Rethinking Foreign Exchange in Your Investment Portfolio:
Active, Passive, or a Third Way?

By David Cohen

Back in 2009 I was fortunate enough to hear a leading bond fund manager speak about the future. As he held up a $1 bill, he prophesized that one day we would be telling our grandchildren about these little pieces of paper that people used to exchange for goods and services. The history-minded manager had a theory that currency devaluation was the central bank elixir to the developed-market financial crisis. At the time, it seemed like just a simple prognostication, but in reality it was a prescient forecast of the beggar-thy-neighbor policies soon to be adopted by central bankers—a systematic effort to kick-start economies and create inflation in an attempt to avoid a deflationary spiral.

I began to study what this meant for portfolios and learned that, for most investors, currency management is passive—indeed it is so passive that it is often ignored. The vast majority of investors’ currency exposure is a byproduct of portfolio construction, passively defined by international allocations to stocks and bonds. I also found that even astute institutions with active currency programs generally take a passive approach to what they consider active currency management, simply hedging out a portion of international currency risk in favor of the currency denomination of their liabilities. Many plan sponsors benchmark 50 percent of international allocations to indexes hedged to the currency of domicile, creating a non-committal hedge that dampens volatility but trades foreign currency risk for increased domestic currency exposure. At first this may seem like a reasonable approach, but in an environment where monetary policy is a weapon of mass stimulation, does this kind of passive approach remain prudent?

Perhaps it’s time we rethink foreign exchange (FX).

Passive currency management is most often the default strategy for the following reasons:

1. Short-term currency movements generally are difficult to predict and the management of domestic currency valuation fluctuations relative to foreign purchasing power does not factor into portfolio performance evaluations.
2. Active currency management strategies are complicated and can be costly to implement. Accessing transparent, institutional FX markets requires expertise and a special credit facility, and best execution requires forethought given the unregulated nature of FX markets.
3. Relatively few options exist for traditional investors to implement active currency management strategies through traditional brokerage accounts.
4. The predominant, yet factually incorrect, belief that FX is a zero-sum game; i.e., that relative price fluctuations between currencies and yield differentials between countries generally iron out over time. To that I say, “Tell George Soros that currencies are a zero-sum game.” Mr. Soros made more than $1 billion in 1992 as the result of an investment thesis predicated on the fundamental valuation of the British pound and an understanding that it was unsustainably overpriced.

The Japanese also are cogently aware of the potential impact mispriced currency valuations can have on an investment portfolio. The currency story of 2013 was the yen’s 17.7-percent decline in value relative to the U.S. dollar, but during the past 43 years the yen has appreciated at an average annual rate in excess of 3 percent. In January 1971, the exchange rate of the Japanese yen to the U.S. dollar was 358:1, and as of December 2013 the exchange rate was about 103:1. Whether this type of change in fundamental valuation is the natural evolution for the currency of a country progressing from an emerging market to a developed market is beyond the scope of this article. The data, however, suggest that currency valuations should not be considered a zero-sum game over most investors’ time horizons.

Multidimensional Pricing and the Creation of Currency Beta

A currency’s price is presented as a rate of exchange between two currencies, meaning currencies are priced in pairs. At any given time all currencies also are being priced against myriad other currencies. A euro is priced in terms of U.S. dollars but it is simultaneously quoted in yen. The influence of one currency valuation on another can simultaneously affect the prices of a third currency in which it is also being quoted. Such a circuitous route to determining a currency’s true value typically is not engrained in those of us whose expertise generally has focused on cash assets that generally are measured in basis points.

The added dimension of simultaneously quoted, multilateral pricing obfuscates the true performance of a currency as its fundamental value begins to change. When one asks, “How did the euro perform today?” there must be a follow-up question: “Against which currency, the U.S. dollar, the Japanese yen … the Hungarian forint?”
Most currency transactions are priced relative to the U.S. dollar, which serves as the world’s reserve currency. Cross-pairs, a currency pair that does not include the U.S. dollar (such as pound sterling/Swiss franc), may have dissimilar performance relationships from what is implied individually between each constituent currency and its value relative to the U.S. dollar. For example, the Russian ruble may be down against the dollar and the Polish zloty may be up against the dollar, while the zloty is down against the ruble—yes, this is entirely possible.

