



## The Currency Iceberg Facing Most Investors

Presentation to:  
CIPFA Pensions Network

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Prepared for professional clients only

### A LITTLE STORY .... of risk management

- Of all the excuses - have you heard about the one saying that the moon sank the Titanic!
- Like the Titanic which was unsinkable, fully hedged investors thought themselves fully protected....

**CAN INTERNATIONAL INVESTORS CRUISE THE CURRENCY  
MARKETS ON AUTO-PILOT?**

## Are there any currency investors among you?

- Who has an allocation to a currency hedge fund?
  - > Maybe a classic hedge fund, global macro or CTA allocation
- Who has an allocation to international equities, bonds or property?
  - > Any allocation outside domestic bonds and domestic equities
- Most institutional investors will find significant currency exposure in their portfolio, but UK pension funds have liabilities in sterling

## ALL ON BOARD TO FACE THE CURRENCY ICEBERG



## Currency exposure in a typical portfolio Created by foreign assets

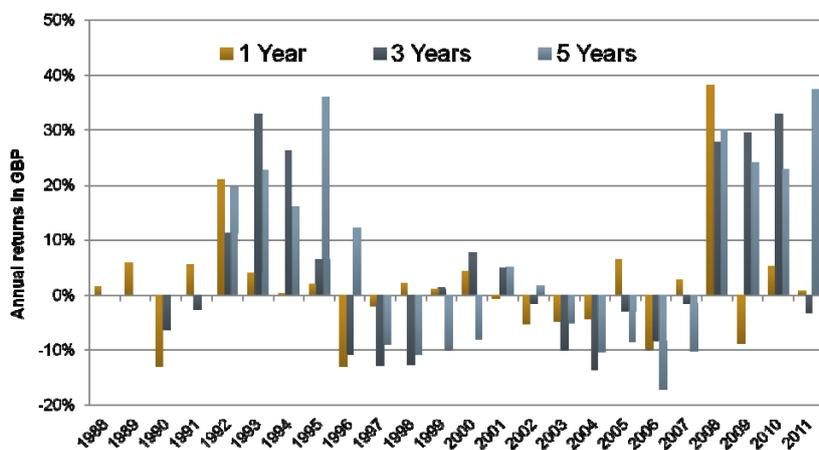
- Domestic portfolios are fully exposed to sterling.
- International portfolios
  - Asset allocation = 100%
  - Currency allocation = 100%
  - Default position is that currency exposure matches foreign asset exposure

UK INVESTOR		Currency allocation					
Asset allocation		GBP	USD	EUR	JPY	Other	
	Domestic equities	25%	25%				
	Domestic bonds	25%	25%				
	Domestic cash	3%	3%				
	Foreign equities	30%		15%	6%	3%	6%
	Foreign bonds	12%		6%	2%	2%	2%
Alternatives	5%	3%	2%				
	<b>100%</b>	<b>56%</b>	<b>23%</b>	<b>8%</b>	<b>5%</b>	<b>8%</b>	

## CURRENCY ALLOCATION IS AS IMPORTANT AS ASSET ALLOCATION



**Currency impact is dramatic on a global portfolio**  
**Adds risk, but has no expected return**



Source: Datastream, MSCI World Equity ex UK index in Sterling from Dec 1987 to December 2011.



**Currency impact is dramatic on a global diversified portfolio**

<b>Average currency move (3YR, 5YR)</b>	approx. 10%
<b>Average international exposure</b>	greater than 40%
<b>Total impact at the total portfolio level</b>	> 4% *

