funds europe

# FX hedging and asset management

## CHANGING APPROACHES TO CURRENCY RISK

*A Funds Europe report in partnership with RBC Investor & Treasury Services*


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# Introduction

## THE REAL IMPACT OF EFFECTIVE FX HEDGING

**AN FX HEDGE** is a transaction placed to insulate a current or future position from undesired movements in foreign exchange rates. In this report, we note that effective FX hedging can have a major impact on the performance of an asset manager's products, ensuring, for example, that the performance of a share class mirrors that of a fund's base currency (share-class hedging) or in managing risk associated with movements in currencies in which a fund's underlying assets are denominated.

Previously, many asset management companies bought an FX share-class hedging service as part of a bundled securities services package. Our expert commentators note in this report that it is becoming increasingly common to purchase this as a specialist, standalone solution, with the asset manager running a dedicated RFP process to select the best provider in market to meet their existing and future requirements.

FX hedging sits at the interface of the investment book of record, the custodian book of record and the dealing book of record maintained by the transfer agent. Strong performance relies heavily on managing the data flows efficiently between these data centres. This demands data accuracy and data timeliness, getting the right data to the right place at the right time – not only when the FX hedge is executed, but also in managing this flow back into the investment book of record.

In the FX hedging roundtable, asset management participants tell us they are looking closely at their oversight models and taking steps to enhance the oversight and governance standards around their FX hedging activity. This includes regular service reviews, detailed attention to key performance indicators and analysis of transaction costs incurred across the FX hedging programme.

For asset managers that utilise FX hedging strategies, automation and technology investment are increasingly at the forefront of their attentions from portfolio management teams right through to the automation of downstream operational processes. The aim is to remove all possible slippage in the hedging programme – eliminating potential time delays and operational risk generated by manual error.

# Positive engagement is key

*FUNDS EUROPE* SPEAKS TO RBC INVESTOR AND TREASURY SERVICES' PAT SANDERSON, HEAD OF GLOBAL CLIENT COVERAGE FOR THE UK, AND ROGER EXALL, HEAD, EUROPEAN FX SALES AND TMS BUSINESS DEVELOPMENT, ABOUT THE IMPORTANCE OF FX HEDGING AND HOW THE MARKET FOR FX HEDGING SOLUTIONS IS EVOLVING.

**FX HEDGING CAN HAVE** a major impact on the performance of an asset management product. When applying share-class hedging, an asset manager aims to mitigate the effect of exchange rate movements between a fund's base currency and the currency of the share class – ensuring that performance of the share class mirrors that in the fund's base currency as closely as possible.

For portfolio FX hedging, the asset manager aims to manage risk – and in some cases to capture alpha – resulting from movements in the currencies in which a fund's assets are denominated, or from strategic currency positions established by portfolio managers as part of their investment policy.

Previously, many asset management companies bought an FX share-class hedging product as part of a bundled securities services package. However, Roger Exall says that it is becoming increasingly common to purchase this as a specialist, standalone solution, with the asset manager running a dedicated RFP process to select the best provider in market to meet their requirements.

For Pat Sanderson, advances in technology and data management have made it easier for asset managers to purchase their specialised FX hedging requirements on a modular, or standalone, basis. "Technology development is making oversight and data access easier to manage," he says. "Buying a bundled product enabled the customer, among other benefits, to centralise data across multiple functions (e.g. custody and fund accounting, FX hedging, securities lending ...) with a single service provider and to source associated reporting and analytics via a single point of access.

"Now, clients can interrogate data more effectively across multiple providers, linking easily to third-party data service providers. This has generated a more open mindset about how they access data and procure services across their organisations. The challenge is how we take the FX data and

*Pat Sanderson, Head of Global Client Coverage for the UK*

**"THE CHALLENGE IS HOW WE TAKE THE FX DATA AND DELIVER REAL VALUE ON THE CLIENT SIDE."**

deliver real value on the client side," explains Sanderson.

"The strength is to blend the expertise of subject matter experts in the FX team and to overlay this with the experience and creativity of our data engineers to build applications that solve problems for the client."

A requirement, he notes, is to deliver solutions without being encumbered by the bureaucracy of change management that prevails in many organisations. In doing so, RBC I&TS recognised that it could no longer rely on traditional change channels. This has prompted a fundamental review of its data architecture and strategy for managing and communicating data. "As we have adapted, we view the delivery and management of data as a product in itself, rather than simply as a support function for other products and services."

**Future priorities**

At RBC I&TS, the FX hedging team has invested heavily in delivering post-trade data for its clients, providing a view across the full range of oversight requirements and analytics on the performance impact. This has included a focus on data timeliness and accuracy, improving the client's digital experience and continuing to extend automation levels across the FX transaction lifecycle.

