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Currency Risk in Alternative Investments: A Compilation

Structural Challenges and Practical Solutions in Private Markets
by Sean Coakley, CFA





This eBook compiles four articles, written by Sean Coakley, which examine the structural challenges private market investors can face when managing currency risk and some practical solutions.

Sean starts with the fundamentals of uncompensated FX risk in cross-border investment and explores how collateral requirements create cash drag that erodes returns. We then look at how specialty brokers can unlock capital efficiency through flexible credit facilities. The series closes on ways to manage the potential operational bottlenecks of SPV banking and currency management.



Key Takeaways

- **Currency risk is uncompensated risk.**
Unhedged FX exposure can increase volatility by up to 15% and amplify drawdowns by more than 30%, without delivering commensurate returns. For private credit funds targeting 12-15% IRRs, annual currency swings can erode, or potentially erase the targeted return.
- **Collateral requirements and cash drag.**
Traditionally banks have required 5% upfront collateral for FX hedges. On a \$200M exposure, that's \$10M sitting idle, capital that could be earning returns.
- **Banks are structurally constrained.**
Basel III and Dodd-Frank rules can inhibit banks from extending meaningful credit lines to private credit funds for FX hedging, especially for illiquid “level 3 assets,” which are often more difficult to value.
- **Specialty brokers may offer alternatives.**
With a credit review, a non-bank provider may be able to furnish hedging lines with reduced or zero collateral, flexible margins. Tools like Historic Rate Rolls (HRRs) can extend hedges without cash settlement.
- **SPV structures can create banking bottlenecks.**
In a highly competitive business sector, currency hedging might be a challenge.

Chapter 1

Uncompensated Risks: Currency and Cross-Border Investment

When investors commit capital to assets denominated in foreign currencies, they are often taking on more risk than they realize. Before examining the operational and structural challenges of managing FX exposure, it's essential to understand a foundational concept: currency risk is typically uncompensated.

I have often observed a tendency for global investors, as well as for corporates, to handwave the relevance of currency risk in their investment process: in effect, leaving the impact of currency volatility on investment returns as an afterthought.

There are some convenient, but potentially flawed, heuristics that are often relied upon to justify ignoring the impact currency movements have on investment returns.

- **'It all evens out over time.'** In essence a reliance on the conceit of mean reversion, those up on their game see this as the point Nicolas Nasseem Taleb built his entire career dispelling. The reality is spot FX returns have tended to be highly asymmetric, especially on currency pairs that involve the USD. The reason for this is outlined in my earlier pieces on the USD and its centrality for global funding markets.
- **'It's immaterial.'** Even developed market currencies have tended to exhibit considerable variation on quarterly, biannual, and annual bases.
- **'Hedging is expensive.'** This isn't exactly true. As we will explore further in later articles in this series, there are many ways to make hedging cost effective and convenient.

In this opening chapter, Sean explores why foreign exchange exposure adds volatility without improving expected returns and why this dynamic is especially problematic for private market strategies targeting mid-teens IRRs.

Digging into the data.

The reality is, when you are buying an asset denominated in a foreign currency you are executing two trades, not just one. The first is a directional exposure to the asset you actually want. The second is a directional exposure to the currency that the asset is denominated in.

From earlier articles you may have picked up on the fact that I am a fan of AQR Capital Management and the work of its Managing Founder and Principal, Cliff Asness. In their research on public market investing, they found the following.

Currency exposure tends to meaningfully add to portfolio risk without providing commensurate compensation. Historically, unhedged developed market currency exposures have delivered negligible returns while increasing volatility by up to 15% and amplifying drawdowns by more than 30%. In effect, portfolios take on incremental risk without any associated reward – a scenario antithetical to prudent investment management.

Source: AQR Research White Paper: Risk Without Reward: The Case for Strategic FX Hedging (September 18 2015): Jacob Boudoukh, Michael Katz; Matthew P. Richardson Ashwin Thapar

While volatility itself is often derided as an inappropriate measure of risk and the realm of quant nerds, investors are highly attentive to drawdowns, to the point they can be career-ending for fund managers.

