

Currency Alpha: Opportunities for Adding Value Through Currency Overlay

Ralph P. Goldsticker III, CFA
*Managing Director,
Investment Research*

Currency overlay programs separate the management of the currency exposures of a portfolio from the management of the other aspects of holding assets denominated in foreign currencies. There are multiple reasons to enter into a currency hedging program. However, they can be grouped into two camps. The first involves reducing the currency risk that comes from holding assets denominated in foreign currencies, and the second is the pursuit of higher returns by systematically (and correctly) adjusting one's currency exposure.

Before one enters into an active overlay program, one must determine their strategic or neutral currency hedging position. There is extensive literature on the risks involved in holding assets denominated in foreign currencies and the appropriate amount of that risk to hedge. The key points are that currencies do not offer a risk premium, and unless one forecasts that in the long run the local currency will underperform the foreign, the currency risk will not be compensated. From there, the debate evolves into the proper amount of hedging. The arguments revolve around the amount of currency risk in the portfolio, the cost of hedging, and the degree of correlation of the currency risk with the other risks of the assets and liabilities in the portfolio. If one enters into an overlay program solely for the purpose of risk reduction, the larger the currency exposure, the more volatile the currencies, and the lower the cost of hedging, the more one should hedge the currency risks. On the other hand, with smaller foreign holdings, higher costs of hedging, or if one gets a diversification benefit from holding currencies (changes in their value are positively correlated with changes in the liabilities), the less one will hedge.

Once one has determined their strategic currency hedging position (passive or strategic overlay), they should address two more questions. The first is whether the currency positions taken by the managers of the foreign assets will add value relative to the strategic (policy) exposures, or if the active exposures are simply a byproduct