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NAVIGATING MARKET RISK

FX Risk – The Forgotten Factor in Private Capital Performance?

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It is no secret that pension funds are allocating more capital to private investments, such as private equity, private credit, and other illiquid assets, either directly or more commonly via dedicated fund managers.

According to Willis Towers Watson, investors across 22 major pension markets (making up 92% of all pension assets) have been increasing their exposure to private equity, real estate, and infrastructure at an eye-watering pace over the past two decades, from 6% of total assets in 1999 to 23% in 2019.

As the market for private assets is global, with almost half of all private capital AUM being managed by funds outside of the US (according to PitchBook), the increased allocation to private investments has also increased pension funds' currency risk. And this risk is not immaterial. A US pension fund investing in euro-based private equity fund over the last decade may have seen returns eroded by up to a third or more, as the euro depreciated versus the dollar in the aftermath of the Global Financial Crisis.

Of course, currency risk is nothing new for pension funds. Most will hedge some or all of the FX risk associated with fixed income investments, viewing FX volatility as an uncompensated risk in this asset class. Many will also hedge at least some portion of their international equity portfolio, although there is a wider spectrum of views on this. However, when it comes to private capital portfolios, it may seem like currency risk is a subject that is avoided altogether. We reviewed hedging policies of 23 local UK government pension funds and found that while about half (48%) hedge at least some of the currency risk within their public equity portfolio, not a single one hedged the same risks associated with their private capital holdings.

This might seem to be a counterintuitive finding. After all, private equity is still equity, and private credit is still credit. Why would pension funds feel it appropriate to hedge currency risk associated with public market investments, but not when it comes to their private capital portfolio? We believe that there are three main reasons why this might be the case.

Firstly, as noted above, private investments have historically represented a relatively small proportion of the typical pension fund portfolio. As such, the associated currency risk may have been considered immaterial. Clearly, this position is less compelling now, with private market allocations exceeding 20% on average.

Secondly, the operational complexity of hedging the FX risk associated with private investments is considered more onerous, when compared to hedging public equities or bonds. Some reasons for this include:

- Most private investments are done through a LP/GP structure where capital is committed up front and drawn over a period of time. This creates funding risk, something most pension funds are used to, however it also makes it harder to measure the inherent FX risk.

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- The multidimensional nature of FX risk within private investment portfolios can mask currency risk or make it difficult to identify. For example: A UK pension fund may be invested in a EUR-denominated private equity (PE) fund which in turn has made some investments in the US. Depending on the PE fund's own currency hedging policy the pension fund may be exposed to both EUR and USD. This complexity is exacerbated when there is a lack of visibility of underlying assets. Information about new investments, exits and valuations is typically only provided to investors periodically (e.g., quarterly).

- Hedging long duration, illiquid assets with hedging products that are subject to daily mark-to-market valuations and potential margining requirements can create liquidity risk which must be managed carefully.

Thirdly, the conventional tools and methodologies used to evaluate FX risk can be difficult to apply to private capital portfolios. We asked for an opinion from Professor Florin Vasvari, Academic Director of Private Equity at London Business School (LBS), who told us: "Pension funds generally find the measurement of risk associated with their private capital portfolio to be challenging, as standard volatility-based risk metrics are hard to apply. When you throw an extrinsic risk factor, like FX, on top, it becomes difficult for investors to know what to do with it". It seems, therefore, that the inability to identify and quantify currency risk in private capital portfolios could be the first (and potentially biggest) hurdle facing pension funds. As author and management theorist Peter Drucker famously said: 'you can't manage what you can't measure'.

None of these issues takes away from the fact that this currency risk exists, and if not managed can erode investment performance. However, we believe the lack of FX risk management in private capital investments by pension funds is not down to ignorance. Most are acutely aware of the "hidden" risks but are dissuaded from actively managing them due to the issues described above. Some pension funds are making headway though, for example the Danish €21bn pension fund Pensam, which recently changed their strategy for FX hedging to account for their growing allocation to alternative investments. "Now that we have increased our alternative investments outside Europe, we have also increased our FX risk. In contrast to listed equities, where prices can fluctuate somewhat, the valuation of most alternatives is rather stable. Thus, we have matched the FX contracts to the underlying assets," Jannik Teigen Hjelmsted, Head of Liquid Assets and Portfolio Analysis at Pensam, told the news publication AMWatch.

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Other pension funds have opted instead to push the responsibility of FX risk management to the private capital fund managers ('GPs') they invest in. Many GPs are consequently implementing fund-level hedging programmes to deal with mismatches between asset currencies and fund currency and expanding their fund structures to offer investors hedged feeder funds or share classes. While these approaches certainly have merit, given the fact that GPs often are closer to the risks and therefore have access to more information, they are not always available. Jonathan Gilmour, Partner and Head of Derivatives and Structured Products at law firm Travers Smith tells us that "whilst GPs can, and many GPs do, offer fully hedged returns, FX hedging strategies are typically implemented on a fund-wide basis and tailoring hedging for individual LPs is not really feasible in commingled funds. Also, some GPs won't offer active FX risk management solutions at all, either because they don't have the required expertise in-house or because they do not think that they have the necessary scale".

As private capital allocations evolve from niche to mainstream components of a pensions fund's portfolio, it no longer makes sense to treat the corresponding FX risk with any less importance than exposures generated from other investments. Pension funds should seek to delegate the management of FX risk to GPs where it makes sense and is possible but should also be equipped to manage these risks themselves where required – or seek assistance from independent expert advisors who can enable such sophistication through market-tested turnkey solutions. As private capital allocations continue to increase and become more globally diversified, the impact of FX risk will have an even bigger impact to investment performance for pension funds worldwide.

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