STATE STREET
GLOBAL ADVISORS.

CURRENCY
MANAGEMENT

For investors worldwide the increasing importance of international investing means that effective currency management is no longer optional.

Unmanaged currency risk contributes about 75% of the risk on international bond returns and 35% of the volatility of international equity returns.*

SSGA has currency solutions designed to reduce this risk and lock in portfolio profit.

* Source: SSGA, as at 31 March 2017.
WHY INVESTORS NEED CURRENCY MANAGEMENT

Currency risk waxes and wanes and sometimes shocks, but it never truly goes away. Managing the risk throughout the market cycle via a carefully considered currency policy can substantively improve portfolio efficiency and often provides valuable opportunities to help investors achieve their goals.

An Underestimated Risk

Investors often underestimate how much foreign exchange rate volatility can erode, or contribute to, international investment returns. Currencies regularly experience multi-year moves of 40–50% or more, depending on an investor’s home currency.

In today’s global capital market we often see 20–30% of total assets invested abroad and exposed to potentially massive swings in currency valuation.

Better understanding the risks of currency and its correlation with other assets is the first crucial step to improving portfolio efficiency through currency management.

A Byproduct of International Investing

Exposure to foreign currency simply comes along with investments in international assets. For most investors the largest concentration of foreign currency risk enters the portfolio via their allocation to global equities. That means investors tend to hold currency exposure in proportion to the market capitalisation of foreign equity markets.

Holding a large currency position simply because it has a large equity market generally leads to substantial risk with very low and often negative expected returns.

Currency valuations are driven by several factors, including differentials in countries’ inflation and interest rates as well as comparative levels of productivity, balance of trade, deficit financing and political stability, not the size of equity markets, bond markets, or the prevalence of good alternative investment opportunities.

Make currency risk work for you

Investing in currencies based on the size of equity or other markets may drag down a portfolio. But, that does not mean all currency exposures are bad. Currency can offer well-compensated risks, diversify portfolios or provide tactical opportunities. For many, currency provides a ready tool to help achieve their long-run investment goals and improve portfolio efficiency.

No Deadweight Exposures

We believe that all major sources of portfolio risk should carry a long-term expected return. There is no place for deadweight risks in investor portfolios.

Currently, and for the foreseeable future, investment returns are simply too low to accept unmanaged currency risk. It is a deadweight exposure that delivers high risk with near-zero expected return (in developed markets).

Factors Matter

We believe that factor exposures matter and that allocating solely by market cap and ignoring currency factors leads to sub-optimal portfolios. Given the potentially low returns across equities and fixed income, currency factor based investing is no longer a slightly more exotic alternative.

Protect Through the Cycle

A strong argument exists for managing currency risk throughout the market cycle, not just tactically in response to an event such as a rally in the portfolio’s base currency. It’s important to manage risk throughout the cycle not just at peaks and troughs.
Passive Currency Management

Set and Forget
The traditional approach to currency management is to pick a hedge ratio and stick with it over the course of a cycle.

This type of passive hedging approach can be ideal for investors with incidental, unmanaged currency exposure imbedded in their international portfolios who do not wish to manage that risk via other currency management strategies. In fact, we manage more than $100 billion in this way for our clients.*

Which Hedge Ratio to Use?
Pension funds have fixed liabilities in their local currency and leaving some currency gains on the table typically matters less than ensuring that adverse currency swings do not affect their ability to meet critical short- and medium-term obligations.

Hedging is not a binary decision i.e. hedge 100% or 0%. The most efficient hedge ratio depends crucially on factors such as the size of the foreign exposure, asset class composition, investor risk preferences, investment horizon, costs of hedging, and the correlation of the currency exposure with underlying assets. Many investors choose a hedge ratio of 50%.

We examine these and other factors with our clients, using our historical backtesting tools to better inform the choice of hedge ratio.

* As at 31 March 2017.

Dynamic Strategic Hedging (DSH)

Continually Optimizing
Treating all currencies identically by applying a single hedge ratio at all times is typically far better than remaining unhedged, but is generally not the most efficient solution.

Dynamically managing currency exposure customizes the hedge ratio of each currency with the aim of reducing the size of currency losses while providing an added source of diversification in stressed market environments and adding potential excess returns.

We believe that investors can overcome the shortcomings of static hedging by changing their strategic hedge ratio as their base currency shifts from being undervalued to overvalued over a currency cycle.

This type of dynamic hedging can help to reduce the realised currency losses that can result from static hedging programs, particularly when currencies have deviated significantly from their long-run fair value.
Absolute Return Currency

Profit from Volatility
With the search for alternative sources of return a key component in today’s investment environment, treating currency as an added source of alpha can be appealing for many investors.

Additional alpha opportunities exist in the currency markets and a systematic model-driven approach with manager discretion provides access to a diverse range of those opportunities.

The sole goal of this type of absolute return strategy is to add alpha through a full market cycle versus a benchmark.

The high volume and ample liquidity of the currency markets results in low transaction costs compared to most other asset classes. As a result, currency provides an extremely cost-efficient tool to gain exposure to both country-specific and global macro drivers.

Currency Smart Beta

Smart Passive Investing
The unhedged currency exposures in most standard international benchmarks generally introduce significant risk with zero or even negative expected long-run returns. That does not mean all currency exposures offer uncompensated risks, we believe that some offer very attractively compensated risk.

Currency risk premia, or factors, exist as compensation for country, liquidity and cyclicality risk and provide currency exposures with compensated risks. As a result, replacing the unhedged currency risk imbedded in most standard international benchmarks with factor-based, currency smart beta portfolios can provide higher returns for an equivalent level of currency risk. They offer a low-cost alternative to absolute return currency strategies.