**AVERAGE ALPHA EXPECTED ACROSS ALL OF YOUR ACTIVE MANAGERS IS BETWEEN 1% AND 2%**

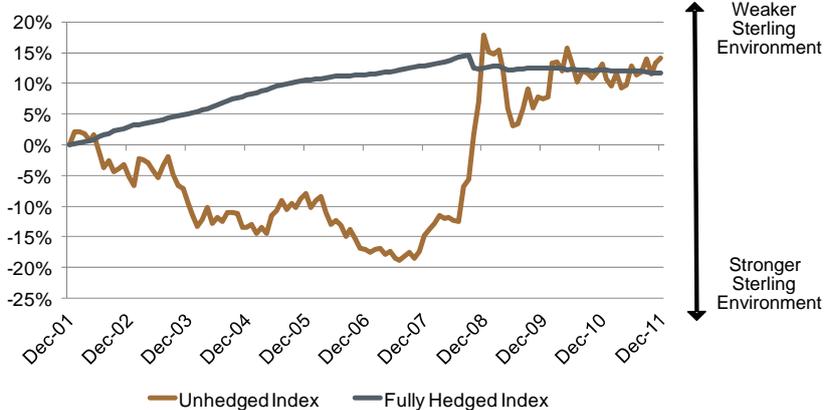


Source: Pareto



## Currency Risk A UK Investor's Perspective

**Sterling vs. Basket of currencies over 10 years**



\*Source: Pareto, DataStream, Index is the MSCI World ex UK, from 31 Dec 2001 to 31 Dec 2011.  
Past performance is not a guide to future performance

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## TO HEDGE OR NOT TO HEDGE...?

December 2001-December 2011

Annualised monthly #	MSCI World ex UK Unhedged (0%)	MSCI World ex UK 50% Hedged	MSCI World ex UK Fully Hedged (100%)
<b>Total Return</b>	1.0%	1.0%	0.8%
<b>Total Volatility</b>	16.0%	15.3%	15.6%
<b>Correlation vs FTSE 100</b>	0.90	0.93	0.91

December 2006-2011

Annualised monthly #	MSCI World ex UK Unhedged (0%)	MSCI World ex UK 50% Hedged	MSCI World ex UK Fully Hedged (100%)
<b>Total Return</b>	0.4%	-2.6%	-5.8%
<b>Total Volatility</b>	17.4%	17.2%	18.2%
<b>Correlation vs FTSE 100</b>	0.91	0.95	0.92

## ARE WE MISSING SOMETHING!?



\*Source: Pareto, DataStream, Index is the MSCI World ex UK, from 31 Dec 2001 to 31 Dec 2011.  
Past performance is not a guide to future performance

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## What does a Currency Hedge mean to you? Trade of choice

- Unhedged currency position: no cash flow requirement, but total exposure to currency return uncertainty
- Hedged currency position: the higher the hedge level the higher the cash flow impact (positive and negative)

**OPTIMUM STRATEGIC HEDGE AIMS TO MANAGE  
THIS CONFLICTING OBJECTIVE**

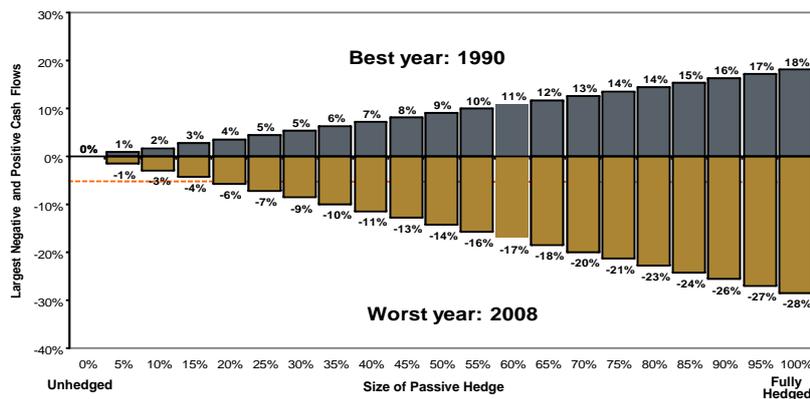


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## How could we miss the currency iceberg! Impact of a passive hedge on cash flows

