NAVIGATING CURRENCIES INTELLIGENTLY.

With tailored solutions for institutional investors, 7orca manages currency risks holistically and cost-efficiently, particularly in the context of investments in Private Markets.

Case study – 7orca FX Overlay.
Holistic FX Overlay for a complex multi-asset portfolio.

The client's challenge.

An institutional investor with a broadly diversified multi-asset portfolio spanning liquid and illiquid investment segments holds foreign currency positions that result from the international orientation of the respective asset classes rather than from a deliberate currency decision. While the asset allocation is defined strategically, the currency allocation across the various investments is largely a by-product of the respective portfolio structure. The individual investments carry foreign currency risks that are, for the most part, managed in isolation and without a consistent methodology.

In addition, the individual asset classes differ fundamentally in their volatility and in their contribution to diversification. In highly volatile segments, currency volatility often plays only a minor role relative to overall risk. As the volatility of the underlying asset class decreases, however, the same currency fluctuation can increasingly dominate overall performance. The specific characteristics of the currencies themselves should therefore also be taken into account – for example their correlation with the underlying assets and the structure of their hedging costs or hedging income.

A uniform hedge ratio for the overall portfolio does not do justice to these differences. The client therefore requires a solution that manages currency risk consistently across all asset classes while differentiating according to the characteristics of each. At the same time, the contribution the hedge makes to portfolio management should be objectively verifiable.

7orca's solution.

7orca implements the 7orca Holistic FX Overlay for the client, which combines strategic and tactical components. The Holistic Overlay process forms the continuous framework of the mandate and is carried out quarterly on an ongoing basis from the start of the mandate. This allows changing market and portfolio conditions to be taken into account systematically.

The starting point is the definition of the Basic reference benchmark. This deliberately market-independent reference, suitable for institutional investors, serves as an objective yardstick against which the value contribution of ongoing management can be assessed transparently.

Within the 7orca Holistic FX Overlay, currencies with particular structural characteristics are first considered separately and assigned to an appropriate, case-specific solution. Examples include currencies that are subject to a peg (exchange rate link) or influenced by geopolitical factors.

For the remaining currencies, 7orca ensures in the next step that only positions of economically relevant size are included in further management. This keeps the complexity of the mandate within reasonable bounds and frequently excludes currencies with high transaction and hedging costs.

7orca then ranks the hedging costs and income (carry) of the remaining currencies relative to one another. This is based on the quantiles of the hedging cost distribution within the portfolio. In doing so, 7orca takes into account that interest rate differentials and the resulting hedging costs cannot, over the long term, be viewed in isolation from the development of the respective exchange rates.

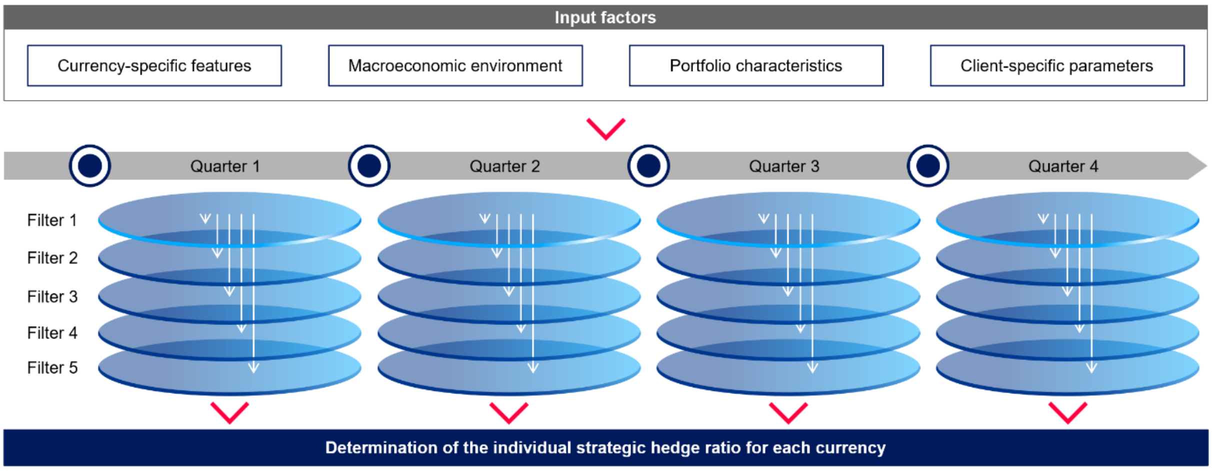
For currencies to which no clear approach can yet be assigned on this basis, 7orca determines the strategic hedge ratio by means of portfolio optimisation. The characteristics of the respective asset class and currency are considered together. From this, 7orca derives the optimal hedge ratio of the currency for the asset class concerned. The optimisation takes into account the currency's risk contribution, its correlation with the respective asset class and the hedging costs associated with the hedge. This results in a differentiated, asset-specific hedge ratio for each currency that reflects both the risk characteristics of the respective asset class and currency and the economic cost of hedging.

