Forward Points:
Ideas from Corpay Institutional

By Andrew Shortreid,
Global Head of Corpay Institutional

Forward Points is an editorial series created by Corpay Institutional. It explores the practical challenges that alternative fund managers, investors, and service providers face as a result of their cross border investment activities, providing readers with novel insights and actionable strategies to address these challenges and enhance the way they think about their international activities.

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Forward Points II: Hedging for Alternative Funds

By Andrew Shortreid, Global Head of Corpay Institutional

*This transcript is based on our recent podcast.
It has been edited for length and clarity.*

What is FX hedging, and why it is important in the institutional space

Hedging is a tool. It's a process that market participants, investors, corporate treasurers and other people responsible for financial performance within organizations use to manage uncertainty and to mitigate risk. Foreign exchange (FX) risk arises where an organization or fund has assets, liabilities or cash flows denominated in a currency other than their base or reference currency, and as a result they have a financial exposure to fluctuations of one or more exchange rates.

Markets abhor uncertainty. The idea of uncertainty poses very real problems for fund managers who are continually trying to optimize how they think about their portfolios and position their assets.

Modern portfolio theory is effectively based on the concept of diversifying away all of the risks for which you're not receiving compensation.

The main practice within portfolio management, then, is to be compensated, to some extent, for each and every risk you take. Therefore currency risk is a factor that, generally speaking, most portfolio managers want to eliminate from the calculus in their fund returns.

The only time that FX hedging wouldn't really be on the radar for an institution or large fund is if they have a global breadth of foreign exchange exposures that provides sufficient diversification to achieve a minimum variance state without hedging.

There are very few investment entities for which this is truly applicable. The majority of funds, in private equity and private credit, real estate, and other asset classes, are just not that diversified geographically. So hedging is a way to minimize those FX risks, and isolating the return of their funds to the investment decisions that they're making on a daily or monthly basis.

Factors contributing to currency volatility

Equilibrium is the base state for all markets. Volatility comes from some disruption to that equilibrium. Markets really enjoy certainty, don't like surprises.

In any marketplace, buyers and sellers come together find an equilibrium price that represents a fair rate of exchange between two assets. Each market represents the sum total of all information that's available at any point in time, plus a consensus view on future events, and this pool of public knowledge is then reflected in the current prices of all assets. When those assumptions or beliefs are challenged so significantly that there's a shift in expectations of a large group of investors or market participants, you're going to see rapid price movements up or down.

FX—foreign exchange—is a market just like any other financial market. In this case, the assets traded are currencies.

Disrupting factors in FX can include geopolitical events, political or economic instability, significant changes to inflation and interest rates, even climate and natural disasters.

Certain factors will lead to lasting volatility, and others can be more temporary in nature. For instance, natural disasters don't often impact the long-term competitiveness or economic strength of a nation, which is effectively what a currency represents.

And so while you might see a tsunami in Japan or an earthquake in another country causing currency volatility on a short term basis, those are rarely reflected in longer term prices.

Market participants

We're focusing here on hedging, and so we are predominantly observing the world from the hedger's perspective. But we also have speculators or investors that are active in the markets, and they're all coming at their investment decisions from different angles.

Some of them, like the hedgers, are looking to immunize or eliminate risk. Others, like speculators, are placing bets in order to generate profits for themselves based on a certain view that may differ from the market consensus at a given point in time.

[1] Special Purpose Vehicles
[2] General Partnerships

So currency volatility can be the result of any number of factors, from the market at large as well as from the changes in the viewpoints of individual participants.

Why a fund manager might consider hedging currency risk

The goal for fund managers, in most cases, is going to be to protect performance on an absolute and on a relative basis.

From an absolute standpoint, you're looking to protect the gains that you may have generated from your core strategies in the currency of your investors, but you also may be measured against a benchmark in a specific currency.

[On a relative basis,] You may have different share classes, and you want to provide balance and equality in the performance between those classes without exposing one group of investors to different sources of return from another.

Think about it this way. An investor is paying the fund manager to make specific types of investment decisions, and to generate an outcome — good or bad — that is derived from those decisions. Active currency management is not typically a competitive strength of many fund managers and will mask performance trends in unhedged portfolios.

For many asset classes, currency volatility can be as high, or higher, than the volatility of their underlying investment strategy. This can lead to wildly different outcomes for hedged and unhedged portfolios. It's too much of a gamble for many managers to want to take.