Meanwhile from the perspective of a domestic investor who is invested in a domestic security denominated in the local currency, the local currency never seems to change in value and thus appears to have no impact on the valuation of the domestic security. But is this really the case? If currency can change the relative value of that security in the eyes of the world, how can there be no impact to the local investor?

To address these complexities, our firm created a currency beta basket index series to normalize performance of all currencies versus a passive selection of the world’s most liquid deliverable currencies.

To further simplify the complexity of multidimensional currency pricing for the investment community, we partnered with a leading index provider, FTSE Group, to create the FTSE Cürex G20 Index1, a basket currency index that can be used as a beta for currency valuation. The FTSE Cürex G20 Index is an equally weighted basket of 20 spot currencies, with allocations approximately one-half to developed markets and one-half to emerging markets. This basket could be considered a reasonable proxy for a beta benchmark for the currency market as well as a performance measurement benchmark for active currency overlay managers.

At its core, G20 offers the market a standardized formula for calculating the value of any base currency by normalizing the relative performance of all currencies (see table 1). The formalization of a more conventional, one-dimensional currency-pricing methodology using a standardized base-currency valuation model gives investors a new tool for comparative market analysis at any moment in time.

Other currency valuation benchmarks do exist; the best-known is the U.S. Dollar Index (DXY), which is a basket established using a fixed weighting of the U.S. trade-weight as it stood in 1973. The basket is calculated by taking the geometric average of price changes in a basket of currencies using a weighting of 57.6-percent euro (EUR), 13.6-percent Japanese yen (JPY), 11.9-percent pound sterling (GBP), 9.1-percent Canadian dollar (CAD), 4.2-percent Swedish krona (SEK), and 3.6-percent Swiss franc (CHF). While this has proven to be a consistent weighting methodology, one might think the weights aren’t particularly relevant today given the evolution of U.S. trade weights over the past 40+ years.

In theory, trade weighting seems like a sensible approach to building a currency basket given its seemingly parallel logic to the concept of market-cap. However, FX price discovery is far more influenced by global investment flows, risk management, central bank policy, and electronic price-discovery arbitrage than the settlement of international commercial transactions. When one considers that trade weights can change substantially over time and that actual commercial trade makes up less than 5 percent of FX volumes, one can conclude that trade-weight currency baskets are not an optimal approach to measuring the overall value of a currency.

The establishment of a beta-base currency basket allows for an easier understanding of the relative performance of currencies. More importantly, it allows any domestic investor to understand how the domestic currency is performing relative to the rest of the world and potentially take action to hedge away from domestic currency exposure.

Table 1: 2013 Currency Performance through December 2013 (%)

<table>
<thead>
<tr>
<th>Currency</th>
<th>Return vs. USD</th>
<th>Return vs. G20</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD</td>
<td>0.00</td>
<td>2.03</td>
</tr>
<tr>
<td>EUR</td>
<td>4.52</td>
<td>6.26</td>
</tr>
<tr>
<td>JPY</td>
<td>-17.71</td>
<td>-19.09</td>
</tr>
<tr>
<td>GBP</td>
<td>7.70</td>
<td>8.90</td>
</tr>
<tr>
<td>CAD</td>
<td>-6.29</td>
<td>-4.54</td>
</tr>
<tr>
<td>SEK</td>
<td>1.29</td>
<td>3.28</td>
</tr>
<tr>
<td>CHF</td>
<td>2.92</td>
<td>4.81</td>
</tr>
<tr>
<td>Volatility</td>
<td>6.55</td>
<td>3.49</td>
</tr>
</tbody>
</table>

Source: Cürex Group
currency indexes then can be combined with traditional stock, bond, and commodity indexes to make hybrid strategies that deliver alternative portfolio characteristics.

Specialized FX market microstructure expertise can be incorporated into the construction of these new "smart" FX indexes to ensure that the implementation of an FX index's methodology meets the combined obligations of best execution, minimal tracking error, and fiduciary duty. With these enhanced capabilities, new strategies can be introduced through passive FX indexes and efficiently implemented in an array of financial product structures.

