

”How to make your assets work harder” – or using your existing cash and securities to full advantage.

Overview of the issues

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- Currency Management
- Securities Lending
- Possible sources of cost savings
- Conclusion

- Do our assets work hard enough?
- Is there money left on the table?

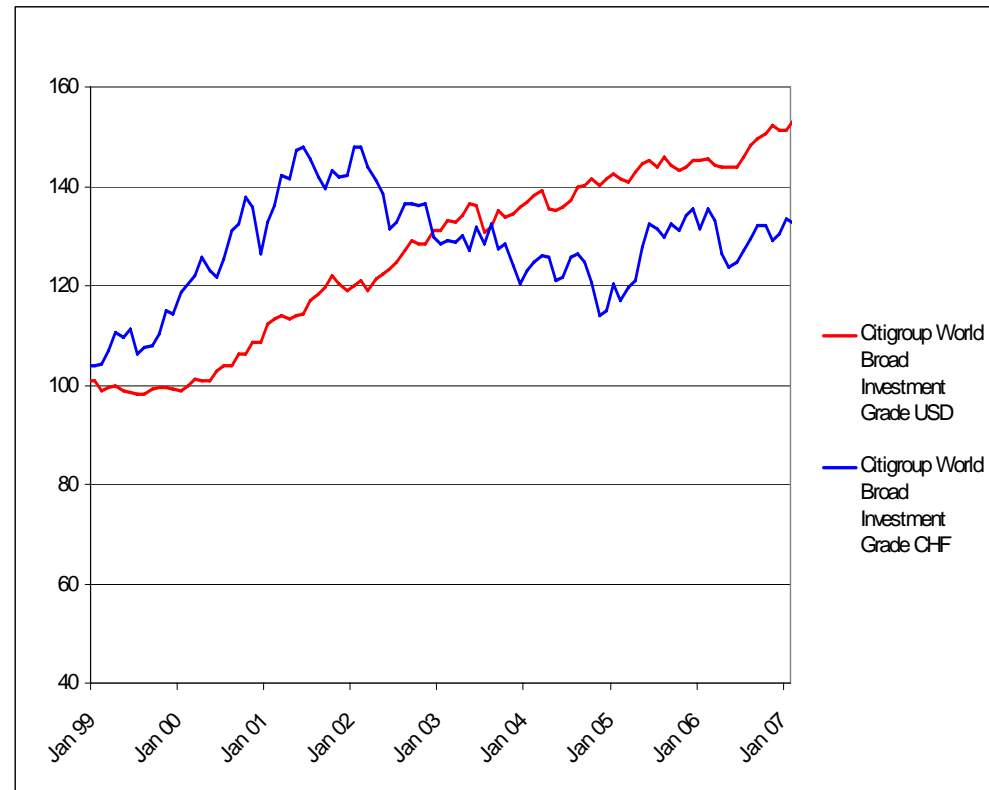
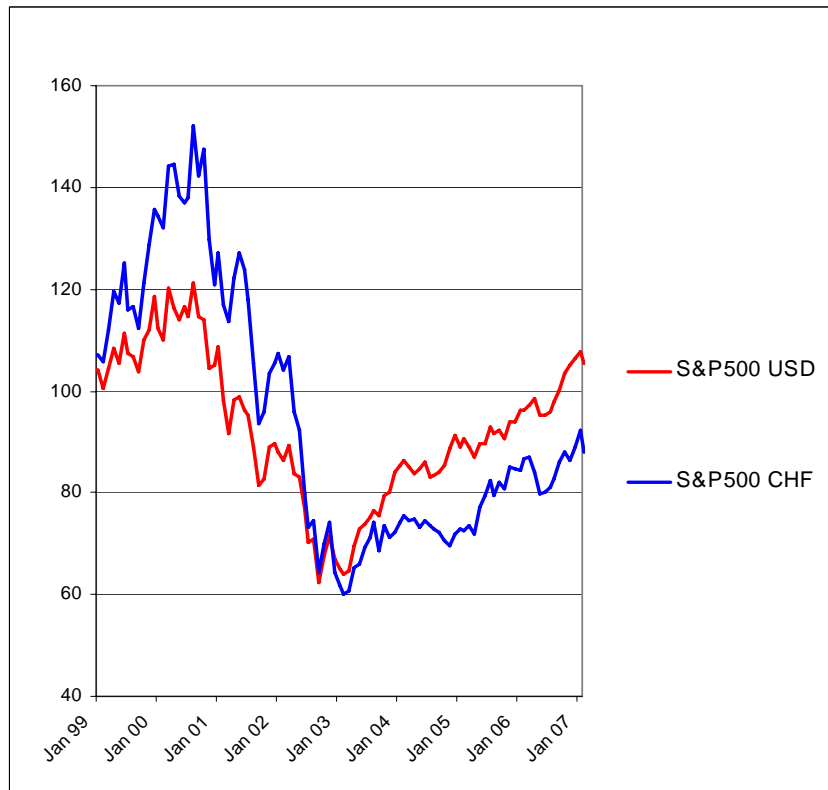
→ Is there a free lunch?

