Investor &
Treasury Services

Currency Risk Management

Transcript

Murray Bender: RBC Investor & Treasury Services presents "Insights on the Opportunities and Challenges Facing the Financial Services Industry". Today's podcast features Mark Hogg, Head of Currency Overlay Services at RBC Investor & Treasury Services, on the topic of currency risk management. Thanks for joining us, Mark.

Mark Hogg: Thanks, Murray. I'm really pleased to be here today.

Murray Bender: So why is it important for cross-border investors to manage currency risk?

Mark Hogg: Yeah, well anyone even with a passing interest in finance or markets will have an appreciation of the importance of spreading investment risk across a diversified portfolio of global assets. You know the benefits are clear. They're undisputed.

What's less clear though, is the reward from taking the accompanying currency risk. Often this risk is taken without any real expectation of adding risk-adjusted value to a portfolio of investments.

If you consider that the risk in return on any foreign currency denominated investment can be separated into two components. In one hand you have the investment return that's generated by the underlying investment in its local currency. And then in the other hand you have the foreign exchange gain or loss, when you're translating the value of that investment back to your home currency.

So we could take you as an example, Murray. You're a Canadian investor. And if you were to buy units in the UK Equity Fund, then the return that you will experience in Canadian terms will be a combination of the return on the UK equity, in sterling terms, and the change in the Sterling/Canadian dollar exchange rate over your holding period.

So you can see that the impact of the translation of a foreign investment back into your home currency can hugely affect your final return.

Now of course it can run the other way and you might make a gain on the foreign exchange. But unlike an investment in real assets where the expectation is generally for price appreciation over time, there's no such expected positive return on foreign exchange.

You know it's sometimes compared to a zero-sum game. And perhaps that's true if you're holding period is forever. But most of us have a much shorter investment horizon than that.

So I would argue now that you know that this risk is present, and you can form an opinion on your appetite to bear it. Like you can simply choose to ignore the risk entirely. Many people do. But you should do so consciously. Or you might choose to passively hedge your way, all or a proportion of that risk. At the complete other end of the spectrum, you might choose to actively introduce currency risk. You know to try and overlay extra return.

And but it all starts with an understanding of the simple fact that you can unbundle your decision to invest in a foreign currency asset and your decision to accept the imbedded foreign exchange risk that that investment entails.

Murray Bender: So, Mark, you mentioned the two different strategies for managing currency risk. What's the difference between passive and active currency overlay?

Mark Hogg: With passive currency hedging, it's fundamentally a risk-reducing activity to remove currency risk in a systematic and like a rules-based way. The aim is to neutralize all or a proportion of the risk coming from—again, from translating those foreign currency investments back to a home currency. It's taking away the risk arising from movements in foreign exchange rates.

If we jump back to that previous example of you as a Canadian investor allocating some capital to UK equities, a passive hedge in that scenario would have sought to mitigate the risk of converting the sterling value of those investments back to Canadian dollars.

And it would have protected you in such a way that you would've benefitted from the strong return on the UK equities without giving up those gains to an unfavourable translation back to your home currency, you know, on account of the strengthening Canadian dollar.

You could look at it from an investment manager point of view as well. They might consider setting up a Canadian hedged share class to combine the asset exposure and the currency hedge in one convenient package for clients. So you would have a Canadian dollar hedged share class of UK equities.

Now but contrast to active currency overlay, very different thing altogether. And it aims to add value by deliberately inviting currency risk into a portfolio. So, you know, techniques and models vary in risk and complexity. And it may be entirely unrelated to the actual underlying investments.

You know, for example, I might choose to introduce Australian dollar exposure into my portfolio, even though I might not have any actual investments in Australia. But I would do so because I think the currency is undervalued relative to my home currency. So it's an active currency bet. I'm not trying to remove currency risk that's already present.

Murray Bender: Let's focus on passive currency overlay for a moment. What are the key considerations in designing a passive overlay solution?

Mark Hogg: Yeah, really it's all about determining what I call the rules that the hedging program will follow. The key is that there's no discretion in the process. The objectives, they're set up front. And then the rules are built around those.

And some of the questions that an investor or a manager will consider that will help them in this process, they're going to ask like, what's the performance benchmark of the portfolio? What's the nature of the underlying assets? Which currencies do I want to hedge? How often do I want to rebalance the hedges? How long should the head contracts be for the hedge tenor? Do I want to think about a minimum exposure size to hedge? Or a minimum trade size?

