reversionary "driver" that will take it back to a previous level.

This means that once pension plans lose money on currency, it's gone. One implication of this is that there is no expected return to assuming currency risk passively. Currency exposure therefore gives a fund unrewarded risk that creates big gains or losses. Pension funds should therefore manage this risk, argues Pareto, either with a focus on adding incremental returns in a risk controlled manner, or with a focus primarily on risk reduction (See *Currency Management Styles*).

In a similar vein, Mr Lee, a renowned currency expert, puts it this way: "Overlay is better than underlay. Since international investors do have a currency exposure, it is better to go for an explicit approach to currency management. Currency overlay is an obvious idea – what drives currency markets is different to that which drives the major asset markets, so therefore you need a specialist who lives, eats and sleeps currency."

Performance claims of currency managers vary, but they are all quite upbeat. JP Morgan steers prospective clients towards expected information ratios (excess return over unit of

risk) of between 0.6 and 1 (in reality, it has been as high as 2.5, depending on the time period), while Mr Lee is confident of delivering between 1 to 1.3. In simple language, anything above 0.5 – what typical asset classes provide – is pretty attractive.

In terms of fees, they are fairly low. Fees vary according to the currency management style selected and the size of the mandate. According to Mr Halpin, fees typically begin at 30bp and reduce as the size of the mandate increases. A mandate for over \$1bn would be 10bp or less, he says. Mr Lee says fees in the industry range from around the 20bp mark to as low as 7.5bp for assets of over \$600m.

But currency overlay is not recommended for every pension fund. Pareto advises funds to go for overlay only where currency exposure is going to affect returns materially. Typically this means cases where international exposure is over 15% and rising, or in the case of a very big fund which may have an international exposure lower than 15% but the value of its international assets is nevertheless very significant – say 5bn euros. An average account managed by Pareto (currency risk management style focusing on protecting international assets and adding value where risks are favourable) or JP Morgan (fundamental and technical style) – the two biggest players in this market – is around \$500m. However, as Pareto also points out, the median is just over \$200m.

Mike Smith, director of investment research at Hewitt Associates in Atlanta, takes a similar view. He says pension funds considering currency overlay should first and foremost be large – about \$2bn, although normally over \$5bn, and should have an international commitment of over 20% of total assets.

"Our view is that currency starts to add risk between when between 30% and 40% of total equity investments are invested internationally. However, this is not an exact science and it is really a 10 year/20 year proposition," says Mr Smith.

"In reality, pension plans have to weigh up the short and long term. If you are concerned with risks such as career risk, valuation risk and PR risk over the shorter term – three to five years, you should consider currency overlay. Overlay should be also considered is where the domestic opportunity set is smaller than the non-domestic opportunity set. In the case of the UK – which represents around 20% of the world – I would say that pension plans, which typically have higher international exposures than plans in other countries, almost have to consider hedging."

"The biggest issue, though, that we hammer home to clients is that it is irrelevant to look at asset class risk in isolation. The focus needs to be on the total, integrated portfolio risk – the combination of all the correlations and volatilities that you are concerned with." ●