# global money management QUARTERLY

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Institutional Investor Intelligence

# Swiss Investors Demand CHF Hedged Share Classes

Hedged options in funds denominated in foreign currencies are becoming a top priority for Swiss investors after the franc's rough ride during the summer months. An example of such an option is a fund that uses a blend of forwards and options bought from third parties to offer the asset class in the investor's home currency. "For many pension funds, collective investments where currency hedging is implemented within the fund have moved into the foreground," said **Stephan Skaanes**, senior investment consultant at **PPCmetrics**. Overlay programs are also attracting interest.


*Stephan Skaanes*

Hedging into the Swiss franc is mostly done by purchasing one-month currency forward contracts, among other techniques. The aim is to allow investors to access the returns from investments in other currencies without being affected by currency movements.

The importance of hedging against foreign currency risk is inflated by most Swiss investors being forced to look for opportunities abroad due to the low interest rates and a lack of choice on the local market. "It's a difficult situation, because, although we support the diversification benefits available through foreign investments, some Swiss investors have a lot of money on unhedged foreign currency exposure and so have become nervous about the whole idea," said **Michael Valentine**, an investment consultant at **Mercer** in Switzerland. He added that managers providing share classes hedged into the Swiss franc have an advantage in the local market, while those that don't offer one may find it harder to attract interest. "The dramatic impact of the strong Swiss Franc on the performance of foreign investments has made this more of an issue now than ever," he explained.

This consideration concerns primarily fixed income investments, which are strongly affected by currency fluctuations. Consultants in the region advise their clients to hedge only 50% of their equity exposure, since the diversification within these portfolios already has a hedging effect. "Our advisor, PPCmetrics, told us we can accept the risk with equities," revealed **Eric Noirjean**, manager of the **British American Tobacco** pension fund in Switzerland. The 21% exposure of the CHF350 million scheme to foreign bonds is fully hedged. "Hedging fixed income exposure is simpler and there are more vehicles on offer," explained Skaanes. Overlay managers tend to use futures for the task, since options are a more expensive alternative.

## LARGE VS. SMALL: OVERLAY VS. INTEGRATION

**Pensionskasse des Bundes PUBLICA**, which holds around CHF32 billion in assets, uses **Record Currency Management** as overlay manager for its fixed income portfolio and **Russell Investments** for the equity portion, and hedges 100% of its hard currency exposure. "Our philosophy is to partner with best-in-class asset managers, so we separate the foreign currency hedging programme from the underlying asset class," said Portfolio Manager and Deputy CIO, **Stefan Beiner**. Within this framework, a currency overlay is used to hedge all investments in foreign currencies, so there is no need for this to be built into the mandate by the incumbents managing each asset class. He pointed out that the preferred European equities manager, for example, may not possess the appropriate skills to manage the hedging task. **Roland Weiss**, chief financial officer at **BLPK Basellandschaftliche Pensionskasse**, painted a similar picture. The CHF5 billion fund also outsources currency hedging to Record Currency Management, which uses a currency overlay technique on 85% of the foreign currency exposure and 100% of the exposure to alternatives. Equity investments are not hedged. "As a large fund, we cannot avoid investments in foreign currency altogether," Weiss highlighted.

For smaller funds, the high costs associated with hiring another manager to handle the currency overlay in addition to the manager of the fund in which they're investing are a significant issue. This fuels a search for funds denominated in the local currency. "All the hedging is incorporated directly into the mandates held by our incumbents; any new funds we invest in must already be hedged," asserted **Mario Gmür**, manager of **PV PROMEA**, a smaller fund in Schlieren with around CHF1 billion in assets. "I would not consider an offer from a manager who doesn't provide this option," echoed **Heinz Eigenmann**, managing director of **Pensionskasse St. Gallischer Gemeinden**, with CHF1.2 billion assets under management. He has noticed more and more managers offering an option hedged into the Swiss franc, which is making diversification possible without taking on foreign exchange risk. He is convinced that the growing demand will drive more managers to introduce hedged options within their funds, and remains on the lookout for these. If such opportunities arise, he would swap funds held in foreign currencies for the equivalent hedged option. "Historically, the franc has been overvalued against all other currencies and it will remain this way, so if I did invest in foreign currencies, I would just lose out in the long run," he said.

