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Feature Articles

This month's focus: **Managing Currency Risk in Institutional Portfolios**

For the past quarter century, Japanese investors have generally been controlling exchange rate fluctuation risk either by hedging or using other options. Using hedging, one can avoid exchange rate fluctuation risk, though a higher premium is necessary if the hedging cost is high.

Whether one uses hedging or an alternative, one also needs to diversify the composition of currencies away from the major ones to others.

Yet, there is no commonly established way of diversifying currency composition. In my opinion, it is an important task to find a way to diversify composition from just major country currencies to also include those of emerging countries.

Currency management is a long-standing theme for yen based investors as yen has been a relatively low yield currency and suffered appreciation when market sentiment deteriorated. In this article, we rethink currency hedging by considering a balance between hedging cost and risk management. Our simulation results indicate that full hedging is not always the best solution, and that reduction of the hedging ratio may improve cost efficiency. In addition, dynamic downside management strategy to replicate protective put pay-off can be considered a solution to avoid paying full hedging costs all the time while mitigating downside risks to a certain level.

Japanese pension funds have faced two challenges in terms of currency risk management. One is the shrinking expectation regarding benefits to be gained from diversifying currency composition since the latter 2000s. The other is hedging costs imposed on lower interest rate countries. To address and manage these challenges, we propose a two-step risk management process based on a long-term view and short-term strategy.

We also reviewed the currency risk management style of foreign public pension funds in order to confirm that it could be different depending on the base currency.

Investment strategy discussions focus on equities and bonds, but there is little discussion about the role of currency. However, the globalization of investments has increased the impact of currency on total portfolio returns. The question of how to manage currencies depends on many factors, including the base currency of the investor, fund characteristics, liability structure, etc. Currency policy recommendations have often been based on outdated academic research on 'optimal currency hedging', which proved to be unstable and unworkable.

In this paper, I will touch on the revolution surrounding currency management and discuss the importance of measuring the impact of currency on fund risk and return. In addition, I will explain how structural changes in the currency market have substantially increased the impact of currencies on Japanese institutional investors. Finally, I will refer to the importance of laying down explicit currency management policy.

Active currency hedging aims to create positively skewed active information content between investment success and error through a stream of investment decisions on currency risk over time. A search for higher quality information drives a recent approach to apply AI to currency hedging. This paper defines an ideal AI-driven framework for hedging, which is to be verified by a combination of Generalized Conditional Risk Attribution (GCRA) and the investor's benchmark-specific utility preference regarding visibility of the investment outcome.

Prospects

Economic and Industrial Analysis

Article

Recently, corporate real estate (CRE) strategies have attracted greater attention following the shift to fair value accounting. However, corporate real estate has seldom been studied on its own. The aim of this study was to ascertain the effect on stock markets of information disclosed by companies that have adopted accounting for impaired assets, and to examine idle real estate. As a result, a relationship between financial indicators and disclosed information about assets was observed, the mechanism whereby idle real estate is generated was explained, and investors were educated as to the usefulness of information about idle real estate.