CIBC ASSET MANAGEMENT

INSTITUTIONAL

STRATEGIC AND ACTIVE CURRENCY MANAGEMENT

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Introduction

The role of currency in investment portfolios is often misunderstood. We provide clarity. There are two important, and distinct, decisions in the management of currency exposure:

- First, and most important, the **strategic** decision on how much inherited currency exposure to hedge. This decision should be included in the investment policy of each institution.
- Second, and completely independent of the strategic decision, whether to allocate to a tactical, return-seeking **active** currency strategy.

Both decisions are important. But they are independent of one another.

Decision #1: Strategic currency hedge

Exposure to global assets diversifies investment portfolios. But every allocation to a foreign asset inherits an associated, passive exposure to foreign currency. This currency exposure is not the primary motivation behind the allocation decision—the underlying asset investment is—and mostly has no associated expected return. But its contribution to total portfolio risk can often dominate the benefit of global diversification. One objective of strategic currency hedging is to mitigate this risk contribution, by systematically eliminating at least some proportion of inherited currency exposure.

Risk management is not the only consideration motivating the choice of strategic currency hedge ratio. Other, often competing, considerations include: the percentage and characteristics of liabilities denominated in base and foreign currencies; tolerance for cash flow volatility; willingness to pay for currency hedging to achieve a reduction in portfolio risk; and investment horizon.

There is no single optimal strategic hedge ratio for all investors across all investment horizons. Reflecting the complexity of this decision, investors often select a generic, rather than specific, hedge ratio: fully unhedged; 50% hedged; or 100% hedged.

Inaction is action

Some investors with global assets do nothing at all with their inherited currency exposure. Ultimately, inaction is action, and this approach leaves these investors with an unhedged benchmark, whether or not this choice is appropriate. It is important to choose a strategic hedge ratio proactively, even if the most appropriate choice is to remain unhedged.

Establish strategic currency hedge oversight

Concurrent to the decision to implement a strategic currency hedge, an oversight review process should be established. This process will provide a forum to regularly reconsider and challenge the relevance of macroeconomic analyses that drive correlation and volatility assumptions underlying the strategic hedge ratio. It should be conducted every 3-5 years, as part of an Asset-Liability Management study, or on a cycle that is consistent with the plan's investment horizon, and over which the investor is confident that the identified macroeconomic, political, and legal structures of relevant countries can be assumed unchanged.

Is it appropriate to tactically adjust the strategic currency hedge ratio?

We recommend investors keep short-term tactical views separate from long-term strategic portfolio decisions.

Some investors do tactically adjust strategic currency hedge ratios. This is often termed Dynamic Hedging. The magnitude of associated tilts tends to be relatively small and infrequent, and the number of currencies involved is often low. This means that the potential portfolio benefit of implementing these views will likely be limited.

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Decision #2: Active currency management

Active Currency is a return-seeking tactical, liquid alternative asset class.

Developed market (DM) currency exposure offers a positive expected return, but only as a result of skilled active investing. This contrasts with core asset classes, such as public equities and sovereign bonds, that have an associated market risk premium that can be harvested from long-only passive exposure without the need for skilled active investing.[2]

An allocation to active currency may be appropriate for both Defined Benefit (DB) and Defined Contribution (DC) investment plans. Its relevance derives from a number of features common to many institutional investment portfolios:

- Excessive exposure to equity risk
- Over-reliance for diversification upon a negative—and potentially transitory—equity/bond correlation
- Low expected returns from core equity and bond allocations, and many alternative asset classes, relative to recent history.
- Relatively high allocations to illiquid alternatives.

The opportunity to improve risk-adjusted expected portfolio returns through an allocation to active currency—which often does not require up-front capital funding, and so can be implemented without disturbing the existing portfolio—makes it a particularly attractive, liquid complement to core public and private market portfolio allocations.

Many of the drivers of active currency returns are specific to this asset class. They include the presence of non-profit maximizing participants in the currency market (Figure 1). These participants sustain market inefficiencies that provide active currency managers with a persistent opportunity to add value to investment portfolios.

Deutsche Bank (2018)[3] estimates that non-profit maximizing activity accounts for around one half of all daily currency market flows. Central banks, corporate treasurers, investors in underlying foreign securities, and tourists do not typically actively seek profit from participation in the currency market, even though all are likely acting rationally.

Does active currency add value?

CIBC Asset Management (CIBC AM) is part of a skilled cohort of active currency managers that has generated strong outperformance over an extended period. The long-term performance of the median active currency manager compares favorably to the most skilled active global large-cap equity managers (Figures 2a and 2b).

