

Currency Overlay Strategy: Capitalizing on Misvaluation

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Most investors acknowledge that currency exposures add risk to a portfolio. They also argue that there is not an expected risk premium that compensates for taking currency risk. The big surprise for many investors is the size of the opportunities in the currency markets. For example, since 1976 the yen has appreciated 185% (or 3.8% per year) versus the dollar. Using Mellon Capital's Currency Overlay Strategy, a process of identifying misvalued currencies, it is possible to add value while taking on a controlled level of risk. True to our tradition, this currency strategy transforms fundamental investment research into an innovative and successful investment strategy. Our strategy is based on both relative and absolute currency valuation measures, real interest rate differences and Purchasing Power Parity.

TO HEDGE OR NOT TO HEDGE

Plans with meaningful (10% or more) international exposure need to address the currency decision at the plan level. When you are investing in foreign assets, the relevant currency decision is whether to hedge or not to hedge the currency exposures. Currency hedging can be strategic or tactical. Strategic hedging normally involves choosing an optimal, but more or less static, hedge ratio. In contrast, Mellon Capital's Currency Overlay Strategy tactically alters hedging positions based on the latest expected currency returns.

REAL INTEREST RATE DIFFERENTIALS

Mellon Capital's currency research dates back to 1993 when Tom Hazuka, our chief investment officer, coauthored the original research. Their groundbreaking results based on relative currency misvaluations were published in the Financial Analysts Journal: "A Valuation Approach to Currency Hedging" (March 1994). The paper defined the economic cost of hedging as an opportunity cost, and compared expected returns from hedging currency exposure with returns from not hedging.

The following example illustrates our approach. In early 2001, short-term interest rates were around 6% in the U.S. and 5% in Euroland. Hedging the euro would have locked in the forward premium of 1%, which is set by the nominal interest rate difference (6% - 5%). Leaving the euro exposure unhedged would have captured...