Currency Management: Fundamentals (1)

- The influence of the currency on the risk-/return-profile is different for bonds and foreign stocks. Generally the return of foreign bonds is more sensitive to changes in the exchange rate.
- Two major risk components for foreign bond investments:
 - Interest-rate risk
 - Exchange-rate risk
- By investing in foreign bonds the risk-/return-profile (measured in CHF) is dominated by the currency risk. The influence of the interest-rate risk is smaller.

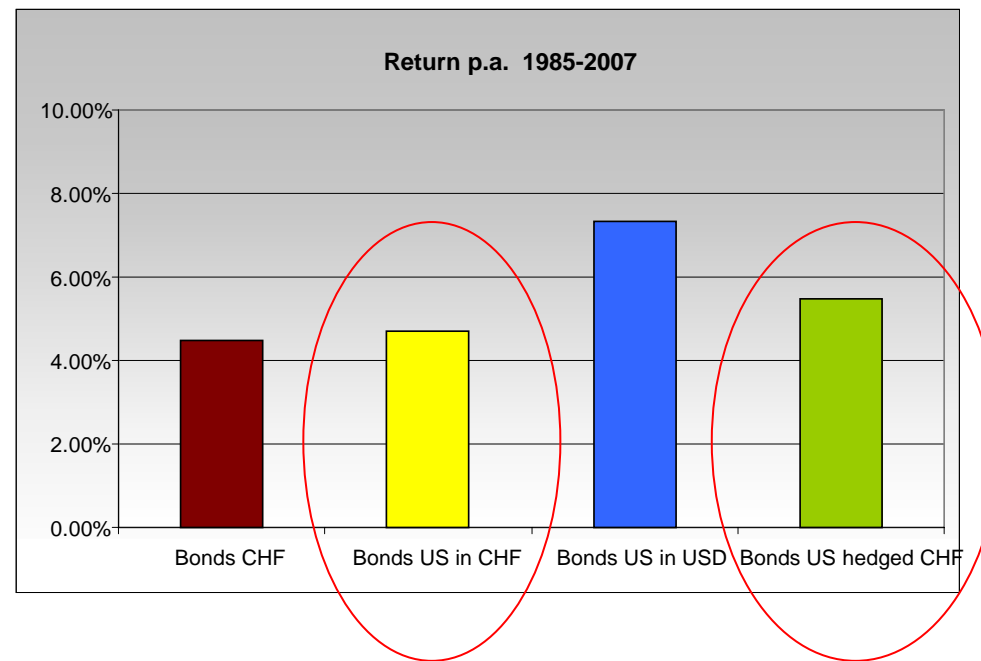
Currency Management: Fundamentals (2)

- Currency fluctuations increase the risk (volatility) of foreign investments.



Currency Management: Fundamentals (3)