Figure 2a - Active currency performance – manager universe

Information ratio	1 yr.	5 yrs.	10 yrs.
25th percentile	0.65	0.33	0.41
Median	0.15	0.15	0.33

Figure 2b - Global equity large-cap performance – manager universe

Information ratio	1 yr.	5 yrs.	10 yrs.
25th percentile	0.25	0.65	0.38
Median	-0.50	0.02	0.13

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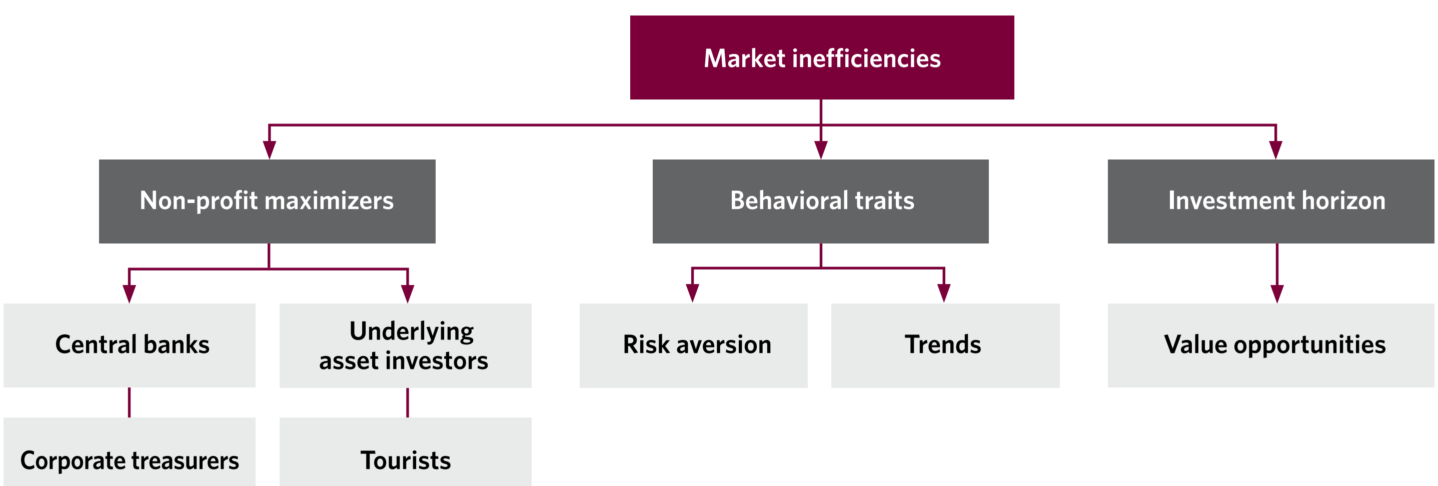
Figure 1 - The currency market is extremely liquid, but also inefficient and heterogeneous. These characteristics provide persistent profit opportunities for skilled active currency managers.



The information was prepared by CIBC Asset Management Inc.

[2] In contrast to DM currency exposure, many Emerging Market currencies do offer a positive passive risk premium. This reflects compensation for associated economic, political, and liquidity risks to which holders of these currencies are occasionally exposed.

[3] Deutsche Bank (2018), A Guide to FX as an Asset Class.

CIBC AM has achieved a 26-year Information Ratio (IR) of 0.52, and over this horizon is in the top quintile of active currency managers based upon manager performance data captured by MercerInsight. From a statistical perspective, we can be 99% confident that the CIBC AM Active Currency team has demonstrated investment skill over an extended period encompassing many different macroeconomic and market environments (Figure 3).

Active currency fulfillment options

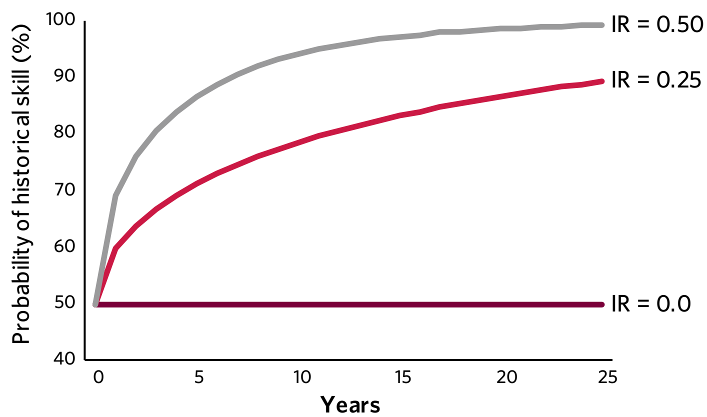
An active currency mandate can be implemented to accommodate different return and risk objectives, investment constraints, preferred investment style—relative to, or agnostic of, underlying benchmarks—as well as differences in plan investment resources and assets under management.