For safe-haven currencies, highly volatile investments regularly result in a lower optimal hedge ratio, as an open currency position can contribute to diversification. Cyclical and commodity-linked currencies, by contrast, tend to receive a higher optimal hedge for these investments, as they can amplify the existing risk rather than contribute to diversification. For the client's low-volatility investments, on the other hand, the optimisation results in a high hedge ratio for almost all currencies. This is intended to prevent currency effects from having a disproportionate impact on the overall performance of these segments.

The hedge ratios determined at the level of the individual asset classes are then aggregated for each currency on a volume-weighted basis. In this way, the different risk, diversification and cost characteristics of the individual portfolio segments are translated into a consistent strategic hedge ratio for each currency. As a result, the 7orca Holistic FX Overlay provides a strategic hedge ratio for each currency that reflects the structure of the underlying multi-asset portfolio while enabling efficient operational implementation of the FX Overlay. The strategic process is complemented on a mandate-specific basis by 7orca's tactical risk management, which manages currency risks in a market-adaptive manner.

Crucially, the strategic orientation is not set once and left unchanged. The entire process – from the treatment of structural particularities and the carry classification to portfolio optimisation and volume-weighted aggregation – is repeated in full every quarter. Changes in interest rate differentials, and hence in hedging costs and income, in correlations, in the portfolio allocation or in other relevant market conditions can thus feed into the next update of the strategic hedge ratios.

Figure: 7orca FX strategy process



Source: 7orca – own schematic illustration

The client’s benefit.

The client has a consistent and transparent approach to currency management that takes account of the differing characteristics of the asset classes instead of applying a uniform hedge ratio to the entire portfolio.

Currency risks can thus be limited more tightly where they account for a significant share of an asset class’s overall risk. In more volatile segments, by contrast, the natural diversification contribution of individual currencies can be deliberately preserved. At the same time, the strategic optimisation takes into account the hedging costs associated with the hedge and weighs them against the achievable reduction in risk. Furthermore, potential carry premiums are factored into the strategic decision rather than hedging currency risks across the board regardless of the associated costs.

As the process of the 7orca Holistic FX Overlay is repeated in full every quarter and adapted to changing market and portfolio conditions, the hedging strategy is not based on a single decision taken once and left unchanged. Instead, the strategic orientation is reviewed regularly on the basis of the prevailing conditions.

The defined Basic reference benchmark also creates an objective and robust basis for communicating the value contribution of the FX Overlay transparently to the management board, investment committee and supervisory bodies.

The 7orca Holistic FX Overlay thus creates a consistent, differentiated and regularly reviewed basis for managing the currencies of a complex multi-asset portfolio. Instead of a blanket hedge ratio, currency risk, diversification effect and hedging costs are considered together and first translated into asset-specific hedging decisions. Their volume-weighted aggregation then produces a strategic hedge ratio for each currency that takes into account both the risk structure and the composition of the overall portfolio.

Contacts.

Tindaro Siragusano, CEO
tindaro.siragusano@7orca.com

Sven O. Müller, Head of Relationship Management
sven.mueller@7orca.com

7orca Asset Management AG
Am Sandtorkai 77
20457 Hamburg
Telephone: +49 40 33 460 4613
www.7orca.com