Chapter 1

Uncompensated Risks: Currency and Cross-Border Investment

What About Alts?

Anyone who has been paying attention to markets is aware of the massive increase in capital-under-investment mandates in illiquid securities like private credit, real estate, private equity, and venture capital.

There is an argument that much of the growth in this asset class is due to its illiquid nature suppressing measures of risk like volatility, standard deviation, and drawdowns. Whether that is true or not is outside of the scope of this article, but the reality is that not even illiquid asset investors are immune to the impact of currency movements on their returns.

Private credit investors typically target annual Internal Rates of Return (IRRs) in the range of 12 to 15%. Yet the average annual peak-to-trough movements in developed market currencies like the CAD, AUD, USD, and EUR tend to routinely approach, match, or even exceed these return expectations. In other words, an unhedged cross-border private credit investment might face currency-driven volatility that rivals, or at times exceeds, its entire targeted annual return.

Worse still, as evidenced in the work of AQR and others, unlike credit spread or illiquidity risk, FX risk is not a well-compensated risk factor. There is no built-in premium for bearing currency volatility; it is an uncompensated risk that can arbitrarily erode returns.

Despite this, many investors continue to leave FX risk unaddressed. Why? While I have a few theories, lack of awareness of the impact of FX movements is one. Likely more influential, but less often discussed, are the structural barriers, operational complexities, and institutional inertia around deploying FX risk management, which may stand in the way.

The Case for Hedging

Fortunately, effective hedging strategies can, using products that have pros and cons, mitigate the majority of this downside risk, even in emerging market currencies or currencies that have a high cost of carry. As shown, effective FX hedging can drive value creation for investors who do it right.

At the end of the day, we don't work for free, so, arguably, why would we take on risk without trying to get compensated for it?

In upcoming pieces, I will explore the structural constraints that can prevent investors from implementing effective FX risk management programs, and I will illustrate solutions I have developed to help mitigate those constraints.

If currency risk is uncompensated, the next question is how investors attempt to manage it—and at what cost. For many private market funds, the answer lies in hedging programs that introduce a less visible, but potentially damaging, drag on return.

Chapter 2

Cash Drag: The Hidden Cost of Protecting Returns

Hedging currency exposure is often viewed as a defensive necessity. But in private markets, the mechanics of hedging can quietly erode performance through collateral requirements and idle capital.

In this chapter, Sean Coakley covers how cash drag emerges from traditional FX hedging practices, why illiquid assets exacerbate the problem, and how even modest collateral requirements can materially raise return hurdles for private credit and other alternative strategies.

Earlier, I explored how global investors are often not sufficiently compensated to bear FX risk, yet there is still a tendency to avoid FX hedging on the part of investment managers. My personal opinion is that this is not due to ignorance around the impact of currency movements on investment returns but instead to operational and structural barriers which sometimes make it difficult for investment managers to actively hedge FX risk.

Key amongst those barriers? **Cash Drag.**

What is Cash Drag?

'Cash drag' is the silent erosion of returns when capital sits idle instead of being deployed into investments.

For funds executing FX hedges through banks or prime brokers, cash drag arises from the collateral deposit requirement to support those hedges. Historically, initial collateral requirements for forward contracts amounted to 5% of the notional value of the contract.

You can see why this could be a problem: if a fund manager had a \$200M USD FX exposure that they wanted to cover, they would need to post \$10M USD to support the hedge.

Beyond that, imagine a fund targeting a 12% net return for investors. If 5% of its capital is tied up as collateral, that

leaves only 95% of capital deployed to generate returns. To maintain a 12% net return, the deployed assets now need to yield over 12.6%, a materially higher hurdle.

Collateral, Margin & Credit – Uniquely Challenging for Illiquid Assets

The reality is that margin lines can be accessed from prime brokers, and depending on your counterparties, you may be earning yield on your collateral, so it's not all bad. Yet the ability of fund managers to access collateralized hedge facilities varies widely, and often the underlying investment in the fund greatly impacts the ability to access FX hedging lines. This is especially the case with fund managers investing in illiquid asset classes like Private Debt, Private Equity, Infrastructure and Real Estate.

Why is this?