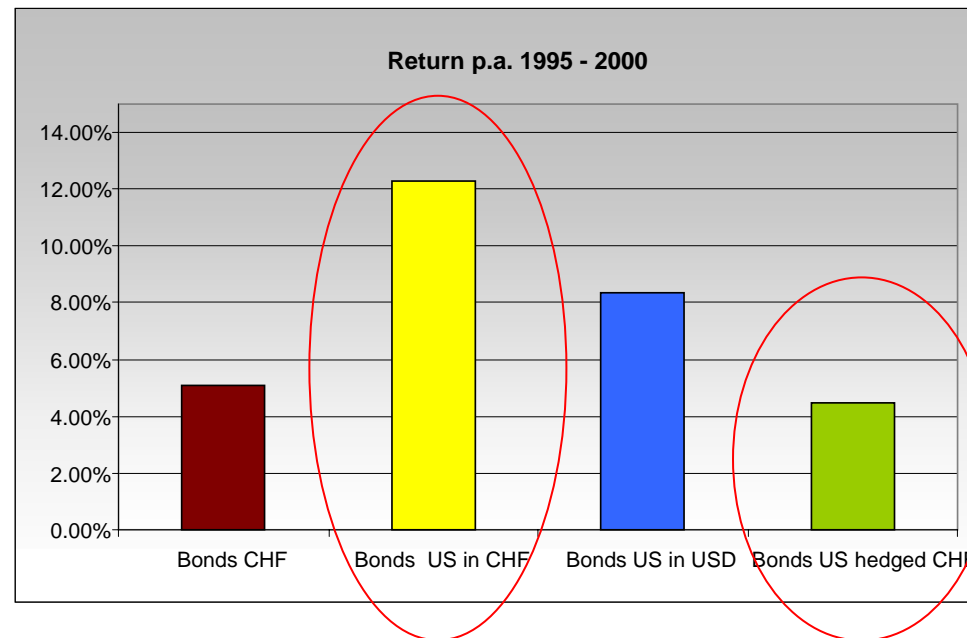
- Comparison of returns:



- From 1985 to 2007 hedging was slightly profitable because there has been a devaluation of the USD.

Currency Management: Fundamentals (4)

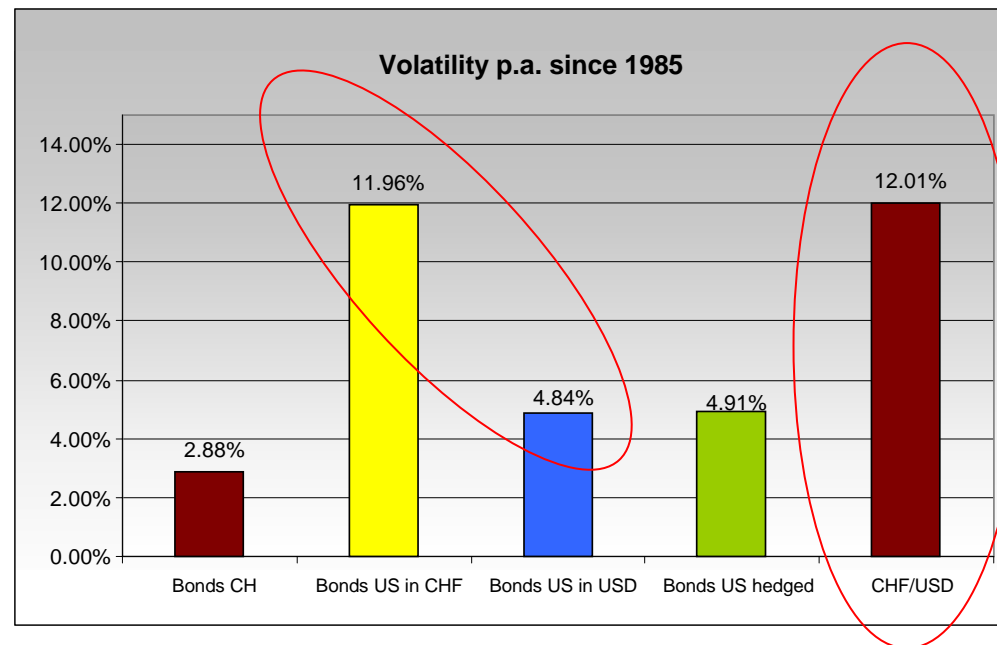
- Comparison of returns:



- From 1995 to 2000 hedging was **not** profitable, because there has been an appreciation of the USD (compared to CHF).