**"WE HAVE SEEN THE WILLINGNESS OF CLIENTS TO WORK WITH RBC I&TS AS A SOLUTIONS PROVIDER ACROSS AN EXPANDING RANGE OF AREAS."**

Looking ahead, Exall says that the immediate focus will be on continuing to invest and expand its range of data and analytics solutions to provide more value to clients: "A collective positive and open engagement is key and we have seen the willingness of clients to work with RBC I&TS as a solutions provider across an expanding range of areas – delivering data and analytics that support their needs from the investment decision through to their post-trade requirements." Exall also highlights opportunities to assist asset management clients with collateral optimisation, ensuring collateral is mobilised and allocated efficiently to where it is required.

To be relevant, Sanderson believes that service providers need to address the key macro challenges that are confronting their asset management clients – risk management, revenue generation, operational efficiency and managing regulatory change. "Typically, if a solution does not hit one of these key

*Roger Exall, Head, European FX Sales*

challenges, asset managers may be reluctant to engage," he says. "With this in mind, the portfolio of services that we offer at RBC I&TS is targeted directly at these important macro drivers."

In doing so, timeliness of delivery is essential. "As a specialist, standalone FX service, if you cannot deliver solutions quickly then you will fall behind the market," he concludes. "But for a post-trade industry that is not always known for executing quickly, the development of our FX hedging service illustrates how we can engage with clients to deliver fast, effective solutions." **f**e

# Where does FX hedging sit in your development priorities?

OUR PANEL OF EXPERTS DISCUSS APPROACHES TO SHARE-CLASS AND PORTFOLIO FX HEDGING, MANAGEMENT OF FX DATA AND ANALYTICS, ADVANCES IN GOVERNANCE AND OVERSIGHT, AND APPLICATION OF TECHNOLOGY AND AUTOMATION TO THE FX HEDGING LIFECYCLE. **BOB CURRIE** REPORTS

## PANEL

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NEIL SILLS
Head of Fund Accounting, BlueBay Asset Management

JOSEPH SPROUL
Principal Consultant, Alpha FMC

BOB CURRIE
Research Editor, *Funds Europe*

***Funds Europe* – How automated is your process for handling FX hedging calculation, execution and post-trade analysis?**

**Dan Cunningham, Merian Global Investors –** We employ an outsourced operating model for the majority of our share-class FX hedging requirements. The one exception in our product range is a Cayman-domiciled hedge fund, which offers monthly liquidity, where we support our FX hedging requirements in-house.

For all outsourced activity, we expect our service providers to deliver high levels of automation across the transaction lifecycle, taking in files from multiple transfer agents (TAs) and fund administrators and being able to push files out to custodians and other service providers with high straight-through processing rates across this workflow.

**Michael Paterson, Mediolanum International Funds –** We encounter some additional complexities for our fund-of-fund (F-o-F) range, in terms of evaluating the FX exposures held by the funds in this F-o-F product and assessing how we should hedge this exposure. In practice, we have 46 independent fund managers sending us FX data across 142 funds that we hold with them. Once collated, this is then fed into our outsourced hedging model. During the past 18 months, we have substantially improved automation levels across this activity. Previously, we needed typically to commit one to two person days per week to this activity in sourcing the relevant files and passing them on to our service provider. With automation, we have now cut this requirement to five minutes or so – the time required to confirm that we have received the required data through our automated workflow and passed this through to our FX hedging provider.

**Neil Sills, BlueBay Asset Management –** Our FX hedging uses a mix of outsourced and in-house expertise. The share-class hedging activity is largely outsourced and we expect

"WE HAVE MOVED TO AUTOMATED PROCESSES, BUT WE STILL HAVE EXPERTISE WITHIN THE TEAM WATCHING CLOSELY ON WHAT IS HAPPENING ACROSS THE HEDGING PROGRAMME."

*Michael Paterson, Mediolanum*

this to be highly automated. In contrast, we continue to manage our portfolio hedging activity in-house. We have recently completed the first phase of an automation project, ¬implementing a system that automates the calculations for the quarterly rolls on our portfolio hedges. We expect to deliver further automation across our portfolio FX hedging activity as we move this project to completion by the end of 2020.

**Joseph Sproul, Alpha FMC –** As a consultant, the messages that you have shared so far align with the priorities that we are encountering in our discussions with clients. Across the industry, there is an expectation that outsourced FX hedging should be highly automated. For internally managed FX or portfolio hedging, this is more of a mixed bag – some asset managers operate high STP rates, others still have significant levels of manual intervention. It depends on the clients' focus. Typically, when the FX hedging function sits as part of the client's wider treasury or liquidity management activities, with management focus and investment, we often we find higher levels of automation. When it operates as a standalone function, typically there is a higher manual component and automated process flows are taking longer to establish.

**Ryan Mitchell, First State Investments** – Our experience is quite similar at First State Investments. Our share-class hedging activities are fully outsourced and we benefit from the investments in automation made by our outsourcing partner. A primary consideration is to verify that files come in from the fund accountant, transfer agent and other key parties to the fund transaction in an appropriate format so that we can get these over to the hedging managers for them to do their work.

