Adding Science to the Art of Active Management

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Active currency management is a critical part of an efficient portfolio, but many investors don't understand the key benefits. Here, I discuss three of them.

Fundamental valuation is more robust for currencies than it is for equities and bonds.

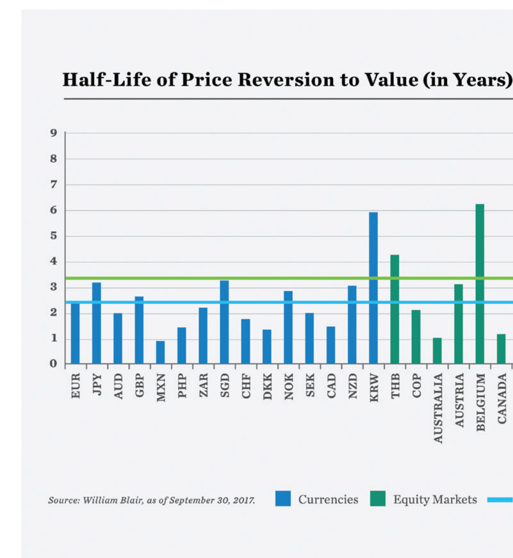
Most investors understand that equities and bonds have a fundamental value – an anchor or a centre of gravity to which price should typically converge over the intermediate- to long-term. Prices will often fluctuate on either side of that fundamental value based on various influences, but they always have a tendency to revert to it. However, many investors remain skeptical that currencies have a fundamental value.

I beg to differ. The real exchange rate – the amount of goods one can buy with one currency versus another – ultimately gravitates to a fundamental value as well.

To determine fundamental value for currencies, we use a relative purchasing power parity approach, which is grounded in the idea that an exchange rate finds its fundamental value and equalises the prices of goods and services in different countries. *The Economist* does something similar with its "Big Mac Index", which translates the retail price of a McDonald's burger in many different countries into one common metric and identifies where it is expensive and where it is cheap. From that perspective, it derives an estimate of which currencies are strong (overvalued) and which are weak (undervalued). We use more than a Big Mac in our consideration of prices, but the concept is relatively similar.

In fact, fundamental valuation is more robust for currencies than it is for equities and bonds. There is ample theory, as well as empirical evidence, to attest to that and our own investing experience confirms it.

Take the Brazilian real, for example – five years ago it was strong and rising. The signal from a fundamental valuation perspective was that the real's price was unsustainable. Since then, the real has weakened substantially; passing through fundamental value to the point at which we now believe it is one of the most fundamentally undervalued currencies in our investment universe.



Source: William Blair, as of September 30, 2017.

This shorter reversion cycle to fundamental value provides the opportunity to quickly exploit value/price discrepancies for currencies – simply put, it is a key example proving how fundamental value can be a very powerful tool for currency management.

Active currency management can help diversify a portfolio.

Currencies respond to macro influences differently than equities and bonds and that presents a diversification opportunity. Over longer-term horizons, correlations between currencies and traditional assets approach zero.

Observing the Japanese yen during 2013 provides a good example. The same policy influence – in this case, the economic measures that were introduced by Prime Minister Shinzo Abe, often referred to as "Abenomics"– had opposite impacts on the Japanese equity market and the Japanese yen. For a lengthy period – more than two decades – investors were accustomed to being very pessimistic about Japan. So, when Japan began ramping up fiscal spending in order to stimulate the economy, equities reacted positively, particularly in export-oriented sectors.

The same policy measures were negative for the yen, however, because all else being equal, weak monetary policy of an unconventional sort is typically a negative for currency. The best way to maximise the benefit from such an environment is to actively manage both equities and currencies, and to have the flexibility to do so independently.

Yes, there are rare moments when assets and currencies are highly correlated. That was the case in the third quarter of 2015, for example, when we saw positive correlations between currencies and equities across many emerging markets. But correlations are more likely to be close to zero over the longer-term – and this makes the excess return potential available from active currency management highly complementary to a portfolio.

A significant allocation to active currency management is essential to obtaining *Macro Diversification.*

In the macro-oriented portion of their portfolios, investors want positive total returns without the downside volatility of equities, and they want those returns to be relatively consistent over time.

To try to achieve that, we believe top-down, or macro, diversification is important. It's not just a complement to bottom-up management; it's essential to navigating the macro developments around the world that affect market and currency prices.

We believe in seeking out dimensions of active investing where there are opportunities we can successfully exploit that are not correlated with traditional equity or bond markets. In our view, fundamental currency management ticks all those boxes, which is why we utilise it and utilise it to the extent that we do.

Our approach differs from momentum-based currency management, which is what many investment managers use. With momentum-based (or technical) currency management, one seeks to identify a short-term trend in an exchange rate, jump on that trend in the belief that it will keep going for some time, and hope for a signal to exit in time.

In addition, while some investment managers dabble in currency management, we're completely dedicated to it. The breadth of the universe we cover – more than 30 currencies – is wide, and we allocate a significant portion of our risk budget to active currency management.

Active currency management, conducted within a fundamental framework and implemented independently from asset decisions can be a value-added component to a portfolio as well as a driver of return over both the intermediate- and long-term.

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