Corpay Institutional

Forward Points II:
Hedging for Alternative Funds

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About Forward Points: Ideas from 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.

In our first post in the series, we introduced Corpay Institutional and its global practice. We looked at the macros: the challenges and the opportunities in today's global investment environment, and an overview of broad industry trends.

In this editorial, we move from the theoretical and the macro to the more practical, delving into FX risk management strategies and how to design and implement a hedging program.

We explore some of the factors that cause currency volatility, what goes into creating a hedging policy that accounts for risk appetite and investment parameters, and how some hedging tools work.

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In any market, buyers and sellers come together to find an equilibrium price that represents a fair rate of exchange between assets. Markets like certainty: volatility comes from disruption to that equilibrium.

The foreign exchange market is a market like any other. Disruptive factors can include geopolitical events, economic instabilities, significant changes to inflation and interest rates, even climate and natural disasters. Fund managers are typically tasked with reducing or mitigating undue risk to maintain focus on investment's performance, not the impact of currency movements. Developing and implementing a strategy to hedge FX risk is an approach many fund managers consider.

Typically, a fund's risk appetite, including currency risk, is codified in the Fund policy documents, agreed by leadership and guiding the actions of everyone from investment managers to accounting teams. Everything stems from that framework.

Hedging for Alternative Funds

Hedging is a tool

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

For most institutional investors and fund managers, hedging currency risk is a tool used to help reduce uncertainty stemming from changes in foreign exchange rates. Because currency movements are unpredictable, and there is no consistent return premium observable in currency, maintaining this as an unhedged exposure in a portfolio is often viewed as suboptimal. Hedging allows managers to mitigate risk and isolate the performance of their funds to the investment decisions that they're making on a daily or monthly basis.

Factors contributing to currency volatility

Disrupting factors in the FX market can include geopolitical events, economic instabilities, significant changes to inflation and interest rates, even climate and natural disasters.

Certain factors will lead to lasting volatility; others may be more temporary. Natural disasters, for example—a tsunami, an earthquake— can have significant short-term impact on exchange rates, but they don't often impact the long-term competitiveness or economic strength of a nation, which is effectively how currencies are priced on a long run or equilibrium basis.

FX Market participants

The FX market includes different participants: hedgers; investors; speculators. Each one of these participants will interact with the market in a way that provides them utility and results in them obtaining a desired risk-reward profile. Currency volatility can result from the macro events such as the ones noted above, or it can come from changes in the viewpoints of large groups of market participants.

For our purposes, we are looking through the lens of a participant who is hedging to immunize or eliminate FX risk.

Considerations in hedging currency risk

For most fund managers, the goal is to reduce risk, not open doors to new sources of risk for them and their investors.

Annual currency volatility can be as high, or higher, than the mean annual return (or expected return) of a portfolio's underlying investments. This can lead to wildly different outcomes for hedged and unhedged portfolios.

In short: investors are paying fund managers to make specific types of investment decisions, and to generate an outcome — good or bad —derived from those decisions. Active currency management is not typically a competitive strength of many fund managers. At best, it may cloud performance trends in unhedged portfolios. At worst, it can lead to poor relative performance or even negative absolute returns despite positive returns on the underlying assets.

Guiding principles for hedging: why and how

There are two basic qualifications that you need to be an active FX hedger:

- 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: ensuring that what you're doing makes sense for the fund, for its structure, and its goals. That is what will guide your actions.

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.

We work closely with portfolio managers, investment executives, FX risk advisors, as well with corporate treasury and other disciplines, to help educate them on the strategies, the tactics, the role of governance within their fund structure, and in effective implementation.

The role of governance in creating a hedge policy

Putting a hedging policy in place starts at the very top of the organization. The governance structure is usually laid out at the fund's inception by its leadership and key stakeholders.

Everything flows from there.

Funds will have written policies around risk management and investment procedures, and how these risks are controlled and reviewed. The governance framework addresses implementing these policies as well: administration; finance and accounting; settlement, reporting, and measurement.

So it's not just purely policy or theoretical. It is also practical.

Policies and considerations for different fund structures

When you're running a fund and thinking about managing and optimizing FX exposure to meet your goals, you need to weigh short-term and long-term investments as well as individual assets' tenors.

You also need to consider how different assets are structured with regard to the underlying investment and what constraints require consideration, such as the liquidity requirements underpinning each of those assets, to ensure your policies are built bottom-up.

Differing regulatory and reporting requirements

Funds may have different regulatory or stakeholder reporting requirements based on the asset classes they are investing in. The investment duration or expected holding period can also impact reporting needs. Managers should seek to align their hedging program so as to not conflict with any of their regular auditing and performance reporting requirements.

Different risk considerations might require different tools

The tools and hedging products chosen largely depends on the fund structure and its goals. However, the principal hedging methods we typically see are forward exchange contracts or currency swaps. We see some collar structures used for certain protection strategies, but otherwise don't observe much options exposure in this market segment.

