

DIRECT CURRENCY

Overlaying currency on top of your core strategy can pay off.



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Overlay programs are, in general, very efficient ways to add alpha to a fund. They have quite low capital commitments, and the instruments used have low transaction costs and very high liquidity. However, within the universe of overlay programs, one type is often overlooked—currency overlays. Those programs are meant to overlay the existing currency exposures held by any fund that invests outside of its base currency.

Currency overlay programs can provide superior risk-adjusted returns with one of the lowest capital commitments of any program (overlay or otherwise), and are a natural part of any fund that has any foreign holdings.

LOOKING FOR ALPHA ...

Why should currency overlays provide superior risk-adjusted returns? The currency market is extremely large, with a US\$1.2 trillion per day turnover and 24-hour-a-day operation. You might think, therefore, it is one of the most efficient markets in the world, and a market where it is next to impossible to earn alpha. When we look at who is transacting in such volume, however, we find many participants are either not profit-seeking, or may not be aware they are even transacting in the market!

Central banks are clearly quite willing to be on the “wrong side” of a trade—the massive intervention by Japan to weaken the yen was not to make a profit. Corporate treasury departments are also willing to be on the “wrong side” of a trade, if it manages to reduce the risk of currency translation in the revenue or expenses. We also see many cross-border equity investors trading in the currency market with no intention of doing so. Just because you like U.S. equities is no reason to think you should like the U.S. dollar, and yet many non-U.S. equity investors do just that.

All these market participants are “inefficient,” and so they create inefficiencies that a well-constructed curren-

cy overlay can capture.

... IN ALL THE RIGHT PLACES

Currency markets also have some of the lowest transaction costs in the world: they’re often measured in single-digit basis points, which can be ten times smaller than in other more “traditional” markets like equities. In fact, the currency market is one of the best places to go looking for alpha! Where else can you find a huge pool of inefficient participants along with near-zero transaction costs to capture those inefficiencies?

Once you’ve decided to create a currency overlay program, there are a few questions you need to answer.

First, what are your expectations for the program? How much risk and return are you targeting? Since you’re applying the program as an overlay, ask these questions from the fund level. Remember that currency alphas are diversifying both for other sources of alpha as well as market returns.

Then you’ll need to ask what your benchmark is for the program. Generally this is a hedge ratio over the existing foreign exposure, but it can just as easily be over a standard index (MSCI EAFE, etc.). You will want to consider allowing net-short and net-long exposures to give the program the most opportunity to achieve the goals you set out for it.

Now you have to decide who is going to run the program. Do you build an internal team, hire external managers, or both? Whatever you do, make sure you select a good mix of managers that have diversifying styles.

To start the program, you may only need some initial margin. In fact, you may only need credit lines to start the program, which means there is no initial capital commitment!

Finally, don’t forget to measure the performance of the program, both at the fund-level, program-level and manager-level. ■