svb Silicon Valley Bank

FX risk advisory: manage FX as an asset class

Key takeaways

- Foreign exchange (FX) meets the definition of a separate, standalone, asset class and will impact global returns – worthy of consideration for active FX management.
- Private equity and venture capital investors should evaluate three key criteria to determine if action on FX (aka hedging) is warranted: materiality, investment success likelihood, and exit date visibility.
- Active management strategies can help decrease currency risks and potentially generate a boost to internal rate of return (IRR).

Global investors in equities, credit, real estate, and other assets find themselves exposed to FX as a by-product of investing overseas. After all, their total return will depend not only on the performance of the asset, but on the currency involved. However, seldom does the investment decision involve a defined view on the currency. When choosing Latin America as a destination for capital, for instance, a global fund manager will typically make a decision based on the expected performance of the asset, but will generally be agnostic on the region's currencies.

However, being agnostic does not imply inaction.

Why FX is an asset class

We believe FX should be treated as an asset class, which implies that the expected return from bearing currency exposure is not zero. This is based on the following:

Return magnitude

FX significantly impacts global total returns. A US investor who bought into a diversified portfolio of European equities (benchmarked to STOXX 600 Technology Index) would find that FX shaved 5% off their total return in 2018, measured in USD. For the holding period 2013-2018, the fall in the euro shaved 22% off the investment total return[1]. The return magnitude varies by investment horizon, and the impact may be positive or negative.

Alpha generation

While all global investors experience FX exposure as a by-product, a niche class of investors seek out FX exposure as its own revenue stream. Carry trade investors, for instance, invest in foreign-denominated bonds hoping to capture the foreign interest rate, plus the return of the currency. This strategy has worked well in emerging markets. For the period 1999-2019, a portfolio of short-dated foreign-denominated bonds would have returned 4.6% per annum to US-domiciled investor, inclusive of FX gains and losses, with a Sharpe ratio that exceeds that of US stocks[2].

Low correlation

Currencies generally exhibit low correlation to other asset classes, swinging independently of other asset return streams.

Since FX will impact global returns, we recommend that investors give it the same close consideration as they would any other major asset class.

Active vs. passive FX management

Active FX management involves awareness, analysis, and possibly hedging. If applied to a venture capital investment, it may include the increased cost from adverse currency movements between the sign and close period. Active FX management may call for strategically securing the exact foreign currency required well before the close date– which could also involve hedging.

What if currency purchase considerations only happen at the close of a transaction? Take for instance the situation where a venture fund calls capital for an overseas investment, only purchasing currency at a late point near the close. By not considering the potential FX impact at the start of the transaction, the fund will feel the effects of FX. This is an example of passive FX management which could positively or negatively impact investment performance.

Read More: Examine why passive FX management falls short.

Determining when to actively address FX

According to the SVB Venture Capital FX Checklist, three criteria determine when it's appropriate to focus on FX: materiality, investment success likelihood, and exit date visibility.

Criteria 1: Materiality

Suppose you have deployed $10 million of capital outside the US. Viewed as a standalone investment, the impact of FX on total return could be material. However, if the $10 million is a portion of a $250 million fund, FX becomes less of a concern as even a sizeable adverse currency move may not move the needle.

Ask yourself these questions as part of your discovery process for materiality:

- What percent of fund capital assets are held in foreign currencies?
- Do you have Limited Partnerships (LPs) outside the US committing non-USD capital?
- Have you built a "5% buffer" into foreign investments to allow for the difference in timing between capital call and investment?
- Is the buyer or seller of foreign denominated assets located in the US or overseas?
- Are these credit assets that generate regular non-USD denominated cash flows, or equity assets that anticipate large back-end flows?

Generally speaking, if a minimum of 20% of the fund's net-asset-value (NAV) is invested overseas in non- USD, you've met the materiality threshold and we suggest you take a closer look at FX.

Read More: Gain insight into evaluating FX materiality.

Criteria 2: Investment success likelihood

Since the probability of investment success during a start-up's early stage is uncertain, handling FX passively may be appropriate. A lower likelihood of investment success may mean that there is no concrete FX exposure.

Once a company achieves scale, it will start to build revenues and ultimately, profits. As success grows, so too will FX exposure for the investor. A higher likelihood of investment success could create a situation where FX exposure is a nice problem to have.

Investors should understand that their FX exposure changes throughout the course of an investment, rising and falling with the potential for investment success.

Criteria 3: Exit date visibility

Once you have confidence that the overseas business you've invested in will survive, examine exit timing visibility. Knowing *how far out* to hedge is important, as is knowing *how much* to hedge.

For example, it is easier to hedge an investment with a foreign-listing IPO planned in the next 12-18 months than it is to hedge a portfolio company that has just completed its Series B round. Once you have achieved a higher degree of certainty that a foreign-denominated exit will indeed occur, knowing the exact exit date is not a limiting factor to proceed with FX risk management. For further details on how to structure a hedge despite timing uncertainty, please contact us for access to the SVB PES FX Risk Advisory library.

FX raises a host of considerations and could give global investors pause. But by understanding the criteria above, investors will have the insight needed to help understand when to act, and what actions to take.

IRR boost from FX hedging

Investors bearing FX exposure, who meet the criteria listed above, may hedge against currency movements using FX forward contracts. This may result in an IRR boost by taking advantage of potentially favorable forward pricing. Due to rising US interest rates in recent years, currency hedgers generally receive a better rate for selling developed economy currencies such as EUR, GBP, JPY and buying USD to the exit date on the forward market, as opposed to the spot market. This benefit, known as the FX carry pick-up, generally grows with tenor and may be as high as 3% per annum for euro, franc and yen as of the time of this writing according to Bloomberg.

This value proposition may appeal to investors who stand to gain no currency risk exposure and a potential IRR boost. Of course, forward contracts are just one possibility. Options may also make sense for investors who expect foreign currency appreciation, however, the IRR boost is likely the place to start.

Conclusion

We have established that FX exhibits characteristics of a separate, standalone, asset class, implying currency fluctuations will impact cross-border asset returns. Global private equity and venture funds should pay attention and create a framework to evaluate the benefits of an active approach. They should understand what actions to take, and when to take them in order to mitigate risk and maximize the potential for gains.

Achieving an "agnostic" state on currencies requires a calculated understanding of the risks involved, and subject to defined view or investment objectives, action such as hedging.

Read our other FX Risk Advisory papers.

If you'd like to discuss your specific risk profile, contact Bobby Donnelly at bdonnelly@svb.com, West Coast/Central, or Ben Johnston at bjohnston@svb.com, East Coast. You can also contact the author, Ivan Oscar Asensio, Head of FX Risk Advisory, at iasensio@svb.com.

[1] Bloomberg 2018.
[2] Bloomberg 2019.