Banks and prime brokers require margin for one fundamental reason: to protect themselves against the counterparty default risk that arises when derivative contracts lose value due to market movement. In fact, in many asset classes and markets, it is a regulatory requirement that derivatives be collateralized or margined.

For public markets investors it is relatively easy to assess the value of publicly traded assets. The market prices

Chapter 2

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refresh frequently; the assets themselves are liquid so it can be easier to take custody or sell them to cover margin when hedgers can't cover margin calls.

In private credit or any illiquid non publicly traded asset, potential default risks are amplified by structural realities:

1. **No easy mark-to-market.** Unlike public equities, private credit valuations are model-based and infrequent, making these investment vehicles more difficult to underwrite for daily margining. These 'level 3 assets' require specialized knowledge and quite a bit of judgement to value, banks and brokers are often not up to the task.
2. **Illiquid Assets.** If a margin call is missed, seizing and liquidating underlying private loans or private equity stakes is a process that is complex, slow, and often involves very expensive legal counsel. This can make brokers and banks more reluctant to provide uncollateralized facilities in the first place.
3. **Fund Structure.** Historically, private assets were held mostly in closed ended funds, either directly or allocated to the fund via proportional interest in a Special Purpose Vehicle (SPV), with a limited time horizon of 5-7 years, after which it would be wound down. This would be relatively easy to evaluate and understand. The growth in Evergreen and open-ended fund structures holding illiquid assets has altered this landscape, making assessing fund-level liquidity more difficult to model and underwrite.

In the end the universe of potential investments and fund structures is almost limitless. There is no one-size-fits-all: traditional banks and brokers may not have the flexibility or capacity to deliver solutions to fund managers that allow them to hedge currency risk in a way that is both efficient and minimizes the impact of cash drag on their investment performance.

This is where providers like Corpay can help fund managers address FX risk while breaking free from cash drag and onerous margin requirements.

Cash drag is not simply an inconvenience; it can stem from deeper structural constraints within the banking system. To understand why these costs persist, it's necessary to examine the regulatory and balance-sheet limitations that shape how banks provide FX hedging to private market investors.

Chapter 3

Breaking Free from Collateral and Cash Drag

The global regulatory environment has fundamentally changed how banks extend credit and manage risk. For private market investors, these changes have narrowed access to flexible FX hedging solutions and increased reliance on cash collateral.

Previously we explored how the collateral required to hedge FX exposures with banks or prime brokers creates cash drag, eroding private credit returns.

But why is it so hard for private credit funds to access hedging lines?

The answer lies in regulation.

Banks are constrained by Basel III and Dodd-Frank rules, which require them to provision capital against uncollateralized exposures and register as swap dealers. Structurally, this prevents them from extending meaningful credit lines to private credit funds for FX hedging.

So what's the alternative?

Specialist brokers, like my own firm, are regulated differently, and may have less constrained balance sheets, and ROIC (Return on Invested Capital) that are higher than lenders. Most importantly, they may have specialist underwriters willing to go the extra mile in due diligence while servicing the commercial requirements of their clients.

Often specialty brokers are able to furnish clients with hedging lines that require less upfront collateral (and at times, no collateral), with flexible or no margin

In this chapter, Sean unpacks why traditional banks are structurally constrained by post-financial crisis regulations, and how many specialty brokers and non-bank providers are able to offer alternative hedging solutions that preserve capital efficiency.

requirements, and have maximum tenors that can extend for years.

This creates an entirely different economic outcome for funds. Instead of tying up 5-15% of capital to support hedges, 100% of fund capital remains deployable into yield-generating assets.

Historic Rate Rolls (HRRs): A unique tool

Prior to the Global Financial Crisis era, Historic Rate Rolls (HRR) were quite common. Instead of being obligated to a cash settlement at expiry of a forward or swap, the swap could be extended with the execution rate adjusted to reflect the new forward rate (typically with a charge for the embedded credit extension). Since this charge is based on wholesale lending rates, fund managers would often opt for the HRR rather than tie up cash in the settlement of an OTM position.

