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The relationship between exchange rate exposure, currency risk management and performance of international equity funds

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Abstract

This paper assesses the currency risk management policies for a sample of Australian international equity trusts. The relevance of currency risk management is considered in the context of exchange rate exposure and performance measures. The study incorporates differing economic climates and particular emphasis is given to the Asian crisis in mid-1997. Our results indicate that a good proportion of funds do implement specific currency risk management policies. Furthermore, we find that for those funds managing currency risk, there is some evidence of a favourable impact on currency exposure and fund performance.

JEL classification: G23
Keywords: Managed funds; Currency risk management; Exchange rate exposure

1. Introduction

International equity funds provide a convenient avenue for individual investors to access international markets. Hence, the assessment of fund performance and identification of factors influencing performance is very relevant to the investor. One issue, important in the evaluation of international funds, is the extent to which the fund is exposed to changes

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in exchange rates and the policies that are implemented in managing exchange rate risk. In this paper we report on a survey of fund managers that assessed the currency risk management policies implemented within the international equity fund sector. We take these results and consider the impact of the policies on the level of exchange rate exposure and performance evident in the fund returns. Our study focuses on the period 1995–2001 and therefore we compare results prior and subsequent to the Asian crisis of mid 1997 and consider periods of an appreciating and depreciating Australian dollar.

Research on the consequence of risk management policies of funds is scarce. Koski and Pontiff (1999) investigated the use of share derivatives within equity mutual funds. They found derivative users and non-users had similar return distributions and risk exposures. Geczy et al. (1997) and Tufano (1996) assessed derivative use in other industries. Our study focuses on currency derivatives. The apparent diversity of policies within international equity funds leads us to question if risk management has a material impact on their performance. It is possible to assess this impact by comparing policy information with exchange rate sensitivity and performance measures.

Exchange rate sensitivity is a term describing the link between the change in the value of a portfolio and changes in exchange rates. The value of a fund portfolio may be directly affected as a result of a depreciation (appreciation) in the home currency relative to the invested country's currency whereby the fund price would increase (decrease). There are however, a number of indirect effects that induce change in the underlying value of the fund portfolio as a result of exchange rate exposure incurred by individual firms comprising the portfolio. The exposure to the firms may be due to adjustments in export sales, cost of inputs or organisational competitiveness following a currency depreciation or appreciation. Transaction exposure may also affect a firm's cash flow where, for example, dividend income is received in a foreign currency or contracts are executed in a foreign currency. Numerous studies have examined the exchange rate exposure of individual corporations and industry portfolios and generally they have found some evidence of exposure (see for example Jorion, 1990; Loudon, 1993). Research on the exchange rate exposure of equity funds is limited. Previous research (Benson and Faff, 2003) has indicated that the returns of Australian international equity funds reflect varying degrees of exchange rate exposure. We now seek to assess the relationship between this exposure and currency risk management policies.

Additionally, we assess the relationship between the performance of the funds and the currency risk management policies. There are a number of studies analysing international investment fund performance. Selectivity and timing performance have been assessed by Cumby and Glen (1990), Eun et al. (1991), Droms and Walker (1994). These studies implemented models from Jensen (1968), Treynor and Mazuy (1966) and/or Henriksson and Merton (1981). Kao et al. (1998) and Gallo and Swanson (1996) also implemented a two factor international APT model. The results indicated that generally funds are unable to outperform the market index. At an individual level some funds did display selectivity and timing abilities. In the current study we apply the Treynor and Mazuy and Henriksson and Merton models to assess selectivity performance. We then analyse these results in light of the currency risk management policies identified from a questionnaire survey.

The extent to which the fund manager can control the effect of indirect exchange rate exposure on the fund is limited to the level of diversification and asset selection within