As with all investment mandates, a less constrained implementation affords active currency managers more opportunity to generate risk-adjusted returns. In recent years, an increasing number of investors has focused on unconstrained absolute return mandates.

An allocation to active currency can be achieved directly, or indirectly (Figure 4). A direct allocation is typically implemented on a capital efficient unfunded basis. Most direct allocations are also made on a standalone basis, and not tied to the asset exposures of the underlying investment portfolio.

One way to make an indirect allocation to active currency is via a macro multi-asset absolute return fund that encompasses tactical currency positioning as one source of expected return.

Figure 3–CIBC active currency performance has been consistent with manager skill

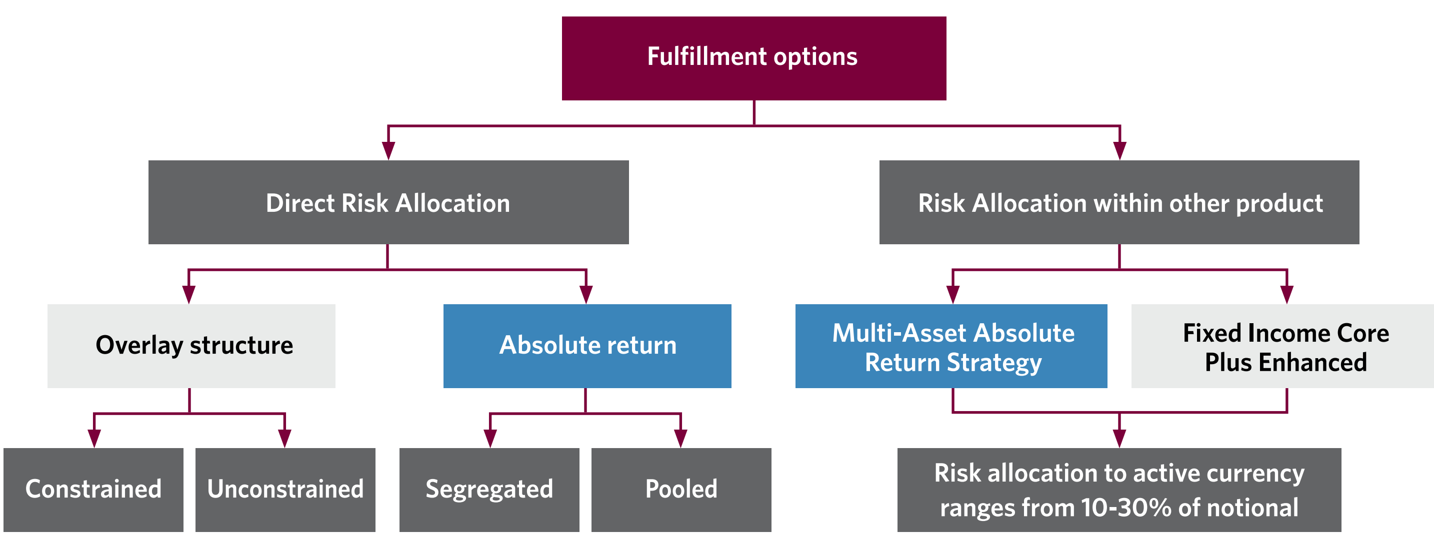


The information was prepared by CIBC Asset Management Inc. using the following third party service providers' data: Raymond, D. (2008), Paying (Only) for Skill (Alpha)—A Practical Approach. CFA Institute. http://cfapubs.org. Data as at May 31, 2022. Illustrative example. As per Raymond: "If one assumes that active returns are normally distributed, [the] probability [of manager skill] is the cumulative normal distribution, F(•), of the information ratio, IR, at time N (number of years) multiplied by the square root of time."

Conclusion

Investors are often uncertain how to think about currency risk. We simplify what many consider to be a complex topic. There are two distinct decisions. The most important is the strategic decision that addresses the treatment of currency risk inherited from global investments in underlying assets. The second is a tactical decision whether to allocate risk to an active currency strategy with the expectation of adding a diversifying, liquid, and capital efficient source of returns to existing portfolios. Both are impactful decisions. They should be considered independently of one another.

Figure 4 - Active currency mandate fulfillment options



Source: CIBC Asset Management, Inc., illustrative example.

Let's connect

Should you have any questions about this report or anything else, please do not hesitate to connect:

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