## MANAGERS RESPOND TO DEMAND

Some asset managers from outside Switzerland have already caught onto this trend. In July, **Frontier Investment Management** launched a Swiss franc share class for its *FrontEdge Global Hedge Fund*, responding to demand from both institutional and retail investors in Switzerland. Most recently, boutique fund manager **Managing Partners Limited** has introduced a Swiss franc share class within its *Traded Policies Fund*, expecting demand for this offering to grow as the limited supply of funds denominated in the domestic currency dries up. "The recent events have emphasized the importance of launching our new share class," commented Managing Director **Jeremy Leach**, referring to the **Swiss National Bank**'s (SNB) decision to set a ceiling on the value of its currency. On Sept 6, the bank set a cap of 1.20 on the exchange rate between the Swiss franc and the Euro, in an effort to rectify the lack of demand for Swiss products from abroad due to unaffordable prices. The hope is that artificially pegging the Swiss franc to the euro will boost economic growth in the country.

**Thomas Liebi**, chief economist at **Swisscanto**, one of the largest asset managers on the local market with CHF57.6 billion (GBP41.2 billion) in assets under management, said it appears that some of the outflows in Euro-denominated assets have been reinvested in CHF-denominated funds, although he noted that asset managers do not have reliable information regarding money flows caused by currency fluctuations. "If an asset manager offers hedged and unhedged tranches, which is usually the case over here, a pension fund will just switch products," he said. Swisscanto has been launching fixed income funds with share classes fully hedged against various reference currencies since 2006, having noticed an increasing demand for currency hedging. These funds include *Absolute Return, Global High Yield, Global Corporate, Global Convertible* and *Global CoCo*. CIO **Peter Bänziger** has added that SNB's move has given a "second chance" to those pension funds that failed to hedge their currency exposure earlier.


*Peter Bänziger*

***—Anna Fedorova***

# Consultant Cue:

## Should European Funds Focus On EM Debt?

With this issue, *GMMQ* introduces a new feature, *Consultant Cue*, in which we ask prominent consultants in any given region a key question about current market trends. In this month's issue, we examine European consultants' views on emerging market debt—and whether that's still a good market to pitch in. Senior Reporter **Mirza Gazic** conducted this month's interviews.

GMMQ: Is emerging market debt still a good investment? What segment is the biggest trend at the moment and what future developments can we expect?

### MARK HORNE

**Senior Investment Consultant-Manager Research, Towers Watson**

This is a testing time for government bond markets, and in general it has served to reinforce our positive stance when it comes to discussing an allocation to EMD with clients. The more positive economic fundamentals that many emerging economies have, together with favourable wealth dynamics, continue to support their improving credit quality and market dynamics. This should, in the long run, lead to lower yields and stronger currencies compared to developed market currencies.

In general we suggest that clients invest in a mix of external and local currency EMD. We are mindful of the U.S. interest-rate risk that this includes, but for now continue to advocate this approach.

There has been a great deal of external corporate bond issuance, with corporations taking advantage of strong demand and low interest rates. That is expected to continue and to eventually evolve to issuance in local currencies by corporations. We fear that the corporate market is still rather nascent and therefore are not yet recommending any dedicated allocations.

Client interest remains strong and word about the potential benefits of investing in EMD has been spreading, which has been of, and should provide for, support for the asset class during volatile times. Ultimately, EMD will either cease to be a relevant term at all and the market will no longer distinguish between developed and emerging economies—which is where Towers Watson is heading—or mandates will migrate to a kind of EM Aggregate structure as the asset class broadens and deepens further, with suitable benchmarks being developed. We expect hard currency sovereign (debt) to be the smallest component of future issuance.

### TAPAN DATTA

**Senior Asset AllocationSpecialist, Aon Hewitt**

We think that emerging debt should be part of your long-term strategic asset allocation because it's an important asset class and it's growing fast.

However, in the next two to three years we would be underweight our strategic allocation. The reason is that the current economic conditions and some of the valuations are not attractive enough to be bullish. We think the underperformance seen over the last few months is likely to continue and would hold off on making investments at the moment.

The big growth story over the last few years has been corporate issuance and most of the quality corporate issuance has been in hard currency. Our preference there at the moment would be for corporates over sovereigns as the current spreads on hard currency corporates are a bit more attractive.

Then we have local currency, which for