Currency Management in Action

Our four core currency strategies are the building blocks for complete currency management solutions. In some cases, implementing one of the strategies achieves the desired outcome. In others, combining the strategies can better meet investors’ goals.

Reduce and redeploy imbedded currency risk
Investors often underestimate how much foreign exchange rate volatility can erode, or contribute to, international investment returns. Simple passive hedging can help to mitigate those risks.

Using DSH can further reduce risk and replace some or all of the lost return. The risk saved can be monetised by reallocating it to a more advantageous investment such as a shift from government debt into equities, real estate or alternatives, or investing in Currency Smart Beta or Absolute Return Currency.

Improving Return While Mitigating Risk
For investors with high-risk-premium domestic currencies, a passive hedge can provide a higher expected return.

However, hedging back to those high-risk-premium currencies can also increase risk as unhedged foreign currency exposure tends to perform well during market stress. Leaving foreign currency unhedged or under hedged could be considered a form of equity tail-risk protection, albeit very expensive.

A better solution would be to hedge at a higher hedge ratio and shift some exposure from equities into safer assets like government bonds to offset the higher risk after hedging. The net result is a portfolio with equal risk to the unhedged portfolio and a higher expected return.

DSH may also help offset increased tail risk from simple, passive hedging while augmenting return.

Generating Uncorrelated Alpha
Absolute Return Currency and Currency Smart Beta offer a source of alpha with a low correlation to equity and credit beta exposures.

DSH hedgers may also want to add some absolute return because it can be difficult to remain patient through the valuation cycle.

Absolute return currency strategies don’t attempt to enhance the risk management of a hedge, but allow the hedge to be responsive to short- and medium-term fundamentals and news events.

As an additional benefit, Absolute Return Currency is capital efficient in that it can be structured as an overlay with limited upfront cash funding.
SSGA GLOBAL CURRENCY MANAGEMENT TEAM

Effective resources, impressive trading capabilities and a highly experienced team combine to help you get the very best from your currency investing.

Track Record and Experienced Team
With over 15 dedicated portfolio managers and 5 dedicated FX traders, our team is resourced to deliver on investors’ currency needs.

We’ve been managing currencies since 1989 and the team have, on average, over 15 years industry experience.

We pride ourselves on our:
• Comprehensive advice and effective implementation of static and dynamic strategic hedging programs
• Diversified active strategies that seek to consistently add value in a variety of market conditions
• Robust quantitative currency research
• Cost-managed and risk-managed implementation

Straight-Through Processing
Our asset size enables us to invest in systems which promote accuracy and reliability, and reduce the potential for operational risk and miscommunication.

The portfolio management process and order creation is automated as much as possible with minimum manual intervention and all inputs are checked by a second person.

Effective and efficient FX execution
We are one of the world’s leading asset managers in terms of Request for Streaming usage and one of the first asset managers to begin to explore netting facilities.

Our scale and presence in currency markets — undertaking almost 275,000 fx trades in 2016, with a value of around $1.3 trillion — results in effective and efficient trading execution. This efficiency is key to ensuring low-cost solutions.

Truly Global: SSGA’s Business Decomposition

- **37.7%** EMEA
- **39.7%** ASIA PAC
- **22.6%** AMERICAS
Established Track Record
Solid Risk Management
Comprehensive Compliance Framework
Extensive Reporting Suite
Efficient & Effective Execution
Robust Investment Process
Experienced & Stable Currency Team

For more on how we can help you get the best from your currency investing, please contact your relationship manager or visit us at ssga.com
Investing involves risk including the risk of loss of principal.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Currency Hedging involves taking offsetting positions intended to substantially offset currency losses on the hedged position. The value of the hedging strategy will differ differently than expected, the volatility of the strategy as a whole may increase and even exceed the volatility of the asset being hedged. There can be no assurance that hedging strategies will be effective.

Investing in futures is highly risky. Futures positions are considered highly leveraged because the initial margins are significantly smaller than the cash value of the contracts. The smaller the value of the margin in comparison to the cash value of the futures contract, the higher the leverage. There are a number of risks associated with futures investing including but not limited to counterparty credit risk, basis risk, currency risk, derivatives risk, foreign issuer exposure risk, sector concentration risk, leveraging and liquidity risks.

Actively managed strategies do not seek to replicate the performance of a specified index. The Strategy is actively managed and may underperform its benchmarks. An investment in the strategy is not appropriate for all investors and is not intended to be a complete investment program. Investing in the strategy involves risks, including the risk that investors may receive little or no return on the investment or that investors may lose part or even all of the investment.

A Smart Beta strategy does not seek to replicate the performance of a specified index and as such may underperform such an index. The factors to which a Smart Beta strategy seeks to deliver exposure may themselves undergo cyclical performance. As such, a Smart Beta strategy may underperform the market or other Smart Beta strategies exposed to similar or other targeted factors. In fact, we believe that factor premia accrue over the long term (5-10 years), and investors must keep that long time horizon in mind when investing. While diversification does not ensure a profit or guarantee against losses, investors should diversify across a mix of factors to address cyclical changes in factor performance. However, factors may have high or increasing correlation to each other. A quality style of investing emphasizes companies with high returns, stable earnings, and low financial leverage. This style of investing is subject to the risk that the past performance of these companies does not continue or that the returns on quality equity securities are less than returns on other styles of investing or the overall stock market.

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Asset Allocation is a method of diversification which positions assets among major investment categories. Asset Allocation may be used in an effort to manage risk and enhance returns. It does not, however, guarantee a profit or protect against loss.

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