THE "CURRENCY EFFECT"

Don't treat foreign exchange risk as an afterthought in managing a global pension portfolio.

DORI LEVANONI

Director and currency product strategist, First Quadrant

IS CURRENCY RISK SOMETHING YOU SHOULD WORRY ABOUT IN A GLOBAL EQUITY PORTFOLIO? DEFINITELY!

Any time a portfolio has some portion of its assets invested outside of the base currency, there are risks associated with embedded currency exposure that should be attended to. Globally, there appears to be in excess of US$2 trillion in assets that fit that description. In those portfolios, where do we find these risks, and what do they look like?

The first and most frequently discussed source of currency risk in global portfolios lies within international equity portfolios. When we studied the "currency effect" in a foreign equity portfolio from a Canadian perspective, using data from January 1980 through June 2003, we found that while the unhedged equity portfolio returned 13.3% per annum on average, the "currency effect" was only 0.15% per annum. On average, the currency exposures inherent in the foreign portfolio had no effect on the return. In other words, so what?

But this is a study of risk, not return. What happens when we study the effect on the risk of that foreign equity portfolio? What we find is that the "currency effect" had just over 7% tracking error over that same span. That is quite a significant allocation of risk to an asset that adds nothing to your return.

Is currency risk something you should worry about in a global equity portfolio? Definitely!

How about bonds? We repeated the same study, using a foreign bond portfolio in place of the foreign equity portfolio. Over the same time span, the unhedged bond portfolio returned 11.3% per annum on average, while the "currency effect" was only 0.94% per annum. So what? And again we would point out that the "currency effect" had just under 7% tracking error over that same span. That is still quite a significant allocation of risk to an asset that adds nothing to your return.

Is currency risk something you should worry about in a global bond portfolio? Again, definitely!

RISKS IN ACTIVE MANAGEMENT OF CURRENCIES

Active management of currencies is often described as too risky, too speculative, or simply too difficult for a pension fund to spend any time considering as part of an overall active program. Two reasons are most often given for that view: currencies are more difficult to forecast than other assets and there is less breadth in the foreign exchange (FX) market than for other assets. However, active management of currencies is not as risky as you might think. Why should it be more difficult to forecast an asset where:

1. There is a large and liquid market,

2. There are market participants who are either implicitly or explicitly not profit-seeking,

3. There are many participants who have no views on the asset at all.

The FX market may be a better place to hunt for alpha than most other asset markets, given the large number of inefficient participants and the relatively small number of arbitragers or speculators who are chasing those inefficiencies.

And, while there are only 13 developed market currencies to choose from if you are an active currency manager, compared to many more assets in other markets, in reality the difference in the transaction costs are so significant that the true "size" of those other markets, from an active manager's viewpoint, is not much larger than that of the FX market! ■