Post GFC, HRRs have become scarce. The banks that used to provide these sorts of facilities have stepped out of the market. Instead, cash settlement at mark-to-market has become mostly mandatory. It's rare that a fund manager would be happy to call investor capital to settle hedges, but sometimes they are left with no choice. Admittedly, that's an extreme example; but even then the ability to roll hedge expiries to more effectively match short term liquidity means funds can stay closer to fully invested.

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Why does this matter?

Returns matter. Every dollar immobilized by margin requirements or reserved to settle hedges is a dollar not earning a return. In a market flush with capital, where fund managers need to compete, brokers offering solutions that improve liquidity management offer a structural advantage: uncompensated risk reduction via FX hedging without sacrificing returns via cash drag.

Even when hedging structures are optimized, investors may still face operational challenges that can slow execution and strain liquidity. Nowhere is this more evident than in the banking infrastructure supporting special purpose vehicles (SPVs).

Chapter 4

SPV Banking and Currency: The Hidden Bottleneck in Alternatives

Special purpose vehicles are a cornerstone of alternative investment structures, offering legal and economic clarity for investors. But from a banking and currency management perspective, SPVs can introduce complexity, delay, and friction.

Many alternative investments, including private credit, real estate, private equity, and infrastructure, rely on special purpose vehicles (SPVs) to manage and hold assets. The SPV structures protect managers against liability, facilitate control, and align investor waterfalls, but they come with a hidden operational challenge: banking and currency management.

SPVs and Feeders (et al) are, in essence, legal entities created to hold a particular asset or allocation of an asset. They may be created to facilitate the pooling of funds from offshore investors that are subject to different tax rules, as is common in a Master-Feeder arrangement.

This arrangement is designed to hold assets that are then allocated across multiple funds, investors, or fund series, or provide a legal framework for different classes of investors who have different rights, risk exposures, or that sit in different parts of a return waterfall.

Add in the fact that LPs and SPVs can have multiple entities in multiple jurisdictions, and you can see why organizational charts can quickly come to resemble spaghetti thrown against a wall.

Complications

While each entity may have been created to serve a specific purpose, investment and operations teams are stuck with a tricky org chart to manage with regard to setting up each entity with accounts to collect, hold and disburse cash.

In the final chapter, Sean takes a closer look at how banking requirements for SPVs can create operational bottlenecks. He explores how non-bank providers are rethinking account structures and currency management to better align with the speed of private market transactions.

Legal requirements to satisfy local Anti-Money Laundering (AML) and Know-Your-Client (KYC) rules for bank accounts vary wildly between countries. Even in areas where rules are clear, banks often don't move with the same urgency that investors do. While a deal may take a few days to crystallize and close, it can take months to set up bank accounts for a newly incorporated entity.

So what's the solution?

Non-bank providers with strong cross-border correspondent banking capabilities can furnish GPs with virtual accounts in the legal name(s) of newly created SPVs. This grants access to local currency collection, holding, and disbursement in dozens of currencies, all under a single KYC process completed in as little as three business days.

The bottom line: Satisfying legal, regulatory, and return requirements can result in fund structures that are very complex. This complexity need not be a barrier to accessing global currency collection, holding and disbursement on a timeline.

This is where partners that understand fund structures can deliver innovative solutions that drastically reduce operational bottlenecks, close transactions faster, and keep their focus where it belongs, managing the dough and making it grow.

Conclusion

Currency risk in alternative investments is often framed as a market problem. In reality, it is an operational and structural one.

Across these four chapters, a consistent theme emerges: foreign exchange volatility can introduce uncompensated risk for private market practitioners, while the mechanisms designed to manage that risk frequently tie up capital, disrupt liquidity, and slow down execution. Regulatory constraints, collateral requirements, and fragmented banking infrastructure can all contribute to outcomes that run counter to the objectives of private market investors.

The solution is not to ignore currency risk but to manage it in a way that reflects the realities of private market structures. Providers who understand illiquid assets, fund mechanics, and the limitations of traditional banking models can help investors protect returns without sacrificing capital efficiency.

The question is no longer whether currency risk matters. It is rather whether investors are equipped to manage it to reduce operational friction that can erode performance.



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