How to manage emerging market currency risk

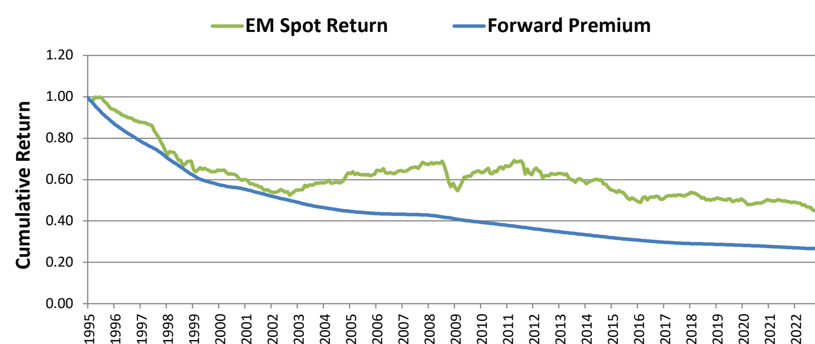
Investing in emerging debt or equity markets is a prudent way of adding diversification to portfolios for institutional investors. Associated with investment in these assets is a currency exposure that should be wisely managed, rather than just naively assumed. In this article we look at the investment characteristics of this currency exposure and the spectrum of approaches to managing it.

Investment characteristics of emerging market currency

While emerging markets are defined differently by different index providers, they do tend to have a large degree of overlap. The MSCI Emerging Markets Index currently incorporates 24 countries across Asia, EMEA, and Latin America. There are such large differences between the economies in this group that viewing their currencies as one block of like investments misses a lot of nuance. For example, Latin American currencies have been about 50% more volatile than Asian currencies on average over recent years.

A basket of emerging market currencies (equity cap weighted) is of moderate risk: about 6% annualised volatility versus the US dollar since 1995. Currencies of different regions diversify well and there are several Asian currencies with large weights that are managed to have low volatility by their central banks (particularly renminbi).

There appears to be a persistent excess return to many emerging market currencies that have higher yields. The rate of spot depreciation in these currencies does not keep pace with interest rate differentials (forward premiums) and this can be seen in emerging markets currency as a basket.



Source: MSCI, AL&P

There is economic logic behind this return: capital must be attracted into faster-growing economies by offering a premium to the currency. This premium is compensation for risk, and our research confirms it is correlated with risky asset markets generally.

Liquidity has been steadily improving over the years, with spreads in many emerging currencies now comparable to developed currencies (e.g., spot and forward spreads in Chinese renminbi and Mexican peso tend to be similar to those of Swedish krona and Norwegian krone). These costs are much smaller than equity or fixed income transaction costs.

Formulating a policy for emerging market currencies

The factors that drive any currency—emerging or otherwise—are the relative demand for goods and assets across borders. These are distinct from factors that drive equity and fixed income markets like expected earnings and domestic economic growth. This makes any currency quite separate from the asset that caused its purchase, so it follows that currency strategy should be separate from asset strategy.

A familiar framework can be used to determine such a policy: firstly, the investor should make a strategic decision about how much currency exposure to hold; secondly, the investor should decide whether the remaining exposure should be actively managed to tactically alter individual currency exposures and add value; thirdly, the investor should decide who should make these currency decisions.

Investors who choose to strategically hedge emerging market currencies as a group can expect to pay the risk premium described above, so it is unlikely that passive hedging of every currency would be an attractive strategy. However, an approach that targets different strategic exposures for different regions may be more suitable; for example, one could only hedge Asian currencies which have a low or negative forward premium.

Tactically, there is a strong case to be made for hedging emerging market currencies, especially at times of significant risk or expected depreciation. There are several well-documented systematic factors that have demonstrated power forecasting relative currency strength and weakness, such as carry (interest rate differentials), value (versus some measure of purchasing power parity) and momentum. The performance of active currency managers also lends support to this approach versus pure passive.

As to the question of who should be responsible for currency, it is possible to manage currency in-house, or to employ one or more currency specialists. Specialists are likely able to provide better outcomes for whatever strategy is being employed, offering better execution, better reporting, better risk management, clearer delegation of responsibility, as well as being a resource for their clients. But they will charge a fee for this. If responsibility for currency is neither taken in-house nor delegated to a specialist, the exposure will likely be unhedged and actively managed as a by-product of the underlying asset managers' decisions. These managers are unlikely to be credible currency specialists as well as asset specialists.

Approaches to tactical management of emerging market currency

A range of solutions is available for hedging emerging markets currency. At one end of the spectrum is passive hedging, perhaps enhanced by focusing on some regions while leaving others unhedged. It is worth noting that for investors based in commodity-exporting countries like Australia and Canada, strategically hedging the basket in large amounts is not advisable; this is because emerging markets currencies tend to perform in line with global economic growth and risky asset markets much like these investors' base currencies—the result could be lower return and higher volatility.

At the other end of the spectrum of solutions is pure active management of emerging market currencies on an unhedged benchmark. Such a program would decrease or increase individual emerging market currency exposures with the aim of adding as much diversifying alpha to the portfolio as possible. This approach reduces risk when the base currency is expected to appreciate, and adds return.

A more conservative approach is to only hedge individual currencies when they are expected to depreciate relative to the base currency, adjusting individual exposures within the bounds of the underlying exposure (fully or partially hedging each or leaving them unhedged). This can be expected to reduce risk with a better return outcome than a simple passive hedge.

Yet another approach is to dynamically increase hedging across all currencies equally as the basket depreciates and decrease hedging equally as it appreciates. This can be achieved through delta-hedging, which in theory replicates a put option on the basket and equates to hedging approximately 50% over time. This dynamic strategy will offer some excess return if there is a trend in emerging markets currency prices. There is some evidence that trends develop regularly in most currencies, but not all.

Conclusion

While there is no one strategy that fits all investors, it is unlikely that passively hedging emerging market currency would be a good fit for most. Actively hedging individual currencies using one or more currency specialists and a tailored currency program is the approach most likely to deliver a risk and return profile that would satisfy investors' needs.

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