**Size of Largest Annual Passive Cash Flows According to Hedge Ratio (1988 to 2011)**



**A TIGHT LIMIT ON NEGATIVE CASH FLOWS MAKES A  
PASSIVE HEDGE LARGELY INEFFECTIVE**



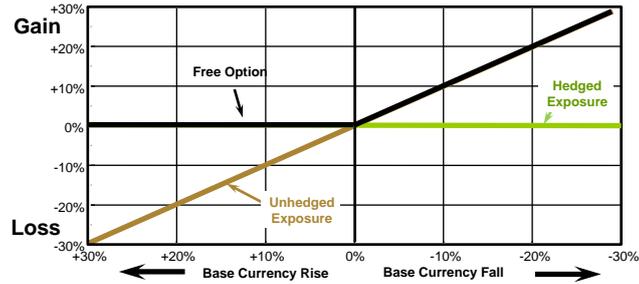
\*Source: Pareto, DataStream, Index is the MSCI World ex UK, from 31 Dec 1987 to 31 Dec 2011.  
Annual cash flows taken as sum of four quarterly settlements. Past performance is not a guide to future performance

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## Active Currency Hedging objectives Different ways – Different styles

- Strategies seek to hedge when the base is strong, and unhedge when the base is weak.
  - Would it be possible to keep the upside (foreign currency gains) but to avoid some/most of the downside (foreign currency losses)?
  - Hence all successful hedging strategies payoffs must be “option like”.

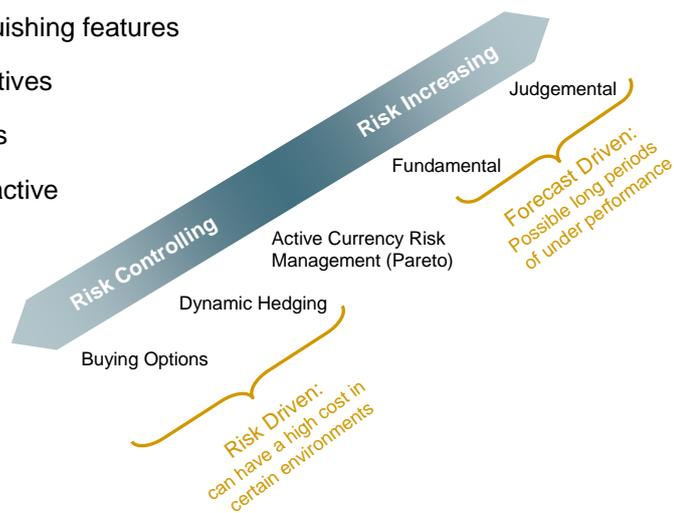


- The real difference between approaches is the risk / return balance.

## Active/Dynamic Currency Hedging Management styles

### Distinguishing features

- Objectives
- Beliefs
- How active



**Our way of avoiding icebergs... successfully**  
**Middle ground**

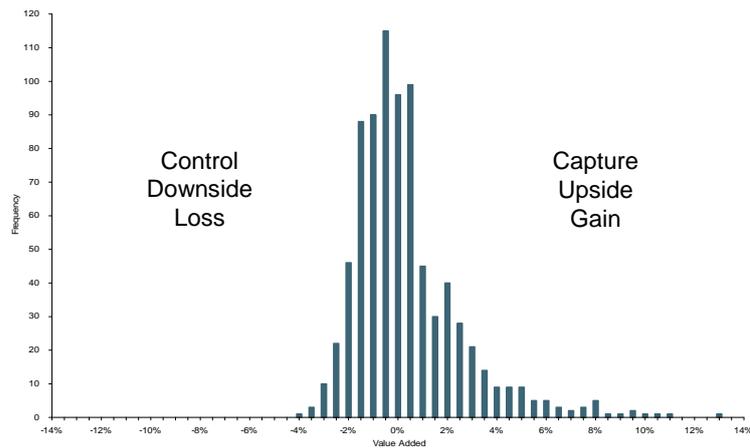
**Dynamic Currency Risk Management**

- Acknowledge difficulty of forecasting future currency movements
  - > Use risk measures which demonstrate more stable properties
- Recognise sources of the threat
  - > Takes existing asset based currency exposure
- Most investors do not like losses
  - > Focus on negative cash flow controls and probability of loss
- KEEP IT SIMPLE!
  - > Strategies seek to hedge when foreign currencies are weak and unhedge when they are strong