Portfolio hedging activity sits within our broader portfolio management function and is not highly automated at present. The fixed income portfolio managers are able to enlist the help of an FX support team as they hedge bond trade positions, for example, but they liaise directly with these FX specialists rather than through an automated process linked to each trade. More generally, we continue to review our middle-office activities, including our FX hedging capabilities, and expect further automation to be introduced as part of this wider programme.

**Krystian Cabaj, J O Hambro Capital Management –** Much of our current FX hedging activity is outsourced to RBC I&TS. We are currently extending our use of portfolio hedging and have been focused on some of the challenges this presents in relation to calculation of performance fees.

We are also reviewing our cut-off points, in consultation with our service provider. The cut-off point for subscriptions and redemptions activity is currently 12.00, which aligns with the valuation point for our fund range. However, this creates problems for our FX hedging provider in setting hedges in place for this midday timeline. We are currently reviewing our

**"PRESSURE FROM CLIENTS HAS ENSURED THAT SERVICE PROVIDERS ARE RAISING THEIR GAME IN PROVIDING PERFORMANCE DASHBOARDS AND FACILITATING BETTER OVERSIGHT."**

*Ryan Mitchell, First State Investments* cut-off points to enable the FX hedge provider to strike the hedges at 12.00 in alignment with the NAV valuation point for our funds.

**Paterson –** At Mediolanum, automation and technology investment are at the forefront of a lot of what we do, from the portfolio management teams right through to how we automate our downstream operational processes. We wish to remove all possible slippage in our hedging programme – to remove all potential time delays and operational risk generated by manual error. This is particularly important when managing large institutional subscriptions and redemptions, when we have large flows and it is important to mitigate this potential FX exposure promptly and efficiently.

A lot of the advances we have made come down to our ability to learn from experience, to apply the expertise we have gained across the team from doing this many times previously. An important point is that we have moved to automated processes, but we still have expertise within the team watching closely on what is happening across the hedging programme. Human expertise is still heavily bound into the risk management process.

**Sproul –** FX hedging sits at the intersection of the investment book of record, the custodian book of record and the dealing book of record maintained by the transfer agent (TA). Success in this area relies heavily on managing the data flows efficiently between these data centres. At Alpha FMC, we see this across the full FX transaction lifecycle and recognise that multiple elements need to be right for this to work efficiently. This centres on data accuracy and data timeliness, getting the right data to the right place at the right time ¬not only when the FX hedge is executed, but also managing this flow back into the investment book of record. This embraces a wide range of challenges. As of today, many firms still have challenges getting this right.

**“INVESTORS HAVE BEEN SEEKING FURTHER EXPLANATION OF WHY THEIR RETURNS HAVE BEEN SO DIFFERENT TO PAST EXPERIENCE. NOW WE CAN IDENTIFY SIX OR SEVEN CONTRIBUTING FACTORS.”**

*Neil Sills, BlueBay Asset Management*

**Funds Europe – Joe, you highlight the importance of timely and accurate data and getting this to the right place at the right time. This is a challenge that extends well beyond FX hedging and is integral to efficient performance across many segments of the asset management industry. What do we do well in managing these data challenges? And where does the industry fall short?**

**Sproul –** Where manual processes are employed, particularly around portfolio hedging, there is a reliance on technical expertise, but this is changing. As organisations invest in their ability to share and manage data efficiently, for example through use of application programmable interfaces (APIs), this will improve organisations' ability to share data closer to real time and the extent to which firms can therefore automate.

To elaborate, many organisations are currently operating legacy architecture that moves data in batch operations, for example from front-office execution through to the fund accounting engines, whether internal or external to that organisation, and the custodian records. It is the high level of expertise and skill within these organisations that is making this model run as efficiently as it does – but there is hard work to be done to establish automated end-to-end data flows that move beyond this batch environment. A large part of this automation process is in re-plumbing the data flows between organisations, and across internal teams to the FX hedging transaction within each organisation, which then leads to opportunities to increase automation and optimise execution.

**Roger Exall, RBC Investor & Treasury Services –** To expand on this from a service provider's viewpoint, we've invested heavily into delivering post-trade data for our FX hedging clients, providing them with a view across the full breadth of oversight requirements and analytics on the performance impact. We maintain consistent dialogue with our clients in an effort to explore how we can continually evolve our digital offering and move to the value

> "IF WE GO BACK A COUPLE OF YEARS, WE HAD RELATIVELY FEW QUESTIONS FROM CLIENTS AROUND PERFORMANCE DIVERGENCE... NOW THESE QUESTIONS ARE BECOMING MORE FREQUENT AND DETAILED."
>
> *Roger Exall, RBC Investor & Treasury Services*

component in terms of ensuring the program is optimal.