Currency Management: Fundamentals (5)

- Comparing Swiss Bonds and US Bonds:

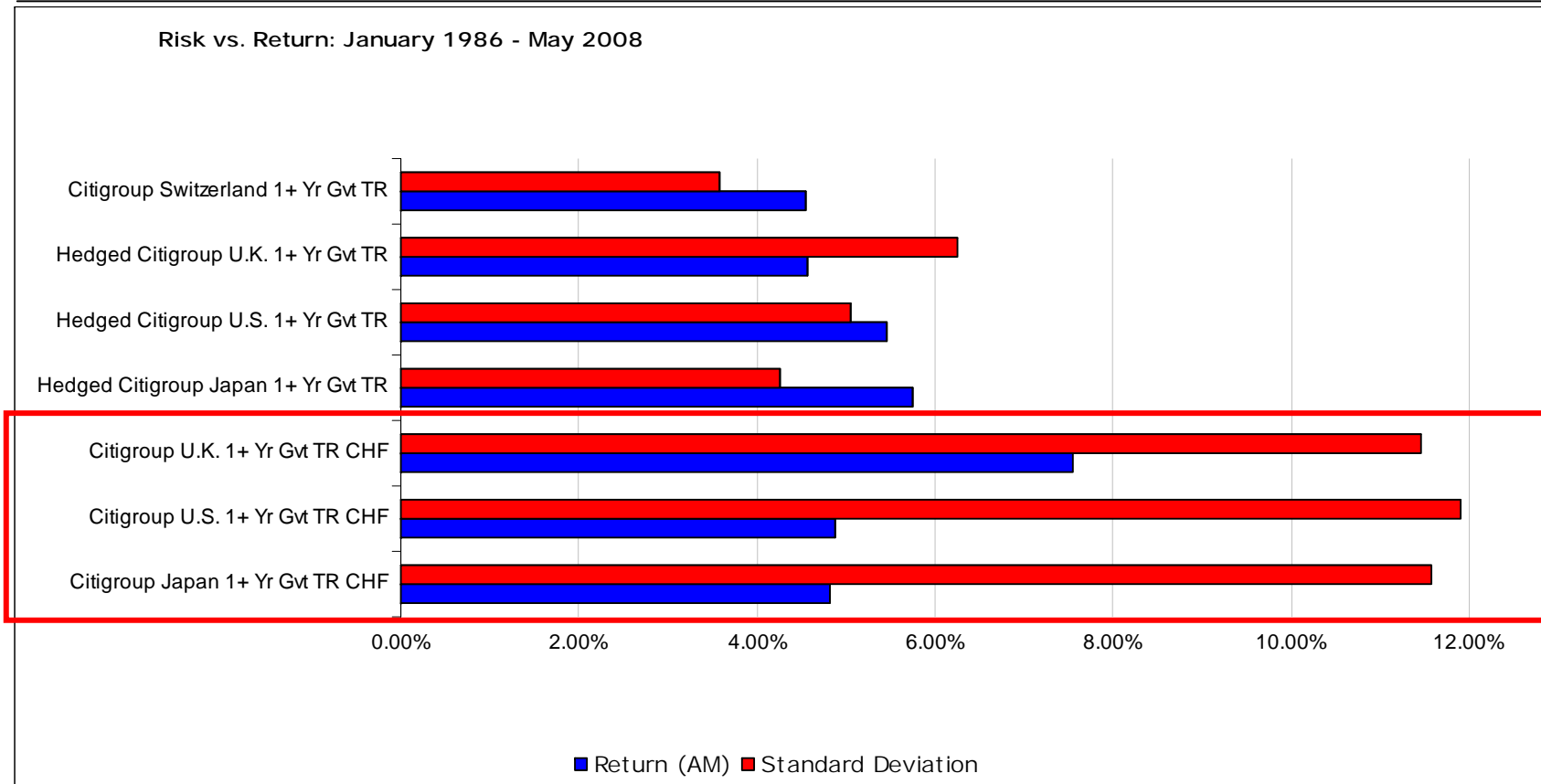


- What is “currency risk”?
- Is it the volatility of the CHF/USD-Exchange rate (12.01% p.a.)?

Currency Management: Fundamentals (6)

- From a Swiss investor's perspective the relevant currency risk is the difference in volatility between foreign bond returns in local currency and foreign bonds returns in CHF.
- In our example the relevant currency risk is: $11.96\% - 4.84\% = 7.12\%$
- The relevant exchange-rate risk is smaller than the volatility of the exchange rate, because a certain amount of the volatility of the exchange-rate is diversified.
- **The relevant currency risk is smaller than the volatility of the exchange rate. But still, currency risk is a source of volatility in a portfolio.**
- **To hedge or not to hedge?**

Currency Management: To hedge or not to hedge?