Most fund managers are looking to protect performance and increase certainty. The point is to reduce risk, not open doors to new sources of risk for them and their investors.

Why and how to hedge: guiding principles

The only two qualifications that you really need in order to be an active hedger in the FX markets are these:

- First: you need to have an exposure that you want to optimize;
- And second, you need to have the requisite knowledge and experience to be able to make good decisions for your fund and your investors.

That's really the crux of it: making sure that what you're doing makes sense for the fund, for its structure, and its goals. That is what's going to guide your actions from a hedging standpoint.

We speak with many fund managers who are cautious and deliberate in in their views on FX and hedging. For most people, it's not a core area of their expertise in the financial markets. They don't want to make a mistake.

We do a lot of work to support portfolio managers, with investment executives, as well as with corporate treasury and other areas, and to help educate them on the strategies, on the tactics, on the role of governance within this structure, and how to implement policies effectively.

We also work with a large number of FX risk advisors, who are an independent voice in terms of helping managers understand their exposures and manage them on real time basis.

The role of governance in creating a hedge policy

The process of putting a hedging policy in place starts at the very top of the organization with the governance structure. This is usually laid out for the fund at its inception by its leadership and key stakeholders. Even seed investors typically have some insight into how they like the fund to manage currency exposure.

Everything flows from there. That is absolutely the starting point.

Funds will have written policies around risk management, and around the investment procedures they're going to be taking. How these risks are controlled, how they're reviewed. The core beliefs of the fund and the managers are all going to be stated, as would what would be required in order for those views to change.

[3] https://www.ey.com/en_lu/insights/wealth-asset-management/private-debt-an-expected-but-uncertain-golden-moment

Again, that's the critical starting point: ensuring that a strong governance framework has been designed and then implemented.

Administrative needs also have to be met as part of this process. Your Finance team needs to be properly trained and educated in terms of how FX and hedges are going to be treated on the financial statements. Your Markets and Operations Clearing team need to understand how trades are going to be settled and where the reporting is going to come from.

The portfolio concerns need to be noted as well, in terms of how the fund may be structured and managed. Your Portfolio Management team will potentially need to access new reports to see how their exposures are changing as a result of FX hedges, and how changes in asset allocation impact the hedging needs of the portfolio.

So it's not just purely policy or theoretical. It is also practical. Throughout the organization, from leadership through administrative functions, policies and procedures need to incorporate what's necessary to truly operationalize an ongoing hedging program.

Policies and considerations for different fund structures

There is a wide variety of considerations to take into account.

- **First, duration.** When you're running a fund, and thinking about managing your FX exposure or optimizing it to meet your goals, you need to consider investments that you're making over different durations: short-term, long-term, and the tenor for individual assets.
- **Second, liquidity.** You're also thinking about how those different assets are structured with regard to the underlying investment. Be it real estate, venture capital, private debt, private equity: you need to think about the constraints that you have with each of those investments, the liquidity requirements that may be underpinning each one of those assets, and ensuring that your policies are built from a bottom-up standpoint.

Differing regulatory and reporting requirements

Another aspect of the fund management process from the hedging standpoint is the regulatory or stakeholder reporting requirements, which might depend on the different activities you do for different asset classes with different durations.

So you will be undergoing regular auditing and reporting performance on the individual hedges as well.

It comes back to that equilibrium point: every consideration, every action that a fund might take, or the fund manager might take, is part of maintaining that equilibrium and reducing risk and protecting gains. Currency hedging is really only a part of that.

Common hedging tools in international investment practice

To a certain extent, the tools and hedging products chosen depend on the fund structure and its goals. The principal method that we typically see funds hedge with is forward exchange contracts or currency swaps. We don't see a lot of options exposure.

This goes back to the concept of providing certainty to investors and to the managers. If you can immunize exposure through a specific contract at a specific tenor, that's predominantly the method that you as a fund manager would use for hedging.

As I like to say, there are really smart people doing really difficult things in this marketplace. So they will be looking for tools that add certainty, and that don't expose them to undue risk, and that can benefit them and their investors. They're not looking to get too cute, not looking to over-engineer these structures or get too clever in their hedges.

It's less about the products and more about how they're used, the structure of their hedging, how they're layering them out and over what period of time. How they might be breaking them up and rolling them on an ongoing basis to align with the specific cashflows and underlying liquidity circumstances of their fund.

