The Top Excuses For Not Actively Managing Currency

FIELD NOTES

BY TRISTRAM S. LETT

Currency may be one of the least understood sources of risk and return, at least among the most common investment exposures. As a result, it seems to have acquired one of the most well-developed lists of reasons why it should be ignored. We might call this list "The Top Myths about Currency," since many of the reasons why investors choose to look the other way when it comes to currency aren't actually correct. The following is a list of the most common reasons.

CURRENCY IS NOT AN ASSET CLASS

Investment management is the business of managing the tradeoff between risk and return. Currency represents both a risk to be managed and an opportunity to earn a return, possibly even an excess return. Whether currency is an "asset class" or not is, therefore, irrelevant to the decision about whether it should be managed. Fortunately, or unfortunately, because foreign assets usually come with currency exposure attached, one rarely has the luxury of avoiding the decision about what to do with it.

It would be fun to engage in a debate about whether assets that are "unproductive" such as currency, precious metals, or derivatives are rightly considered to be asset classes. Some would argue that the low correlation such assets have with other (productive) asset classes give them the right to be called and managed as distinct asset classes. This, I believe, is the principal reason that hedge funds are referred to as a particular, and separate, class of assets. According to this metric, currency does qualify as an asset class, as it has a low correlation with most others (fixed income would be the important exception).

The point is that currency presents a real risk and a real opportunity for return, and therefore, it should be carefully and intentionally managed.

I CAN'T AFFORD THE ADDITIONAL RISK

Of particular importance in risk budgeting is the notion that active risk should be allocated to an array of independent and uncorrelated sources of alpha. Currency scores highly on both its independence and on the uncorrelated nature of its alpha with other active management strategies. It is, therefore, one of the most attractive places to allocate any available risk from the risk budget if any is left. If no risk is left in the budget, there's a case for making room for it.

WITH THE INTRODUCTION OF THE EURO IT HAS BECOME LESS IMPORTANT TO MANAGE CURRENCY RISK

The impact the creation of the euro in 1999 had on currency management was relatively insignificant, despite the fact that 11 currencies were replaced with one. This is a simple issue: the 11 currencies that disappeared were highly correlated to start with. This means that prior to unification, they behaved pretty much like one currency anyway. True, they didn't behave exactly alike, and this meant there were small risks to be managed between the currencies, and a small potential source of value added to be exploited, but they were just that—small.

From an active management perspective, what is required is that asset returns behave dissimilarly. If two assets behave too much alike, there can be little to no value to add in selecting between the two assets. This was largely the case with the 11 legacy currencies. The more meaningful opportunities were to be found by managing the yen vs. the dollar vs. the pound vs. any one of the legacy currencies. That hasn't changed with the launch of the euro.

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...currencies are an ideal hunting ground for alpha!

MY FOREIGN EQUITY AND BOND MANAGERS ALREADY MANAGE THE CURRENCY RISK

There are two reasons to question this assumption. First, the factors that drive currency markets are different from the factors that drive equity and fixed income markets. True, there are some common elements, but the differences are much larger than the commonalities. This argues for currency decisions to be treated separately from equity decisions. Few equity and bond managers do that.

I'M ALREADY FULLY HEDGED

In equity investing, being fully hedged means that you're missing out on a useful source of diversification. Currency returns have a low correlation with equity returns and thus tend to lower the risk associated with equities. With that said, we know that being 100 per cent hedged is suboptimal. Fisher Black has provided the mathematical proof that optimal hedging lies somewhere between zero and 100 per cent hedged, but cannot be found at the extremes.

It's also important to differentiate between the (passive) policy decision and the decision about whether to seek value added through the active management of currency exposures. The policy decision has no impact upon the potential for active currency management to add value from a pure investments point of view. Active management boils down to taking long and short positions relative to a benchmark. What the benchmark is matters less than is typically assumed.

In practice, however, many institutional funds are prohibited from taking net short positions in currencies, which means that an active manager would be prohibited from taking a bearish view on individual foreign currencies. The manager in such a case would only be able to add value when he had a bullish view on individual foreign currencies. This limits, of course, the potential for value added, but active management still remains an attractive option.