For the share-class hedging activity, performance analytics typically compare the client's hedged share-class performance against a fund's base currency class, whereby the difference between the two classes is the FX hedging. For portfolio hedging, there are many more moving parts but we are keen to isolate the FX hedging process and its impact on performance. This will help to identify inefficiencies in the process such as data timeliness and accuracy that, if improved, can enhance a client's ability to reduce performance slippage and, where the mandate allows, measure alpha generation.

In which situations would you say, "If I had access to that information earlier, we would have closed this gap or been able to improve performance in this area"? And how would that shape the hedging process, where the portfolio manager is taking a view on a particular FX position, the trading desk is placing the trades, and so on?

**Paterson –** An area where we have made significant improvements over the past 12 months has been in our oversight facility. We use Tableau to provide oversight of our hedging ratios, ideally aiming to remain between 98% and 102% exposure such that we have flexibility to ensure we comply with ESMA guidance regarding share classes in UCITS funds. With access to this data in real time, we can see at any time what hedging ratios we have in place across our fund range. This provides a sense of security that our hedging programme is being implemented as intended and that there are no potential surprises in the making.

## Oversight process

***Funds Europe –* What does your FX oversight framework look like currently? Do others around the table employ a similar dashboard structure to monitor their hedging activity?**

**Mitchell –** This is something that we have looked at. We use two FX hedging providers, respectively to support our onshore-domiciled and offshore-domiciled UCITS funds, and we rely to a degree on what they can deliver in terms of dashboard tools.

We have been conducting a detailed review of our oversight model and taking steps to enhance the oversight and governance standards around our FX hedging activity. This includes regular service reviews, detailed attention to key performance indicators (KPIs) and a focus on outliers. If a position is not within our hedge ratio, we want to know why. This also includes detailed analysis of transaction costs incurred across our FX hedging programme. In cases where we do not wish to build an in-house solution to support our oversight, we expect our fund accountants and custodians to provide detailed evidence of what they are doing and we will review that. We are really pushing our service providers in these areas, as well as keeping a watchful eye on what is available in the market, to ensure that we are receiving best-in-class service.

**Paterson –** How effectively have your service providers been able to meet these requests? A lot of what we are using has been built in conjunction with our custodian.

**Mitchell –** Yes, that is also our experience. We are working with our service providers to help them design these tools – but these are not a "nice to have", they are a requirement on our part. In earlier experience, we noted that some custodians might focus first and foremost on their larger clients. However, our service providers have been proactive in developing dashboard-type solutions that they can deliver across their client community.

We have a wide service provider map for an organisation of our size. Consequently, we are able to draw insights from service providers that we may not be contracted with directly. This gives us a picture of what best practice currently looks like within the industry ¬and it has enabled us to go back to our current providers to request new developments. Although many service providers have been focused on investment in automation, in improving STP rates across their FX hedging service, pressure from clients has ensured that service providers are also raising their game in providing performance dashboards and facilitating better oversight.

**Cunningham –** We recently conducted a detailed request for information (RFI) process with six service providers, specifically for share-class hedging. As a result, we have a well-informed view of who can offer what in the market. There are five or six providers in the market that offer data visualisation through a dashboard-type service, two or three of which are truly excelling in this area. This enables the asset manager or investor to access their data via dashboards and to customise their performance analytics and reporting, allowing them to drill down to a broad range of metrics required to support their oversight responsibilities.

From this RFI process, we believe that the FX hedging market has become polarised, with some clearly differentiating themselves in terms of their service quality. Some custodians appear to view share-class FX hedging as a bolt-on custody or fund administration service. However, others are offering a high-quality share-class hedging service as a standalone offer – and there are currently some impressive service offerings out there.

In taking up Ryan's point, I don't think that asset managers are thankful any longer simply that a service provider can execute an FX hedge for them through an automated process. That high level of STP is now expected and is a prerequisite for winning or retaining the mandate. It is the service options beyond this that make the difference. Leading custodians

**"THE WAY WE DEAL WITH EXTREME SITUATIONS IS KEY. YOU CAN HAVE A HEDGING PROCESS THAT WORKS WELL 99% OF THE TIME, BUT THE 1% CAN KILL YOU IF YOU ARE NOT EFFECTIVELY HEDGED."**

*Krystian Cabaj, J O Hambro*

and fund administrators are recognising the importance of an asset manager's oversight requirements, for example, ensuring they deliver high-quality metrics to support this. But there are also service providers who haven't chosen to make this commitment and are falling behind.

**Mitchell –** We do source a bundled package of services from our custodian. But, within this service portfolio, the FX hedging team view their solution as a standalone service and provide a high level of professionalism in what they deliver. We source multiple services from our custodian for good reason – this can offer benefits in terms of consolidated data feeds, consistency of reporting and a range of other benefits.