We do see a lot of rolling or laddered hedges, where a portion of the exposure is hedged for each month. It's probably the most common structure.

A fund might hedge out a bit further if they have a specific liquidity event that they're trying to protect against.

In private equity, for example, they might have a deal that's been signed and that is going through confirmatory due diligence. They might expect the transaction to close in three months or four months. So they might set up a bullet hedge for that specific event.

Other funds with a more diversified or evergreen style of assets, say, in private debt, might be rolling hedges on a monthly basis out over 12 months.

Different investment types and risk considerations might require different tools

It comes down to what is the investment activity that the fund is performing, and how they want to manage that risk.

For private real estate, you might have a fund structure with multiple projects underneath it. You would have different durations and different SPVs[1], and you would be thinking about hedging those on an asset-by-asset basis. They're going to have different investors, different tenors, and different needs.

You also might be raising debt in the local currency for a project as well. So that would be different from, for instance, a fund of funds, or a private debt fund with different assets commingled in a single pool.

A single asset fund, for instance, might not require the frequent mark-to-market reporting that another structure, with more frequent investor liquidity subscriptions, would.

The activity — the underlying assets and structure of the fund — align to different tools.

As for investment cadence, a manager might need to hedge the period between a capital call and delivery of funds. The manager might want to hedge the period between an investment being announced and when it's actually being closed. They may want to hedge distributions that are either being paid or received from the underlying funds. So it is based on those activities.

There is a wide range of risk factors, as well as performance factors, that need to be considered, along with the interplay between how a hedge will impact your performance and how it impacts your cash flows.

Final takeaways

I think the most important takeaway on FX hedging for funds is that it starts with a strong governance framework, combined with a clear understanding of the ongoing activities the fund is looking to execute on. With both of those well-defined, you'll be in a much better place to draft meaningful policies and robust procedures at the outset.

You must also have a really clear understanding of what your team needs in order to be able to make decisions. And you also need to have the discipline to be able to stick with the policy once it's been set. You can't decide to hedge and then drift away from that implementation. It has to be codified permanently within your structure.

A strong policy, weakly held, is problematic. You need to have the systems and ability to clearly identify and understand your exposures and assess risk, both in your portfolio as well as in the hedges that you put in place to manage it. You need to understand under what circumstances you may become over-hedged or under-hedged, and to be able to calculate what worst-case outcomes might look like. Either way, if your assets are changing in value, you need to be aware that you might have some decay. How much can you tolerate?

You might see wider swings in different currency pairs, which might put a little fear into the hedger. If your assets are changing in value, you need to have a solid playbook to guide your actions and keep you grounded to policy.

What is your tolerance for deviation from policy? Under what circumstances do you have latitude to change your mind? These need to be codified in your fund's governance, documentation and structure.

It's important to understand how your portfolio is structured and where currency risk can bite. Even in periods of low volatility, you can see 10, 15, or even 20% swings in the value of a currency pair over the course of the year. Obviously if you're hedged, then your portfolio will be protected from a performance standpoint, but there may be cash flow considerations that exist as an offset.

Hedging in this industry is generally regarded as a tool to manage risk, not one for speculation. It doesn't need to be complicated, but it should be thoughtful, deliberate, and aligned with the needs of the underlying portfolio and your investors.

[1] Special Purpose Vehicle

What comes next?

In our next piece, we'll expand on some of the specifics that fund managers and other stakeholders need to consider to create and optimize their hedging portfolio and their hedging policy for international investments.

And we'll address some of the nuances and second-order considerations.

About the author

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With over 20 years' experience across a range of capital market verticals, Andrew is a dynamic, well-regarded and experienced investment management professional. Over the course of his career, Andrew has founded and grown two successful businesses with private equity partners in the asset management space, was the lead Portfolio Manager at a top ranked multi-strategy hedge fund, and most recently was the CFO of one of North America's largest litigation finance funds. Andrew's unique mix of entrepreneurial, institutional and sales leadership experience make him well suited to lead Corpay's Global Institutional Sales team.

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To learn more about Corpay, or to set a meeting with Andrew and his global team, please connect with us for a call-back.

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The team operates from institutional FX desks based in London, Toronto, and Sydney, with local professionals working with institutional customers from branches in Jersey, Madrid, Dublin, Rome, Los Angeles, New York, Singapore, and other key financial hubs around the world.

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