- The volatility of unhedged investments in foreign bonds is much higher than the volatility of hedged foreign bonds.
- There is no clear indication of a consistent risk premium for bearing foreign currency risk.

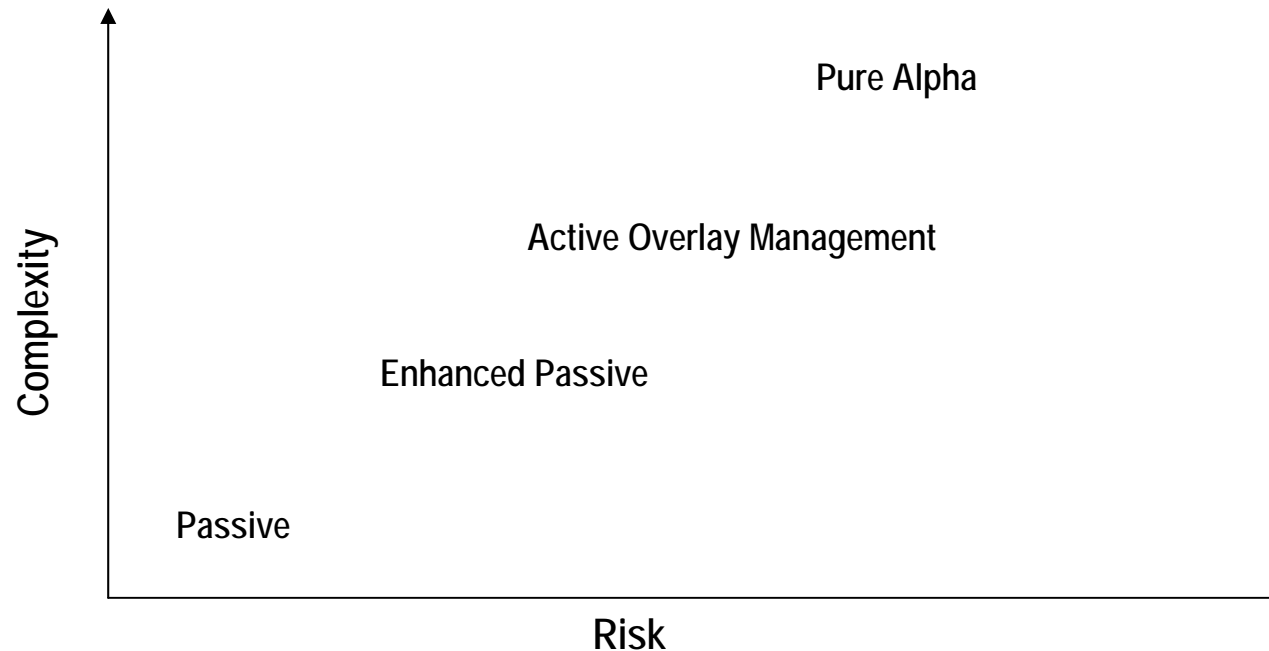
Currency Management: To hedge or not to hedge?

	Return	Standard Deviation	Return / Risk
Citigroup Switzerland 1+ Yr Gvt TR	4.56%	3.57%	1.27
Hedged Citigroup Japan 1+ Yr Gvt TR	5.74%	4.26%	1.35
Hedged Citigroup U.S. 1+ Yr Gvt TR	5.47%	5.05%	1.08
Hedged Citigroup U.K. 1+ Yr Gvt TR	4.56%	6.25%	0.73
Citigroup Japan 1+ Yr Gvt TR CHF	4.82%	11.57%	0.42
Citigroup U.S. 1+ Yr Gvt TR CHF	4.88%	11.90%	0.41
Citigroup U.K. 1+ Yr Gvt TR CHF	7.55%	11.45%	0.66

Data Source: Morningstar, January 1986 - May 2008

- Volatility can be significantly reduced by hedging foreign currency risks.
 - The Risk/Return-ratio is higher when currency hedging is applied.
 - Foreign bonds hedged still offer diversification benefits (different interest rate curve-movements, different rating distributions, etc.).
- **“To hedge” is often the optimal solution.**

Currency Management: Implementation (1)



- Since there is no certain risk premium associated with foreign currency risk, for most of the pension funds a passive implementation is the most suitable solution.
- Alpha is dependent, on the trading capabilities, forecasting power or other skills of the manager.

