

Get used to global investors running our dollar

While there is a trend back to active currency management by Australian super funds, which tend to be more sensitive to currency swings compared with their overseas counterparts, the question about what 'type' of active currency remains difficult to answer. GREG BRIGHT reports on some of the possibilities.

On the face of it, the currency decision is simple. Super funds have three choices: passive overlays; active currency, in overlays or funds; and, alpha-generating currency funds.

But the finance world is far from simple. Let's complicate each of those strategies.

Passive currency overlays are supposedly designed to hedge against currency movements which can destroy the value gained by underlying offshore investments, but they also aim to minimise what is termed 'regret risk'. Regret risk is where you have hedged too much and you have missed out on the gains which the currency movements would have provided when your underlying investments went down. And passive currency is more of a continuum than the name implies. There is also semi-passive, or passive which is rebalanced at frequent intervals.

Active currency looks to take this onerous currency decision away from the fund investment staff and trustees and place it in the hands of a specialist. The active currency manager will look to hedge up and down within a pre-determined range against a major currency such as the US dollar, while at the same time taking active bets on the cross-currency market.

The alpha-generating strategy is basically a hedge fund which uses currencies as its modus operandi. It may be constrained and transparent or not. It will look to use as many tools in the shed to add value in the currency markets as it can. And these managers will tell you that the currency markets are the most liquid in the world.

So, the choice starts to look a little daunting. Just as equities managers come in many shapes and sizes – active/passive, growth/momentum/value, quantitative/fundamental, small-cap/large-cap, and specialising in various geographies and sectors, so too do currency managers.

But, then, currency managers are also different.



Christopher Udy ...
four differing factors for currency returns

According to Dori Levanoni, a partner and currency specialist at First Quadrant in Pasadena, USA, there are four dimensions to currency management which represent the underlying forces driving returns. They are:

- technical management, which looks to the history to forecast currency movements, and fundamental management, which looks at everything else. Both styles can use quantitative techniques.
- systematic management, such as First Quadrant, or discretionary management, such as George Soros. Their names are the giveaways.
- time horizon management, involving the question of 'short or long' or 'both'? These decisions can be blended, to complicate matters further. CTAs, for instance, tend to have a shorter horizon when they trade and have also tended to do comparatively well in periods of high volatility.
- volatility and the managers who trade it. Volatility can provide returns, but the managers who trade currency volatility may not really be currency managers, as such. They look to make money and just happen to do so by trading currencies.

Christopher Udy, the director of research at London-based The Cambridge Strategy, sees it a little differently. He also says there are four 'factors' for currency returns, but they are not quite the same:

1. technical trading, which is really based on the momentum style adopted by equities managers.
2. a value strategy, which looks at Purchasing Power Parity of underlying currencies.
3. the carry factor, which looks

at interest rate differentials and tends to be active in currencies such as the Australian dollar, which usually has higher interest rates than other developed markets.

4. the volatility factor, which looks to capture the risk premia through changing volatilities.

The Cambridge Strategy is a boutique manager formed in 2003, with offices in London, Sydney and Hong Kong. It blends its systematic technical model with its systematic fundamental model, across a range of currency pairs and time frames.

Gary Klopfenstein, CIO and senior managing director of Chicago-based Mesirow Financial Currency Management, says the first movement by pension funds is usually to adopt a passive strategy with a strategic hedge position. Once that is in place, the question arises as to whether to allow the managers to deviate around the benchmark, and by how much.

Australian funds moved to adopt active currency management in the mid-1990s but then pulled back around the time of the Asian currency crisis, according to a longitudinal study by National Australia Bank. The latest study, published in June this year, showed a trend back to active currency management by super funds.

Klopfenstein says that Canadian funds, which also come from a commodities-orientated economy, are a little ahead of their Australian counterparts with respect to currency.

"There is definitely a swing to active," he says.

The problem for Australian super funds is that the \$A has a fat tail – it generally goes up slowly and down

quickly, as we saw last year.

Mesirow adopts a consultative approach with funds, especially focusing on the underlying investments. The firm believes that 10-15bps can be gained per year by resetting the hedge correctly.

The firm also looks to improve the overall efficiency of foreign exchange management by, for instance, custodians. Custodians will often use in-house pricing for their trades, rather than going to a panel of third parties, and according to Mesirow, another 10-15bps is readily available through active management of those trades. The firm has a roster of 13 banks, for instance, and does about 75-80 per cent of its business with the top four.

Carry strategies tend to work in "quiet" currencies rather than volatile ones. For countries such as Australia, there is an embedded carry strategy because of our generally high interest rates.

Mark Snyder, executive vice president of State Street Global Markets in Boston, is in an interesting position as he can see aggregate flows around the world as well as consensus views on buying and selling cross-border assets.

He is not as bearish on the US dollar as many commentators.

"I don't think pension funds are thinking too much about the ongoing weakening of the US dollar," he says. "It's more the consensus of the popular press. There is certainly a troubling case for troubling fundamentals, but over a long period the proportion of sovereign debt in US dollars has held fairly steady. I'm not glossing over what are really serious exchange rate challenges, but we should remember that exchange rates can also be a balancing factor... Foreigners own a lot of (US) debt but we also own a lot of their equities."

State Street's research currently has the Aussie dollar ranked at about 90 out of 100 for "value". This means that the professional market is very long on the Aussie dollar. There is a yield advantage in holding the Aussie, because of interest rates, but funds must wonder, Snyder says: "Do I hold on or do I get out before it gets ugly."

At the end of the day, it is global investors who determine the level of the Australian dollar. Australian investors have to deal with it. ■