Currency Management by International Fixed Income Mutual Funds

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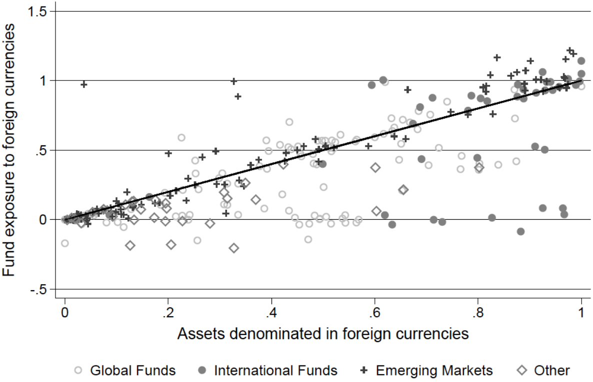
There is a lot to learn from this paper!

- There has been a lot of work on mutual funds
- But this is the first paper to shed light on their use of currency derivatives and their currency management policies
- Novel and granular data on mutual funds' portfolio exposure and currency forwards $\rightarrow$ lots of interesting facts
- Thoughtful and comprehensive analysis on why funds use currency forwards and what the implications on fund performance are

1. Facts

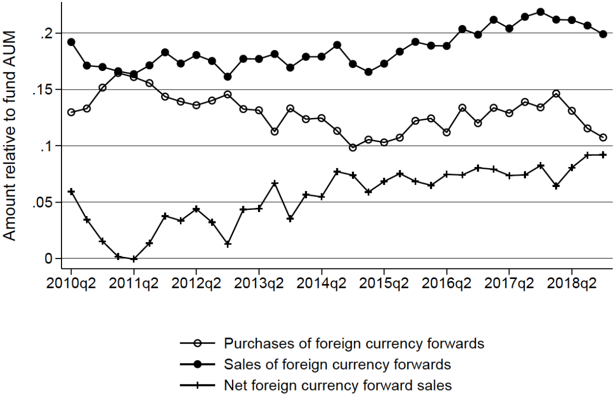
- 90% of international fixed incomed funds domiciled in the U.S. use currency forwards
- Large variation in how much they use:



- Many other interesting facts in the paper

2. Determinants

"It is somewhat surprising that a nontrivial set of fund-quarters purchase foreign currency forwards and thereby increase their foreign currency exposure. This suggests that some funds' purposes of utilizing forward contracts is not to hedge foreign exchange risk."

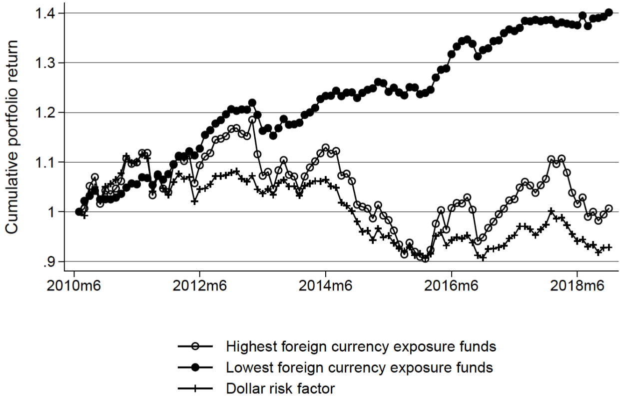


2. Determinants

1. Risk management: hedge asset-side currency exposures
2. Return enhancement: e.g.,currency momentum, risk timing
3. Prevent outflows after poor past performance
    - Specific to fixed-income funds with liquidity transformation
4. Clientele preferences

3. Performance

- Funds with the lowest level of FX exposure have higher returns, lower volatility, and a higher Sharpe ratio
- Outperformance of low-currency-exposure funds mostly driven by currency returns



Comments

1. Costs of using currency forwards
2. Effect of currency exposure on fund performance
3. Sample of funds

1. Costs of using Currency Forwards

- There seem to be many benefits of using currency forwards
  - risk management, return enhancement, reduce outflows, etc....
  - performance of low-currency-exposure funds is the same if not better
- But why don't ALL funds use forwards to fully hedge and enhance returns? Is there money left on the table?
- What are the costs of using currency forwards for funds? How do they vary across funds and time?

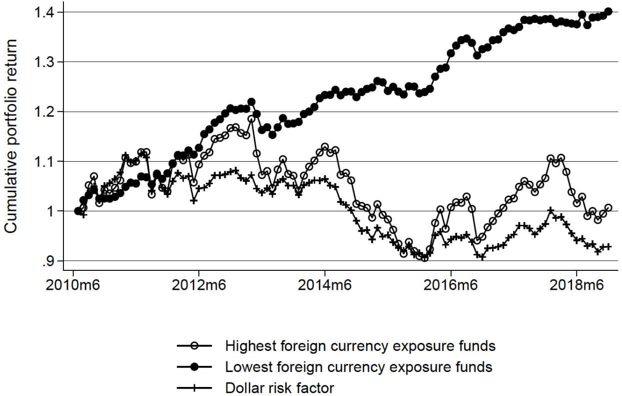
1. Costs of using Currency Forwards

Suggestion: mention and discuss the costs of using currency forwards alongside the current analysis of benefits

- Currency forwards are traded OTC with banks
- Some evidence of costs in one of the specifications:
  - Higher bid-ask spreads $\rightarrow$ lower hedge ratio
- The data seems to have some useful info
  - Currency
  - Maturity
  - Counterparty identity

2. Effect of Currency Exposure on Performance

- An indirect way to back out the costs of using currency forwards could be to check how they affect fund performance
- But recall: funds with the lowest level of currency exposure have higher returns, lower volatility, and a higher Sharpe ratio



2. Effect of Currency Exposure on Performance

- The current findings on the effect of currency exposure on fund performance use NET currency exposure
  - = fund asset currency exposure - currency forward exposure
- Not sure whether fund asset exposure or the use of currency forwards is driving the results
- Suggest: evaluate the effect of currency forward exposure on fund performance, controlling for fund asset exposure

3. Relevant Sample

- Current sample: international fixed income funds domiciled in the U.S.
- Recall the determinants of using currency forwards:

  1. Risk management: hedge asset-side currency exposures
  2. Return enhancement: e.g.,currency momentum, risk timing
  3. Prevent outflows after poor past performance
  4. Clientele preferences

3. Relevant Sample

- Current sample: international fixed income funds domiciled in the U.S.
- Recall the determinants of using currency forwards:

  1. Risk management: hedge asset-side currency exposures
  2. Return enhancement: e.g.,currency momentum, risk timing
  3. Prevent outflows after poor past performance
  4. Clientele preferences

- Only #1 seems specific to funds with foreign currency exposure!

3. Relevant Sample

- If reasons #2,#3, and #4 hold, shouldn't funds without foreign currency exposure also use currency forwards? Do they? Why or why not?
- Suggest: Look into them for more insights on and variation in the determinants of funds' use of currency forwards and their effect on fund performance

Conclusion

- Very interesting paper with lots of new findings! Much potential for follow-up work in this area
- Suggestions
  1. Discuss costs of using currency forwards in addition to the benefits
  2. Distinguish between the effect of fund asset exposure versus currency forward exposure on fund performance
  3. Do funds without foreign currency exposure also use currency forwards to enhance returns?