The Case for Fundamental Currency Management

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Consensus wisdom holds that fundamental value is a less reliable concept for currencies than it is for markets. But our research shows that exchange rates tend to revert to fundamental value over shorter time horizons than prices in markets. We believe they are also equally likely—with high statistical confidence—to revert.

This argues for greater reliance on the use of value/price investment signals in dynamic currency management than for asset-class management, which is likely in opposition to what may be judged to be appropriate by the consensus wisdom of global investors.

Active in Global Currencies

We expect currency to contribute a material portion to the risk taken—and likely to generate a commensurate return—in our multi-asset portfolios over the longer term. That is, the active risk budget devoted to currency exposure often approaches equality to, and in some cases exceeds, the active risk budget allocated to equity and bond markets exposures over time.

One reason for this significant allocation of the risk budget to currency is the diversification benefit that a dynamically managed currency strategy is expected to provide within a broader, global multi-asset portfolio. Over the long term, currencies have no correlation with traditional assets and markets and, therefore, should be expected to deliver performance that is generally uncorrelated with market-oriented exposures.

We believe this relationship between currencies and markets is embodied in our team's long-term, forward-looking Equilibrium risk model. Over shorter horizons, and embodied in the team's shorter-term, forward-looking Outlook risk model, correlations between currencies and markets can be non-zero, but they tend to still be low relative to, say, the correlation of one equity market with another, or one bond market with another.

This means that even if the active currency risk is large in isolation, its contribution to total portfolio risk should typically be low because of diversification effects. This has been our team's experience for more than two decades.

Inclusion of currency thus has the potential to "punch above its weight" in respect of contributions to return and contributions to risk of a dynamically managed multi-asset portfolio, and this argues for an active currency strategy to be employed meaningfully over time, even though there are fewer currencies in the investable universe than there are markets (there are more than 30 currencies in our team's investment universe, compared to more than 75 different equity and fixed income "buckets," which represent countries, sectors, and credit categories).

Another reason for the generous use of currency strategy in our team's portfolios is the efficacy of exchange rate reversion to fundamental value. The foundation of our team's investment process is the determination of fundamental values for asset classes, markets, sectors, and currencies, and the identification of investment opportunities defined as significant discrepancies between prices and these fundamental values.

The Pull of Fundamental Value

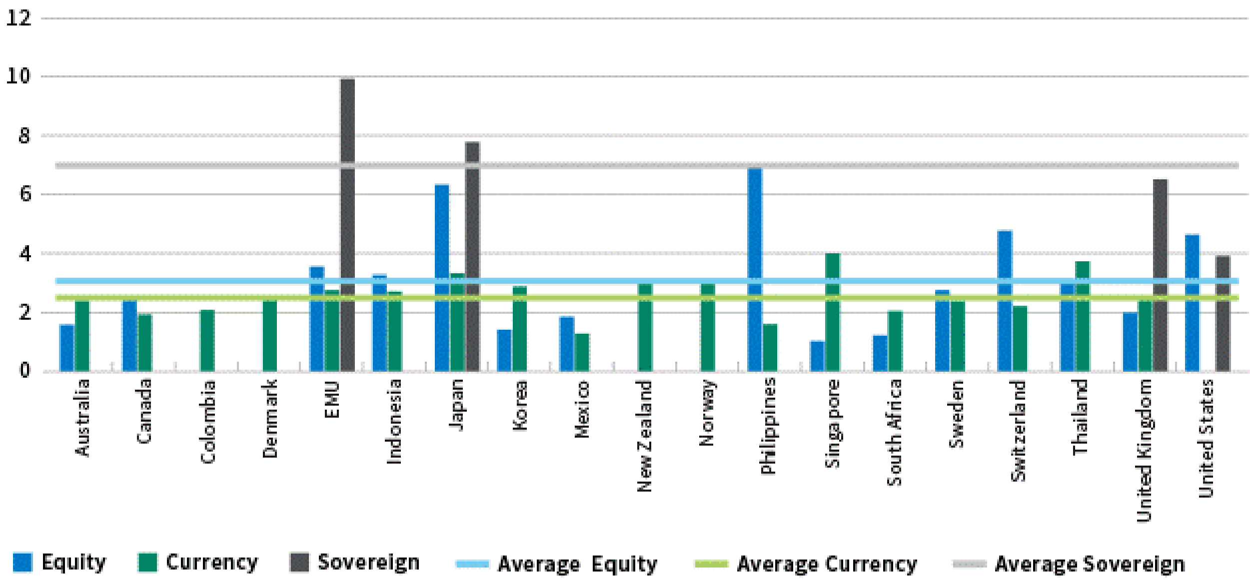
Adherence to the reversion of price to fundamental value is a cornerstone of the justification of major investment exposures in our portfolios as well as the belief that value exerts an inexorable pull on price over the medium term. Fundamental value is a discounted cash flow concept for markets, and a relative purchasing power parity concept for currencies, and our team's valuation methodology is described in two papers available upon request.

We observe that the pull of value on price is at least as powerful for currencies as it is for assets, which means that attractive fundamental opportunities can be identified and exploited within currencies in our opinion. While this finding is supported by rigorous academic research, it is contrary to the consensus of many investment professionals who are often skeptical about the possibility of adding value by investing in currencies.

In our recent white paper, we summarize our findings that currencies have equally robust reversion to fundamental values as do markets. We conducted simple tests involving 19 currencies (18 exchange rates), 14 national equity markets (treating the eurozone as one market), and four government bond markets. We used monthly data from mid-1971 to mid-2021 (50 years) where available, or as much data as possible where it was not.

Broadly noted, we found that the time taken for exchange rates to revert to fundamental value is equal or shorter for currencies than for assets. Accordingly, the probability of reversion to value, looking forward from any point in time, is as large for exchange rates as it is for equity and bond markets. And if currencies revert to fundamental values over horizons similar in length to equities and bonds, or shorter, we believe this property of currencies is an additional reason why active currency management should be materially utilized.

Average Half-Life of Currency and Asset Reversion to Price to Value (Years)



Source: William Blair. Half-life reversion to value is shown based on the rolling 30-year half-life estimate over a 50-year observation period ended June 30, 2021

Emerging Versus Developed Markets and Currencies

An additional feature of our findings is that the reversion statistics for the emerging currencies and equity markets in our data set are similarly compelling as are the results for developed currencies and equity markets (emerging bond markets are not included in our data set).

It is consensus wisdom (with which we agree) that the risk (volatility) inherent within emerging markets is higher than it is for developed markets, which has implications for the relative sizes of investment exposures that should be taken in emerging markets, given the magnitude of value/price discrepancy, when compared to developed markets.

However, a similar efficacy of reversion to value appearing in both emerging and developed currencies and markets suggests that the former stand on equal footing to the latter with respect to inclusion in a dynamic investment management universe. Our team’s investment universe comprises multiple emerging and developed markets and currencies in recognition of this.

Conclusion

In our view, these results argue for a greater reliance on the use of value/price investment signals in dynamic currency management than may be judged to be appropriate by the consensus wisdom of global investors.

It is this, coupled with the expectation of low correlation and large diversification benefits of managing currency in a global multi-asset portfolio, which is the basis for our team's long-standing decision to devote a material portion of its multi-asset portfolios' active risk to currencies.

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Disclosure:

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