> There are really smart people doing really difficult things in this marketplace. They will look for tools that add certainty, immunize them against undue risk, and that can benefit their investors.

It's less about the products and more about how they're used: the hedging structures; how they are layered and over what period of time, settled, or rolled to align with the specific cashflows and underlying liquidity circumstances of their fund.

There is a wide range of risk factors, as well as performance factors, to be considered, along with the interplay of the hedge performance and its impact on cash flows.

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

A strong policy, weakly held, is problematic

This is a process. Be sure you and your team are clear on what's needed to make decisions. Managers must have the discipline to stick with the policy once it's been set. You can't decide to implement a hedging strategy and then drift away from executing it because the currency moves against your hedge contracts. The benefits of a hedging program come from first ensuring it is well fitted to your strategy and thereafter implemented consistently. It must be codified permanently within your operational framework.

Systems must be in place to help your identify exposures, and understand and assess risk. Not just in your portfolio, but also having the ability to monitor how the hedges that you have implemented to manage that risk are performing. It is critical to have knowledge regarding what circumstances might cause you become over-hedged or under-hedged. What do your worst-case outcomes look like? Either way, if your assets are changing in value, you might have some decay and end up with an increasingly imperfect hedge. How much of this slippage can you tolerate?

Final takeaways

I'll take us back to the fundamental point: every action that a fund might take, or the fund manager might take, is directed at adding value in some way. Fund managers are almost always thinking about risk or thinking about returns. Generating returns is the hard part and managing risk, while not elementary, can be greatly simplified with the right partners. Currency hedging should be an essential part of the investment mandate for any fund with cross border exposures. Implemented properly, it is a powerful tool with a specific structure and purpose, that can also be easily tailored to meet your specific investment framework and fund goals.

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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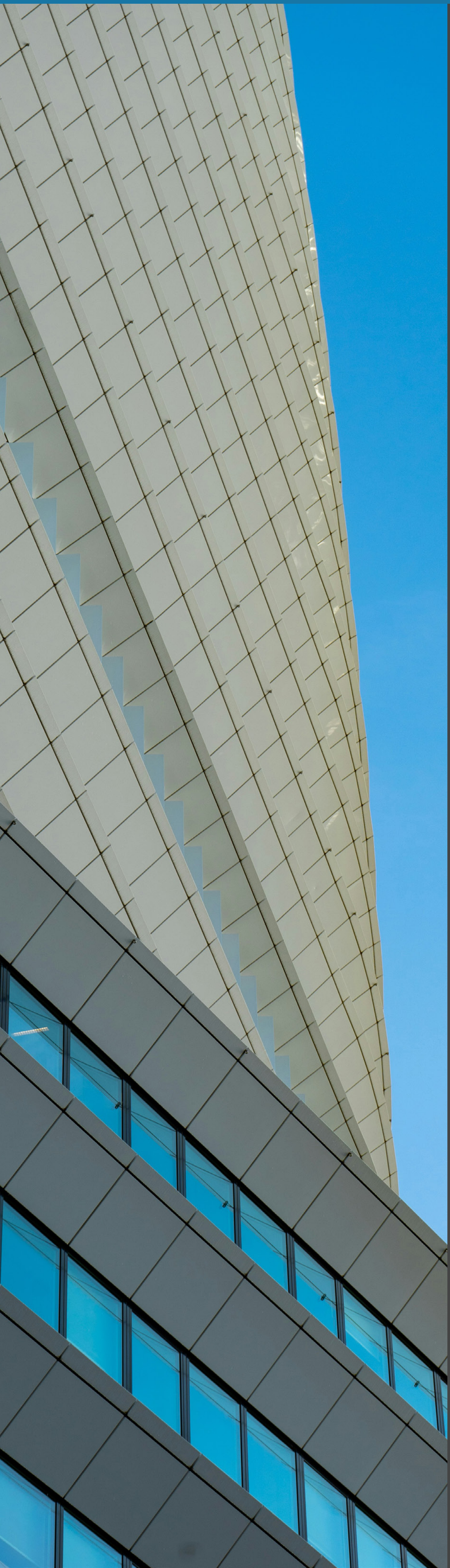

About Corpay Institutional

Corpay Cross-Border's Institutional team supports practitioners across the spectrum of the international funds and institutional sector, providing a portfolio of foreign exchange, global payments and currency risk management solutions tailored to their unique needs.

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.

About Corpay

Corpay, Inc. (NYSE: CPAY) is a global S&P500 corporate payments company that helps businesses and consumers pay expenses in a simple, controlled manner. Corpay's suite of modern payment solutions help its customers better manage vehicle-related expenses (such as fueling and parking), travel expenses (e.g. hotel bookings) and payables (e.g. paying vendors). This results in our customers saving time and ultimately spending less.

Corpay Cross-Border refers to a group of legal entities owned and operated by Corpay, Inc. Global businesses and institutions trust Corpay Cross-Border Solutions to power their international payments, execute plans to manage their currency risk and support their growth around the world. We aim to deliver unmatched service and expertise with respect to moving money globally.

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