With the advent of these types of hybrid concepts, investors no longer need to allow currency exposure to be determined as a byproduct of portfolio construction. Instead, we can marry a traditional asset-management strategy with a currency-management strategy to achieve specific objectives. Such an approach can help investors manage an important risk contained in portfolios: the risk of unmanaged currency exposure.

**Practical Uses for Active Currency Strategies**

Currencies are not an asset class; rather they are an attribute of all assets and serve a primary function as the denomination for all assets. As an attribute, the performance of a country's currency is a component of the total return experienced by nondomestic investors. For domestic investors who own assets denominated in the local currency, the performance of that currency relative to the rest of the world plays absolutely no role in portfolio performance computations. The currency attribute does, however, influence domestic asset valuations in the eyes of foreign investors.

For an investor who buys an international asset, the return experienced is the product of the asset's performance and the relative performance of the currency in which the asset is denominated when compared to the investor's domestic currency. Simply stated, if the foreign asset appreciates 20 percent and the foreign currency depreciates 20 percent relative to the investor's local currency, the domestic investor earns nothing.

By comparison the domestic investor who experiences a 20-percent appreciation of the local currency relative to a basket of the world's currencies and sees the domestic market decline 20 percent may not understand the impact currency has had on a portfolio. It may be that in this case, the portfolio risk would have been better managed addressing the domestic currency risk rather than the traditional market considerations.

There are four practical currency strategies for investors:

**Hedging:** eliminating the foreign currency risk from a security in favor of the currency risk of an investor's domestic currency.

**Diversification:** removing the systemic risk of a domestic currency in favor of a basket of foreign currencies.

**Portable yield:** adding the yield earned from the overnight carry by going long currencies with higher overnight yields and shorting the underlying portfolio's currency exposure.

**Speculation:** a risk trade that may employ leverage, expressing a view on one currency's valuation vs. another currency or currency basket.

To some, these may seem like active currency-management strategies when compared with a portfolio manager's default of doing nothing. However, doing nothing does not eliminate the foreign currency risk regardless of the denomination of one's assets.

**Was 2013 the Year U.S. Investors Began to Rethink FX?**

In this “new normal” era of central bank tinkering across both cash and FX markets, we are beginning to see investor awareness and corresponding investment flows accelerate toward financial products that address currency risk.

In 2013, U.S. investors began rethinking FX by piecing together cognitive investment strategies that highlight the relationship between a country’s currency and domestic equity prices. This rethinking of FX led to the extraordinary success of a few currency-hedged Japanese equity exchange-traded funds (ETFs). In the unhedged versions of those same ETFs, much of the gain in Japanese equities was eliminated as a result of the weakening yen; the hedged versions returned, to investors not domiciled in Japan, performance similar to that earned in the Japanese markets by Japanese investors. To the typical yen-based Japanese investor, the Japanese equity markets experienced an impressive bull run without any negative performance implication from Japan’s currency devaluation.

The strategy deployed in these successful ETFs—switch the international currency in favor of the investor’s domestic currency—is commonly used. In many cases, it can be very beneficial. Figure 1 illustrates the performance of Toyota Motor Corporation stock denominated in yen versus Toyota stock hedged to the U.S. dollar from the perspective of a U.S. dollar-based investor.

Currency hedging is a strategy widely used because investors believe that if liabilities are priced in the domestic currency, assets should be as well. But in the case of 2013, we saw the hedging strategy used to express a trade relative to the policy being dictated by foreign finance ministers. This is a logical and prudent approach, but it is only a start. By extending passive currency management beyond the hedge, investors from around the world may be able to unlock new opportunities to enhance portfolio returns, achieve investment objectives, and even protect portfolios against the risk of devaluation of the domestic currency.

**If Domestic and Hedged Currencies Are Experiencing the Same Assault**

Abenomics² and quantitative easing are central bank strategies designed to weaken currencies and inflate asset values. Data suggest a statistically significant inverse relationship between a country’s stock-market performance and the strength of the domestic currency (see figure 2). This relationship has been very pronounced in
Japan, and the policy of cheapening currencies in an effort to raise asset prices and produce an indirect domestic wealth effect is a tool that all developed-market central bankers seem to use.