**MANAGEMENT IS BY DEFINITION AN ACTIVE PROCESS**



**Annual cash flow improvement**  
**As at 31st March 2012 (806 account years)**



Note: Active accounts are included from inception. The chart excludes passive programs and other significantly constrained portfolios, Base Currency and CRM Benchmark: Various  
 Exposures: Underlying Client Portfolios  
 Inception Date: Various (all accounts commenced from July 1, 1991 to March 31st, 2012)  
 Methodology: Value added by hedges (horizon year basis)  
 Returns are stated gross of investment management fees. Past performance is not a guide to future performance.  
 Source: Pareto Investment Management Limited



## The currency iceberg facing most LGPFs In summary

- No currency hedging exposes fund to potential large foreign currency volatility
- Passive currency hedging simply changes the nature of the risk
  - > Replacing return uncertainty with cash flow uncertainty
- Unmanaged cash flows are the threat to your portfolio
  - > Control of negative cash flows is required
- Currency risk is an underestimated threat to most institutional investors

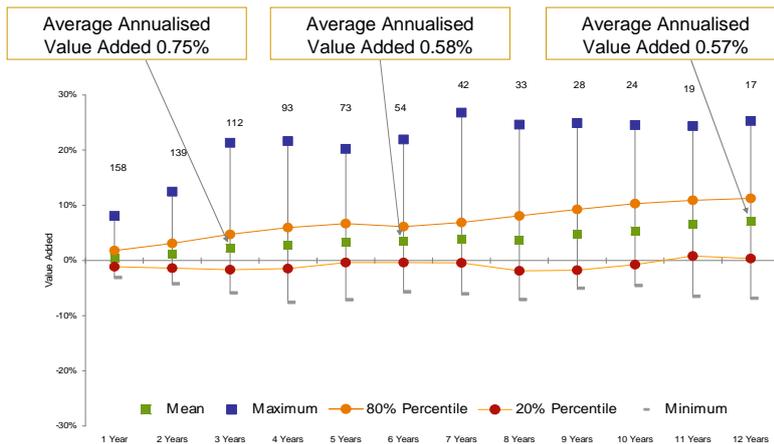
## RISK MANAGEMENT IS BY DEFINITION AN ACTIVE PROCESS



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## Cumulative value added As at 31st March 2012



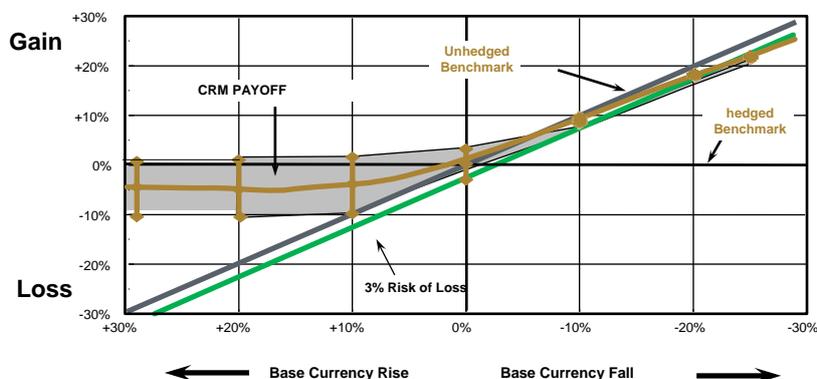
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## Pareto's Currency Risk Management (CRM) Pay-off Objective – Unhedged Benchmark Scenario



**Note:** Risk of loss 3% vs. benchmark  
Benchmark includes rate differential  
Bands narrower for multiple currencies



For illustrative purposes only

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