**Cabaj –** The Tableau-based dashboard solution that we receive from our service provider offers a wide range of basic analytics, including details of hedging ratios and transaction cost analysis broken down by individual trade hedges. However, we are also working closely with our provider to deliver enhancements to this service in terms of more detailed performance breakdown as we receive more and more detailed queries from clients.

**Sproul –** In our view, there are three main levels of oversight for an outsourced FX hedging service. First, there is general oversight of the third-party provider. Second, there is oversight associated with tracking against the mandate and identifying any divergence from the terms of this mandate. And third, there is evaluation of the execution function and transaction cost analysis around this element. These three functions require different skill sets.

I am interested to hear more about how monitoring of best execution and transaction cost analysis is discharged within your organisations. Is this fed through to the investments team? And to what extent have you embedded effective best execution and trade cost analysis?

**Sills –** This can touch many parts of the organisation. At BlueBay, the compliance division is closely involved, the investments team is integral to this process since they are the closest link to the market, and we also involve our operations specialists. Consequently, there are a lot of different touchpoints in this process. This collectively feeds into our Trade Execution Oversight Committee, represented by senior individuals from across these respective divisions, that is responsible for monitoring best execution across the organisation.

**Paterson –** We split this responsibility into two parts. The first is to ensure that the model we adopt for FX hedging is the best model available. To do so, we evaluate what is available in the market and refine our model to ensure this is as efficient as possible. The second responsibility is to ensure this model is implemented efficiently. The investment operations team are closely involved in verifying we have the correct model in place. And we have a TCA oversight team to ensure this is implemented efficiently.

**Cunningham –** Similar to BlueBay, we have a Trade Management Forum, represented by specialists from compliance, dealing, operations and other functions, and we need to demonstrate to this forum that we have effective mechanism for overseeing best execution. For share price hedging, the value of this analysis will depend on how you are executing. Many firms are executing at NAV FX rates or benchmark rates, so the value provided by TCA may be slightly less important. At Merian Global Investors, we use a specialist provider of detailed TCA metrics and we find this insight very important as part of the information that we pass to our Trade Management Forum.

**Sills –** We have also found it important to seek greater granularity. Given the global macroeconomic climate, with interest rates at near to historical lows, investors have been seeking further explanation of why their returns have been so different to past experience. In times past, we may just have put this down to interest rate differentials, but now we can identify six or seven contributing factors to the cost of FX hedging and can break down how far the divergence is related to each of these component factors.

**Cunningham –** Clients are becoming more specific in their requests. They are no longer asking, "Please explain the general causes of my divergence." Rather, they are asking for a detailed breakdown of their divergence since a particular date or investment

**"THERE IS NO SILVER BULLET – NO SINGLE MODEL THAT IS RIGHT. EVERY FIRM HAS TO ADAPT TO THE SPECIFIC CHALLENGES THAT CONFRONT THEM."**

*Joseph Sproul, Alpha FMC*

decision, requiring this down to fractions of basis points. There has been a real step change in the level of detail required from a client perspective.

***Funds Europe* – Is that just your bigger clients, with significant in-house FX expertise? Or does that extend more widely across your investor community?**

**Cunningham –** It is most commonly our larger institutional clients with expertise in this field that are driving these questions. But not exclusively so.

**Exall –** If we go back a couple of years, we had relatively few questions from clients around performance divergence on their hedged class compared to an unhedged class. But now these questions are becoming more frequent and detailed – this motivated us to develop a tool to automate this activity. Previously, we were handling these queries manually and this could be a resource-intensive process – in cases where we received several queries simultaneously, it could be challenging to get a response back promptly to each of these clients.

With an automated tool, the client can access this information on an ongoing basis and will tend to come back to us when they feel something is genuinely wrong or needs further attention. We will then look at this collectively, backtrack through our data and work this out together. This has been a major focus of the development work we have done over the past 12-18 months.

### Model Performance and Optimisation

***Funds Europe* – Do you conduct periodic reviews of FX hedging procedures? And how are these driving changes to your model?**

**Paterson –** We are constantly evaluating what is available in the market and, when we find that a provider is doing something innovative, we invite them in to discuss this further. We also discuss best practice with our peers. During my tenure, Mediolanum has conducted three market-wide reviews with multiple parties. We typically find positives and negatives in every provider's approach and our strategy to date has been to amend our model to take on board these positive elements, rather than choosing to switch to a new provider.

In practice, the model for share class hedging is relatively vanilla. It needs to do what it says – our clients expect us to be hedging their share classes and we need to make sure that we do that, ensuring that we do so as efficiently as possible.

**Mitchell –** There has been a wholesale strengthening of governance across our FX hedging activities and this has driven the discussions with providers across the market that I mentioned previously. First State Investments has established a documented hedging policy that has been driven by input from the product teams and the relevant business areas. This has fed an annual review process.