CURRENCY MARKETS ARE TOO LIQUID TO BE INEFFICIENT

It's easy to sympathize with this position. The currency markets trade between $1.0-$1.5 trillion a day with tiny transactions costs and minimal bid/ask spreads. However, much of the currency trading does not have a profit motive, but is conducted for reasons related to trade in goods and services, the financing of mergers and acquisitions, direct foreign investment, and trade in publicly traded financial assets. Perhaps more important is the fact that currency is a relatively unexploited asset class as far as value added is concerned and therefore inefficiencies are plentiful.

Because of these inefficiencies currencies are an ideal hunting ground for alpha! The greatest impediment to the capture of inefficiencies is transactions costs. However, unlike equity markets, the magnitude of the inefficiencies can be smaller and yet still profitable under the very low transactions costs in currency markets. Such is the case for an active currency strategy.

ACADEMIC STUDIES SHOW PURCHASING POWER PARITY DOESN'T WORK IN THE SHORT RUN—I CAN'T WAIT 3-5 YEARS FOR MY INVESTMENTS TO ADD VALUE

When all else fails, blame the academics! This is a challenge presented to those who would seek to add value by actively managing currency exposures using economic fundamentals. The logic underlying this argument is seriously flawed.

It can be assumed that the proponents of this argument fall vulnerable to an overly domestic orientation to financial assets, i.e., they think of foreign assets as one homogeneous bundle containing one currency risk, "foreign" currency. Currency decisions from this perspective are one-dimensional, and managing currency risk means determining how it should be split between the two risks, domestic and foreign currency. If one bases such a decision on Purchasing Power Parity, and has to wait as long as 3 to 5 years for that decision to prove correct, then it is hard to

add value over the investment horizons most investors really care about.

The fact of the matter is that foreign currencies do not represent one homogeneous bundle called "foreign currency." When you invest internationally, you take on a portfolio of currency risks, and currency decisions should treat them as a portfolio of separate risks. The use of economic fundamentals is no longer limited to a one-dimensional decision, rather, it is now multidimensional. In a portfolio context, the question is "over what horizon does Purchasing Power Parity add value in a portfolio context?"

This should sound very familiar to anyone who has ever hired an equity manager who employs valuation as a part of their approach. We don't ask a value manager whether each asset in the portfolio will return to fair value in the next month, quarter, or even year. What we want to know is whether the portfolio of stocks will, on average, converge towards fair value. The strategy is judged successful if the portfolio of decisions adds value, even if some percentage of the positions don't.

That's exactly what happens in a portfolio of currency exposures. A portfolio of currency exposures based on taking long positions that are "cheap" from a Purchasing Power Parity perspective and taking short positions in currencies that are "expensive" may add value even on a monthly basis, despite the fact that some of the currencies won't converge on fair value for years. A naïve form of the Purchasing Power Parity theory, the *Economist*'s "Big Mac Index" identifies expensive currencies as those where the price of a McDonald's Big Mac is higher than the world average. It has had an information ratio approaching 0.35 since its inception. That's not bad!

IT'S A ZERO SUM GAME—FX RISK "WASHES OUT" OVER TIME

One can't disagree that the effect currency returns have on investment returns does tend to wash out over time. Virtually anyone responsible for managing investments, however, doesn't have the luxury of being as patient as this would imply. Even if currency returns do wash out over the longest time horizons (i.e., 10 to 20 to 50 years), changes in exchange rates can have substantial impact on investment returns over long periods of time —periods as long as most policy decisions are intended for (i.e., 5 to 10 years).

In a market environment where the search for incremental return has grown increasingly more difficult, no one can afford to thoughtlessly discard potential sources of alpha. Many investment returns either "wash out over time" or "wash out on average." Active management, broadly speaking, washes out on average and is, therefore, a zero sum game as well. Should it be ignored for that reason? Certainly not!

In the end, you have to admit that currency management has a broader and perhaps richer list of excuses than any of the other key investment management issues. For investors in Canada, the issue has been one that could be more easily ignored. With the exception of a brief period during the second half of the 1980s and a couple of years at the start of the 1990s, foreign currency exposure has mostly been rewarding (especially the U.S. dollar). With foreign content higher than it has ever been, and with currencies such as the dollar and the pound falling from their expensive levels, this may be just the time to put those excuses away and look for an active approach to managing your currency exposures. ■

* Without the encouragement and inspiration of Max Darnell and Dori Levanoni, both of First Quadrant, LP, this note would not have been written. Errors remain solely in the domain of the author.