**Hedging Domestic Currency Exposure**

The Japanese equity investor who chose to hedge out domestic currency risk ultimately had a bonanza year in 2013 by double dipping on equity gains and capitalizing on a short position of a weakening currency. Was this luck or an effective passive strategy?

Rewinding to November 2012 and without the benefit of foresight, the implementation of that strategy would have forced the question: “If I am going to hedge away from domestic currency exposure, to which currency should I hedge? Euro? U.S. Dollar? Pound Sterling? Aren’t all of these economies also employing similar monetary policy through their own forms of quantitative easing?”

What if one hedged to the world, through a passive index such as a FTSE Currex G20 currency basket index? Wouldn’t this eliminate the risk of choosing the wrong currency into which currency risk is transferred? Wouldn’t this passive strategy encourage diversification (reduction of unsystematic single currency risk) while capturing the essence of the strategy?

Regardless of nationality, today’s investor has a systematic bias toward the domestic currency. Even most returns-based performance analysis software has a domestic-currency bias. Common ratios (returns, standard deviation, Sharpe ratio, beta, etc.) also are biased in favor of the domestic currency because they assume that volatility and price fluctuations of the domestic currency are zero.

Yet, in light of the overwhelming activity of central bankers and the accelerated velocity with which investment flows across borders, investors continue to maintain a preference for the domestic currency. If you knew with certainty that the domestic currency was going to decline in value, would you continue to hold the currency or would you look to diversify?

A pragmatic defense could be to reduce exposure to the domestic currency and increase exposure to a diversified basket of currencies, thus giving you beta currency exposure and a passive hedge against domestic currency. This was a strategy that would have worked well in Japan over the past year, where the Tokyo Stock Price Index (TOPIX) experienced a 61.07-percent increase from the perspective of a Japanese investor. But being long the TOPIX and short the yen in favor of a global basket like FTSE Currex G20 would have been a significantly more successful strategy because it would have produced a gain of 96.52 percent, an additional 3,500 basis points over the same time period for Japanese-domiciled investors.

**In Summary**

Developed-market currency devaluation has the very real potential to adversely impact domestic standards of living over the long
run. In an environment of unprecedented central bank activity, investors ascribing to traditional asset allocation portfolios that ignore the embedded risk of continued central bank action are exposed to the threat of significant underperformance in real terms.

If 2013 was the year U.S. investors awoke to the reality of currency as an attribute, 2014 will be the year that U.S. investors can begin to rethink FX as it applies to international holdings and to the real value of domestic investments.

To date, only two options generally are considered for currency management: active overlay managers and passive strategies that are the byproduct of an international allocation to stocks and bonds, or a hedge of foreign currency risk.

We have suggested a third way: intelligent currency management delivered through carefully constructed passive FX indexes designed to support investment objectives such as yield enhancement and risk management. Currency as an attribute means that this smart currency beta concept can be applied to any index from any index provider. And, by embedding FX market expertise, we can align best execution and the elimination of FX tracking error in the delivery of these opportunities.

This third way represents an exciting new choice between traditional passive and active investing and offers asset managers, product sponsors, and index providers alike new opportunities to rethink FX as they compete to provide investors compelling investment choices.

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Endnotes

1. FTSE Cürex FX Benchmark USDG20: A benchmark index measuring the value of the U.S. dollar against an equal-weighted basket of 20 global currencies (AUD, CAD, CHF, CNY, EUR, GBP, HKD, ILS, JPY, MXN, NOK, NZD, PLN, RON, RUB, SEK, SGD, THB, TRY, and ZAR).

2. Abenomics refers to the economic policies advocated by Shinzō Abe, the Prime Minister of Japan. Specific policies include inflation targeting at a 2-percent annual rate, correction of the excessive yen appreciation, setting negative interest rates, radical quantitative easing, expansion of public investment, buying operations of construction bonds by Bank of Japan (BOJ), and revision of the Bank of Japan Act.

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