In turn, this review process has raised issues with regards to the impact of our hedging process and the model we employ. This has related to timings, for example, particularly when there is a large institutional subscription or redemption.

**Cabaj –** The biggest trigger to amend the process is typically when something goes wrong. Like Ryan, we have been looking closely at the timing of hedges, particularly when there is significant market volatility. It is these specific issues, rather than general concerns about the service provider, that have been driving our review process.

**Exall –** We conduct a mandatory service review at least annually with all of our FX hedging clients – and quarterly for our largest.

For share-class hedging, the process is relatively homogenised across service providers, so we are focusing on adding real value through digital experience. We have a great team of skilled data engineers and scientists that want to continue the evolution of the digital FX experience and are extremely enthused when feedback is provided – whether everything is great or they would like to see particular enhancements based on their current needs.

**Sproul –** Looking in general terms at the industry, we see a range of FX hedging models that were established four or five years ago, typically set up in conjunction with the portfolio management team, the middle office and operations. In some cases, these models have not changed substantially since – even though the market has clearly evolved in terms of complexity of products, regulation and in what the leading providers in the market can offer. For some organisations, when they do not see anything that is obviously broken, they are not inclined to change. However, as we have established, there are also some organisations that are asking more insightful and more sophisticated questions.

**Funds Europe – When you are conducting reviews with clients, who will you typically be discussing the programme with inside those organisations?**

**Exall –** In providing parameter-based hedging, this is a passive and rules-based process, but the discussion may typically involve operations and fund accounting teams. However, investment and trading teams may be involved around optimising FX rates. Particularly as volumes rise in the FX hedging programme, clients need comfort that their FX rates are competitive. There is less debate about the FX Spot rate as this is commonly traded against WMR, but this falls away for the FX forward rates where the focus should be to limit avoidable slippage.

**Paterson –** Absolutely correct. We are trying to squeeze every basis point of alpha from the investment team. It makes no sense to conduct regular and thorough performance reviews on our portfolio managers on the one hand, if we were not to do the same for our FX hedging programme on the share classes on the other. Unless reviewed regularly, we cannot develop a clear idea how many basis points are potentially slipping away through poor performance or cost management.

So, although FX hedging is typically viewed as an administrative function and portfolio managers are less focused in the share-class hedging as part of their daily business, in my team we recognise the need to be lined up in evaluating costs and efficiencies. Although it is largely automated, we look at the seeding ratios and the hedging ratios. A few months ago, for example, we ran a programme where we evaluated and adjusted these ratios in order to gain greater efficiency in the hedging process.

A broader consideration is how many currencies you have in your hedging programme and whether you wish to leave some of the smaller currency exposures unhedged. The reality is that the cost of hedging for these lower-volume currencies often outweighs the benefit of having the hedge in place. This is another area where we have conducted detailed research within the organisation.

**Cunningham –** The point about simulation is key and one that we are looking at more and more. The days of setting tolerances at 99-101% and forgetting about them are now past. We are doing more "what if" analysis based on the impact of using different tolerance levels. What impact would changing our tolerances to 97-103% have over a specified period? And if we anticipate a period of forthcoming volatility, would we be best served by tightening our tolerances or loosening them?

We believe that there are basis point savings to be made by improving our understanding in this area. But responding to Mike's point, it is not the investment team that is looking at this – in our organisation it is the operations team working in collaboration with their FX dealers.

***Funds Europe* – Are you developing your own scenario**

**analysis tools to provide these insights?**

**Cunningham –** We are pushing our FX hedging providers to work with us on this. We are also exploring timing impacts of placing the FX hedge. For example, should we be trading month end? At Merian Global Investors, we moved to trading in-month about a year ago.

**Sills –** Similarly, we have noticed large variations in performance dependent on when we apply our trades. Inevitably, we aim to trade when the market is liquid and this involves scheduling well in advance – avoiding public holidays, for example.

**Cabaj –** On that point, where does the FX hedging oversight sit within your organisations? We are currently reviewing our activities and that is one of the questions that is part of the review.

**Sills –** At BlueBay, the share-class hedging oversight sits in the fund accounting team.

**Mitchell –** This is a mixture for us. The day-to-day reviews via the dashboards, when we implement them, will lie with the fund accounting. But this

**"FX IS CERTAINLY AMONG THE RISKIEST ASSET CLASSES. IF YOU GET IT WRONG, IT CAN BLOW A MAJOR HOLE IN YOUR PERFORMANCE."**

*Dan Cunningham,*
*Merian Global Investors*

also falls under the procedures for assessing third-party service provision and our broader asset servicing relationships.

## Regulatory drivers and industry guidance

***Funds Europe* – The FX Global Code advances a set of principles designed to guide market participants in the governance, ethics, risk management and oversight procedures associated with FX hedging. How important has this Code been in guiding best practice across the industry?**

**Mitchell –** The regulatory focus on best execution and transaction costs has driven our practice to a degree – but this is only a small part of the wider consideration that we have given to transaction costs and processing efficiency.