Currency Management: Implementation (2)

Currency hedging can be done on different levels:

	Asset Manager	External Specialist (overlay manager)	Global Custodian
Pros	<ul style="list-style-type: none"> - Simple implementation - Standard products available 	<ul style="list-style-type: none"> - External Manager is responsible for the whole hedging process - Deep knowledge of markets and instruments 	<ul style="list-style-type: none"> - Custodian knows the composition of the portfolio and therefore the currency-exposure in “real-time”
Cons	<ul style="list-style-type: none"> - Not offered by all Asset Managers - The Asset Manager might not be a specialist in currency hedging 	<ul style="list-style-type: none"> - Implementation might be more complex (especially for collective investment schemes) 	<ul style="list-style-type: none"> - It is not certain that “best execution” is guaranteed

Currency Management: Implementation (3)

- Implementation issues:
 - Risk controlling (tracking of the hedge ratio)
 - Instruments
 - Handling of currency allocation within collective investment schemes
 - Counterparty risk (maximum contract size with one counterparty)
 - Swiss Law (BVV2) prohibits short-selling (the value of the contracts outstanding must not be higher than the value of the underlying asset)

Currency Management: Conclusion

- **Is there a free Lunch?**
 - Empirical evidence is not clear whether there is a risk premium for bearing currency risk or not.
 - Currency hedging is therefore mostly an instrument to reduce risk and not to boost returns.
- **But...**
 - What about **execution** in currency trading and hedging?
 - Best execution in currency trading can significantly improve performance.
 - In the past, most of the trading has been done through the global custodian in Switzerland. External execution can help to get more competitive prices.

Securities Lending: Definition

- Securities Lending:
 - Securities lending refers to **lending of securities** (stocks and bonds) by one party to another for a certain period of time. The lender gets a **lending commission** depending on the type of security, the lending period as well as the terms of conditions in the lending contract.
- Reasons
 - Increasing activities in the futures/derivatives markets, leading to a higher demand for securities. Clearing all these transactions may sometimes cause delays or other problems, which can be solved by securities lending programs.
 - Special trading strategies: short selling, arbitrage, etc.

Securities Lending: Advantages and disadvantages

- + Additional income for the lender
- + Provides liquidity (a need for efficient markets)
- Voting is not possible (if securities are not recalled)
- Risks (counterparty risk, settlement risk/collateral management risk, legal risk)

Securities Lending: Conclusion

- **Is there a free Lunch?**

- The lending commission is not a free lunch since the investor faces risks (e.g. counterparty- and operational risks) and there might be a loss of the voting rights (if the investor does not recall the securities).

- **But...**

- What about the **split of the lending commission between the pension fund and the custodian?**
- We see a wide range of possible splits.

Other possible sources of costs savings (1)

- Cash Management
 - Negotiation of the interest rate mechanism with the global custodian or using different counterparties for fixed-term deposits.
- Trading Costs
 - Regular controlling of the trading costs (brokerage commissions) and the execution quality by comparing the paid prices with the volume weighted average price (VWAP) of the respective trading days. Commission recapture might also be a possibility to save trading costs.
- “Administrative Fees” of funds
 - If the costs of different funds are compared, it’s useful to include the fund’s “administrative fees” for full transparency (total expense ratio, TER).

Other possible sources of costs savings (2)

- Performance Fees
 - The fair value of a performance based fee schedule (using an option valuation model) is often higher than the offered fixed management fees.
- Active Management Fees
 - If your active manager is not performing well, try to renegotiate the fees or consider replacing him with a more cost efficient passive manager.

- It is not clear if there is a risk premium for bearing foreign currency risk, but it is clear, that foreign currency risk is a source of additional volatility. Therefore hedging is often the optimal solution. Best execution can have a significant impact on the performance of currency hedged portfolios.
- Securities Lending is not a free lunch. The lending commission is a compensation for the counterparty risk and the loss of the voting rights. But it might be worthwhile to discuss the split of the lending commission with the global custodian.
- It pays out to look for possible cost saving possibilities in the whole investment process.