This issue of Spotlight focuses on the important issue of currency hedging. Awareness of the part played by currency exposures in potentially shaping investment performance has rarely been higher. The sharp swings in currency markets experienced in the second half of 2008, as investors fled to perceived safe havens, caused major headaches for international bond investors in particular.

But it is not just performance that is pushing this issue up the agenda. Governance pressures, allied to the drive for cost containment, are also encouraging the investment management industry to find ways of managing both their transactional FX and hedging requirements in a more transparent and effective manner.

At Citi, we are playing our part in this process with the extension of our AutoFX services to deliver cost-effective, operationally efficient and above all transparent solutions that meet our clients’ requirements.

The past year has witnessed unprecedented volatility in the foreign exchange markets. For investment managers running large international portfolios, this has magnified already sharp swings in asset prices. At times, the potential impact on performance has been dramatic. Between August and October 2008, more than 80 per cent of the returns on a World Government Bond Index-type portfolio were down to FX movements. And that was at a time when underlying bond prices were themselves highly volatile.

Not surprisingly, interest in currency hedging has risen sharply. FX volatility has fallen back from the peak levels seen late last year but remains high by historic standards. Failing to hedge at least part of a fund’s currency exposure is no longer seen as an option. This is particularly so in bond portfolios where underlying asset volatility is relatively low and currency conversion can dominate the unhedged return.

For evidence of that, look no further than the experience of sterling-based investors in global bonds since 2003. Remaining unhedged would have been a profitable strategy over much of the past two years as a result of the pound’s weakness. But over the period 2003-2007, currency losses would have wiped out all the gains on an unhedged portfolio.

The picture with equities is somewhat different. Most of the volatility in returns on international equity portfolios comes from the underlying assets. Currency conversion has historically accounted for between a tenth and a fifth of the underlying volatility. Nevertheless, the cumulative impact on long-term performance can be substantial, and it is generally accepted that partial hedging, with variable hedging ratios, can contribute to equity returns.

Other pressures are also encouraging increased attention to hedging. Following what has been a period of contraction for the asset management business, many firms are keen to extend their investor base by tapping new markets. Often the target is the Asian markets where investors have a strong preference for investing in US or local dollars. For a UK or European fund, that will involve the creation of a new share class denominated in that currency.

Hedging is necessary if the fund is to eliminate FX movements from its base currency performance. This puts an additional burden on an investment manager’s FX team, which is already charged with arranging the transactional FX required across the fund’s fund range. With spreads still relatively high, and with the pressure to demonstrate best execution – not just for regulatory purposes but also to manage reputational risk – it becomes increasingly important for investment managers to manage the costs of securities-related FX execution. Transparency is critical.

However, cost transparency is about more than just the price achieved on the FX transaction. There are all the attendant costs of transacting to take into account, with no simple formula available to determine the all-in cost. In addition, there are operational, risk and governance costs to consider.
Not surprisingly, in their attempt to achieve best execution with full transparency, many investment firms have turned to multi-bank FX portals. But even here, the price achieved does not represent the full transactional cost and settlement and counterparty risks remain. The latter can be minimised by using a single bank portal or using Continuous Linked Settlement (CLS) for custody FX. But this still leaves a firm with a major governance headache and a substantial cost centre. Turning to a currency overlay manager may provide a solution to the challenge of hedging, but is simply replacing one layer of cost with another – particularly if it leaves the investment manager to manage the funds’ continuing transactional FX requirements.

Increasingly, investment firms are turning to their custodian to leverage its own scale efficiencies to deliver an all-in solution that encompasses both transactional and hedge-related FX services and does so in a completely transparent manner that delivers best execution against a published benchmark. Such a solution ticks all the governance boxes, eliminates third-party settlement risk, removes the in-house operational burden and leaves the investment manager free to concentrate on generating alpha in the underlying marketplace.

Meeting the Currency Challenge: AutoFX Passive Hedge

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To meet the need for a comprehensive, transparent hedging solution to help clients manage currency risk in their portfolios, Citi has created AutoFX Passive Hedge. A natural extension of our existing AutoFX offering which is widely used by clients for their transactional FX requirements, AutoFX Passive Hedge is an automated solution that draws on the world-class capabilities of CitiFX to seamlessly link custody deal determination to FX execution platforms.