And it's the answers to all of these questions in combination that will frame the rules for the passive currency hedging program.

Murray Bender: Taking this a bit further, can you briefly walk us through the steps required to implement a passive overlay strategy?

Mark Hogg: Yeah. The detail is really important. The first step, as we've said, is to determine the program rules. But then you have to turn those into a systematic process. And it has to be expertly implemented and controlled. And that's the key.

The actual mechanics of currency hedging involve entering into derivative contracts. Usually FX forwards. And the volumes can be very large when you're dealing with big, global portfolios of assets.

So at a really high level, the process involves lots of data intake. And then you have to run all that data through a bunch of calculations that help you determine what hedges need to be executed. It'd have to root those orders for execution in the market, and then you have to settle those trades.

And by settling those trades you realize a profit or loss, and that's ultimately what provides the hedge. So, like, if you had a translation loss on the assets back to your home currency, that should be offset by a cash gain on the hedge contract.

So at every stage of the process there are different risks to manage, from operational to execution to market to credit. And each of those has to be carefully measured and controlled.

And finally, I think it's important that you have to also analyze the performance and the effectiveness of the hedging program through time. You have to ensure that the input rules that you established at the outset are in fact are delivering upon your intended objectives.

Murray Bender: Now switching gears and turning to the pandemic for a moment, how have you and your clients responded to the challenges of COVID-19?

Mark Hogg: Yeah. The initial period—the initial March to April period was really very challenging. You had a situation where market volatility surged and investor flow was increased dramatically. And you ended up with this kind of triple impact in the market where the value of the assets to hedge were moving about wildly.

Investors were then kind of panicked into reallocating capital in response to this, and investment managers were faced with constantly rebalancing portfolios to try and keep up with all this. And the net upshot was to place enormous strains on administration agents who are responsible for processing all of this extra activity.

And then from a currency hedging perspective, the volume of FX trades to execute in the market increased massively. And you have to take all of this into account as well that it was all happening at a time when organizations across the whole market were transitioning rapidly you know to work from home arrangements.

And you ended up in this pressure pump. And I've been amazed to watch really how quickly we've all adapted to getting up to speeds with new ways of working, communicating with our colleagues or our clients.

And high-quality communication and frequent communication is really important. You don't realize how much information is conveyed by in-person meetings and all those kind of informal touch points that are built into a day in the office until all that's taken away.

What I also see from many clients now that the initial—let's say the emergency period has passed, I see lots of firms are really focused on redesigning their operating models for a new future. And in lots of cases that means bringing forward difficult decisions around, what's a core activity? What's not? And in some cases maybe that means outsourcing, you know, with the likes of FX hedging activity or the execution of all asset classes for that matter, and I think especially so if it falls into the passive category.

Murray Bender: So finally, Mark, in your view, talking a little bit more about the future, what do you think the future holds for currency risk management? And how do you see currency risk management evolving as we move forward?

Mark Hogg: Yeah. You could spend a long time on this question, Murray, but there's probably two points I would highlight. The first is the whole area of data analytics and visualization. I've personally seen huge progress in the last couple of years in this space.

The ability to consume and to process enormous volumes of data, and then present that in an intuitive, in a visual, in a kind of dynamic format, has really helped with things like oversight of hedging parameters within large programs. It's helped with hedge performance decomposition, execution, quality and cost analysis. You know, many, many applications.

The second point I would highlight is what I think is the inevitable march towards more and more automation in everything that we do. This transformation continues at speed. Operating models are under constant review to increase efficiency, to lower costs, improve resiliency, and so on.

And, you know, I don't think the genie is ever going back in the bottle on this, so we really have to learn to work with these new capabilities, to embrace all the benefits that they bring. But at the same time we have to recognize that this type of change isn't always easy for people and we have to manage this journey sensitively.

Murray Bender: Interesting times indeed. Thanks very much for your time, Mark.

Mark Hogg: Thanks, Murray. I really appreciate it.

Murray Bender: Today's podcast has been brought to you by RBC Investor & Treasury Services, and we hope you found it useful. For additional insights on topics relevant to the financial services industry, visit rbcits.com/insights. I'm Murray Bender. Thanks for listening.

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