**Paterson –** This regulatory push has been important, no doubt, but in terms of FX guidance this provides a minimum standard. The standards set in this area by our trading team are well above this threshold – and that is also the case for

FX hedging functions that we outsource. This comes back to providing tools to our traders to enable them to execute more effectively. Instead of taking this to auction, could we achieve a better outcome through another execution channel? What time did you execute the trade during the day and was this optimal? These are broader questions, that extend beyond FX, of how we can trade better. But in response to your question, our internal standards sit well above the minimum threshold set out by the ESMA guidance.

**Cunningham –** Asset managers had a shot across the bows from the Financial Conduct Authority a few years ago in terms of oversight standards. The second Markets in Financial Instruments Directive (MIFID II) and Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs) are driving detailed attention to best execution and execution costs. These are minimum standards to adhere to, but we are working to higher standards in terms of oversight and in driving cost savings. We have been proactive in anticipation of what our clients expect of us and the fiducial responsibilities that we hold to that client group. We are taking steps to get ahead of the curve and deliver quality oversight, while using as few people as possible to do so. This demands that we apply high-quality tools to the process.

**Cabaj –** I would echo that point. The regulations have their place, but it is our reputation with our clients that is most important in driving standards forwards. The way that we deal with extreme situations is key. You can have a hedging process that works well 99% of the time, but the 1% can kill you if you are not effectively hedged – for example with large subscriptions or redemptions …

**"WE MUST BE CONFIDENT THAT WE CAN MOVE FROM PROCESS A TO PROCESS B WHEN THE SITUATION DEMANDS IT."**

*Ryan Mitchell, First State Investments*

**Mitchell –** Yes, and this is contingent on the fund accountant and transfer agent being able to deliver information on a timely basis to enable the hedging provider to take appropriate action. They require appropriate triggers to move to a Plan B or Plan C and therefore this is not simply a hedging problem, it requires streamlined data flows from end to end. We must be confident that we can switch from Process A to Process B when the situation demands it, and that we are moving to a process that is still highly efficient and automated. We do not want to expose ourselves to more risk by trying to do the right thing, but actually moving to contingency plans that are not operationally robust.

**Cunningham –** With respect to the TA flows, we have midday valuation points, but it still amazes me that three hours after this point, we may still not know from the TA exactly what our flows are. This is one area where the availability of real-time dashboards can offer real benefit, providing real-time access to your data so that you can respond more promptly. We are interested in working with our TAs to improve the overall flow – since they may not be fully aware of how this information delay impacts our FX hedging programme.

***Funds Europe* – This suggests a big variation across the**

**market in terms of timeliness of data delivery?**

**Cunningham –** Some providers are investing heavily in technology and others are more complacent. It is only when asset managers challenge those service providers that are underperforming that we are likely to see a significant improvement in service quality from these organisations.

**Sproul –** One element that has become more prominent in our discussions with clients is the demand for transparency in their FX hedging relationships and questions around what sort of tools they should employ to ensure this. Just as there has been a step change in the detail that clients require around performance attribution and transaction cost analytics for other asset classes, so too they want this for their FX hedging activity. The FX hedging area still has some catching up to do, but things are moving in the right direction.

**Paterson –** As an asset class, FX is one of the hardest to understand in terms of the quality of your execution and the transparency of these processes. I agree that we can expect to see improvement in this area – but FX hedging is relatively complex and it will take time to bring everybody on that journey.

Returning to Dan's earlier point, those service providers that are failing to invest in technology and to upgrade their service standards are likely to disappear. As an asset management company, we are looking to build economies of scale and to operate as efficiently as possible. Every service provider that we partner with needs to be embracing technology, to be automating their processes, to be extending transparency and delivering cost efficiency.

***Funds Europe* – Roger, have you seen evolution in the hedging strategies that your clients apply, developments that are pushing you to refine the FX hedging solutions that you offer?**

**Exall –** I wouldn't necessarily say that the FX hedging product has changed, but its importance to our clients has escalated significantly over the past few years. As a consequence, we've needed to invest into analytical tools to ensure our clients have the data they need to make informed decisions. The focus five years ago was on the calculation and we now have a highly automated calculation engine that is exception-based. These exceptions can be tailored to a granular level (e.g. a client, fund, share class, currency, asset, etc). We get to know our clients well to evolve our rules matrix so that we are engaging with clients when there is an exception worthy of taking the time to investigate.

With this scenario-driven approach – working with the extensive experience in our FX Hedging team and with clients that have encountered a range of stressful situations historically – we hope to not be confronted by many situations that we have not encountered previously. This ex-ante planning is integral to our approach. More broadly, we are fortunate in that the FX Hedging system is an in-house standalone system created and supported by dedicated FX Hedging IT and business resources. We believe this approach has been fundamental to the quality of our FX hedging service and has enabled us to confidently take the next step into the digital era.