This highly flexible and transparent solution uses pre-agreed standing instructions to execute forward or Swap FX contracts based on a portfolio’s valuation - thereby locking in the future FX value of the portfolio. Clients can choose different hedging ratios (at anything from 0 per cent to 100 per cent) for different asset types and apply them for all or just individual currencies. Tenors range from one week to one year. The flexibility to segregate or combine by underlying asset type provides tailored solutions to met client needs, irrespective of changes in trading strategies.

To help maintain the hedging ratios at the pre-agreed levels, an optional trigger mechanism can execute additional hedge requests as markets move to minimise any tracking error on exposures. The process is fully automated. Once the standing instructions have been set, clients have no further need to involve themselves in any aspect of the hedging programme, but are free to concentrate their efforts on generating performance in their funds.

AutoFX Passive Hedge offers potentially unique levels of accuracy and transparency. Clients have the option to be set-up for floating rate spreads, based upon deal size, tenor and market position, or elect to have all transactions executed on fixed spreads against CitiFX Benchmark rates. These are determined by calculating independent mid-rates based on the most accurate and liquid electronic data sources for each currency.

At more than 20 times a day, a snapshot of all sources is taken, statistical outliers are rejected and the most accurate used to reflect the true market rate. All rates are audited by KPMG and published on Reuters and Bloomberg for full transparency.

For maximum efficiency, our AutoFX Passive Hedge integrates seamlessly with our custody and FX systems to deliver a fully automated straight-through processing solution, from deal determination, execution, through to post trade activities including payment processing through confirmation to online reporting. Third-party settlement risk is eliminated and a full audit trail provided online providing for a highly cost-effective solution that can deliver major operational efficiencies. It also comes with no set-up or maintenance fees.

Citi can also help our clients determine optimum hedging ratios for their portfolios. We can take all their portfolio back data and demonstrate comparative performance under different hedging ratios over many years, or clients may have already been mandated to hedge all or a percentage of foreign investments already, where we can quickly implement using this solution. The discussion on the optimum hedge strategy continues, getting the balance right between frequency to adherence to the defined ratio. The trade off is the more frequently you trade to keep alignment with the hedge ratio, the higher the implied transactional cost. Our solution can give you the flexibility to match the model you need and meet your desired balance.

In addition to our AutoFX Passive Hedge, we also offer clients additional sophisticated active hedging strategies - based on purchasing power parity or interest rate differentials for instance - and still deliver a fully automated solution.

AutoFX Passive Hedge draws on our experience of working with many of the world’s largest and most sophisticated investors. It is part of a family of AutoFX solutions that began with our well established AutoFX Settlement product, which facilitates a passive or active solution for all of an investor’s transactional FX. Applying the same, transparent benchmarking process as AutoFX Passive Hedge, AutoFX Settlement also accommodates corporate actions and income transactions. Its scope extends to more than 1,000 currency pairs, again having unrivalled levels of flexibility to deliver tailored solutions.

In addition, Citi’s AutoFX Share Class Hedging product can deliver a highly tailored solution, devised specifically to reduce the currency risk associated with the creation of share classes denominated in a currency other than a fund’s base currency. This solution allows individual fund share classes to be hedged in isolation to eliminate or reduce the impact of FX movements. Hedged positions are monitored on a daily basis and adjustments to the forward positions made as required. Clients can determine their own target hedge ratios and deal size thresholds, and aligned with the other suite of AutoFX solutions, provides clients with a FX solution that allows them to concentrate on their day to day portfolio management.

As a passive solution, AutoFX Share Class Hedging allows investment managers to market their funds in new territories without having to manage the effects of currency fluctuations on the performance of a non-base currency share class.

In all these areas, we have leveraged the twin strengths of our leading Securities and Fund Services and FX operations to deliver innovative tailored solutions that help our clients capitalise on the opportunities on offer in the cross-border investment market while minimising risk, simplifying governance and maximising efficiency.