***Funds Europe* – How are fee negotiations shaping service provider selection in this area?**

**Exall –** Fees are coming under scrutiny. Inevitably, we need to demonstrate that we are delivering services in line with the contractual agreements, from both a calculation and execution perspective. Then you look at the value-add in the context of performance analytics and parameter simulations. All of this translates into a competitive FX hedging landscape where asset managers are looking at FX hedging as a standalone service and selecting best-of-breed rather than having it bundled with their core service provider. This is good for us, given our commitment to being top of the market.

**Paterson –** We all aim to achieve the best value for money. But effective FX hedging is essential to managing investment risk and a significant error in your programme will result in costs that dramatically outweigh small basis point savings on your fees. For this reason, we believe it is important to get your provider selection right and we would not contemplate changing providers simply to realise small fee reductions for our FX hedging.

**Sproul –** We run service benchmarking on behalf of clients and now have 15 years of data in this area. It is interesting to look at the service approach and share-class rate cards that used to sit within bundled custody contracts, where the FX hedging was essentially an addendum to other services. We now see clients running RFI and RFPs for FX hedging as a standalone service.

It is noteworthy that when clients have reviewed their hedging programmes, typically as part of a wider custody contract four or five ago, they are often surprised how far rates for FX hedging have come down and how the tools supporting oversight and optimisation have progressed over this time.

> **"IT IS CRUCIAL TO MAKE SURE THE WHOLE PROCESS IS AUTOMATED AND FREE FROM ERRORS"**
>
> *Krystian Cabaj, J O Hambro*

### Concluding thoughts

**Cunningham –** Service providers are now realising that asset managers can move much more quickly than perhaps was the case in the past. The extension of cloud-based technology provides greater flexibility and ease of migration. For other services, we are constantly evaluating whether costs that we are paying to an external provider may be a service that we can provide efficiently in-house. Collateral management, for example, is an area where developments in technology mean that we may now be able to manage many of our service requirements internally.

**Sills –** We looked closely at the benefits of utilising a give-up model with an FX prime broker, concentrating our FX trading and collateral management relationship with a single party. We put that model into operation several years ago.

**Exall –** What has been your experience regarding the benefits of using a single FX prime broker compared with the flexibility offered by trading with multiple brokers? And how does collateral management efficiency balance up across these approaches?

**Sills –** It certainly adds complexity into your operating model when you need to post collateral with multiple different parties. It is much more efficient to have one single FX PB to work with.

**Exall –** That is an interesting topic as the collateral arrangement for FX, if in place for an FX hedging process, can be somewhat overlooked and needs to be reviewed to quantify the cost plus impact to the FX hedging performance whilst investigating ways to generate efficiencies.

**Paterson –** One important conclusion surrounds the importance of technology development in this space and the value of partnering with houses that are interested to develop their technology in a like-minded fashion. Transparency is also an important issue. We have high levels of transparency in certain areas and we are constantly assessing how we can extend this more broadly across our service provision to give us a complete picture.

**Sills –** Internally, a priority for the coming 12 months is to drive our portfolio automation initiative. Externally, we are constantly working to extend transparency and to improve automated data flows between key parties to our share-class hedging functions, embracing the TA, administrator, prime broker and other key parties.

**Mitchell –** With publication of our internal FX hedging policy, we will be revisiting the results with our service providers to really push them to accommodate that model. We continue to drive for transparency, the ability to access detailed data and performance attribution on our FX hedging activity and to make decisions off the back of that information.

**Sproul –** We have seen that, although firms have different investment approaches, there is a lot of commonality around how they are applying their FX hedging models. That said, there is no silver bullet – no single model that is right. Every firm has to adapt to the specific challenges that confront them and work with service partners to develop tools that deliver an optimal solution for their needs.

**Cabaj –** There is an increasing pressure around optimisation and effectiveness of the FX processing in the industry – especially for J O Hambro Capital Management as we run a performance-fee model on our funds. That is why it is crucial to make sure that the whole process is automated and free from errors. We are constantly reviewing our procedures and work with RBC I&TS to make sure we are ahead of the market in this regard.

**Paterson –** A central ingredient of efficient risk management is to maintain an automated and systematic process as far as possible. Alongside this, we maintain a constant dialogue between the trading team, who see the current flows, and the FX hedging team. So, whenever there is more than say a 5% redemption, there will be an immediate conversation. “Did you see that come through?” “Yes, that is now hedged.” This does involve a level of manual oversight in a largely automated process, but we are willing to maintain this to ensure that the larger flows, the big subscriptions and redemptions, are properly covered.

**Cunningham –** FX is certainly among the riskiest asset classes. It you get it wrong, it can blow a major hole in your performance. This underlines the importance of the issues that we have discussed in this roundtable. **f**e