Insight INVESTMENT

WHY LOOK AT CURRENCY ALPHA STRATEGIES NOW?

MAY 2020

> We believe that there are a number of features that make currency alpha strategies an attractive asset class in the current environment.

EXECUTIVE SUMMARY

Given the increasingly uncertain outlook for the global economy and traditional asset classes, we believe now may be the time to revisit alternative strategies that can generate returns with a low correlation to other assets. In this paper we examine the positive role currency alpha strategies can play as part of a well-diversified portfolio.

- Currencies are a true relative value asset class
- Active currency strategies can be a source of pure alpha
- Currency strategies can be highly capital efficient
- Deep liquidity means strategies can be quickly adapted

i The economic fallout from the current crisis is likely to be severe and long lasting

ii Central banks are unlikely to be able to successfully contain market volatility

iii The notable rise in trade frictions and uncertainty we have witnessed in the past few years is likely to mean we have seen the peak in globalization

- Interest rate differentials are only one element of a broader information set

- We detail our Quantitative and Discretionary approaches to currency alpha
- Combining these approaches can enhance returns

THE CHOICES FACING INVESTORS ARE INCREASINGLY COMPLEX. LOW INTEREST RATES AND QUANTITATIVE EASING PROGRAMMES HAVE CAUSED A SIGNIFICANT PROPORTION OF GLOBAL GOVERNMENT BOND MARKETS TO TRADE WITH NEGATIVE YIELDS. OTHER RISK ASSETS HAVE BEEN SUPPORTED BY MONETARY AND FISCAL EASING, AND THE UNCERTAIN OUTLOOK MAKES IT DIFFICULT TO ASSESS VALUATIONS. WE BELIEVE THAT THERE ARE A NUMBER OF FEATURES THAT MAKE CURRENCY ALPHA STRATEGIES AN ATTRACTIVE ASSET CLASS GIVEN THIS BACKDROP.

ADVANTAGES OF ACTIVE CURRENCY STRATEGIES IN TODAY'S ENVIRONMENT

1. Currency markets are a true relative value asset class, for one currency to be expensive another must be cheap
2. Active currency strategies can be a source of pure alpha, they generally have very low correlations with other asset classes
3. Currency strategies can be highly capital efficient, and can be implemented without meaningfully impacting other core investments such as income generating assets
4. Deep liquidity means strategies can be quickly adapted to changing global events

1. Currency markets are a true relative value asset class

Currency markets are quite unique by virtue that if you are going to be long a currency, you need to be short another one. This makes them predominantly a 'flow' asset as they are neither linked to a stream of payments, as is the case with bonds, or to an underlying revenue-generating entity, as is the case with stocks.

Although the COVID-19 crisis has generated value in a number of asset classes, one of the challenges of investing is that frequently it is hard to find value. Even now, 18% of the fixed income markets that are captured by the Bloomberg Global Aggregate Index trade with a negative yield. One of the corollaries of actively trading currencies is that for each expensive asset, there is an associated cheap one. The currency opportunity set can never be limited by the market as a whole becoming expensive.

2. Returns from active currency tend to be pure uncorrelated alpha

A combination of its relative value nature and the lack of benchmark mean that returns generated from investing in active currency tend to be pure alpha. We can demonstrate this by working out the long-term beta of investing in various 'alternative' strategies versus a traditional balanced portfolio that invests 60% into the Bloomberg Global Aggregate Index and 40% in the MSCI World Equity Index, rebalanced monthly. In Figure 1 we calculate the beta of a range of alternative assets versus this traditional balanced portfolio:

- The HFRI composite hedge index
- A short position in the US dollar versus a basket of developed and emerging market currencies
- A basket of commodities

These alternative assets have a beta of between 0.6 and 1.3, whereas the beta of a blend of the Insight active currency management products is close to zero, suggesting completely uncorrelated returns. In Figure 2 we adjust the long-term information ratio of these strategies by the relationship they have with the traditional balanced portfolio, and again the active currency strategy compares favourably.

Understanding beta

The beta of an asset measures its sensitivity to the change in price of another asset or index. If an asset has a beta of 1 then it would be expected to move in the same direction and by a similar amount. As the beta varies from 1, so returns would be expected to move with a lower or higher sensitivity.

Chart 1: Long term beta of returns versus 60%/40% bond/equity index[1]

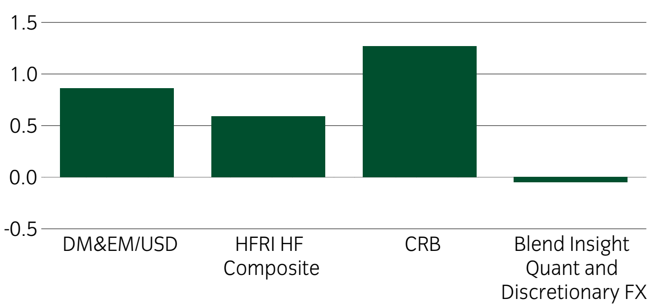
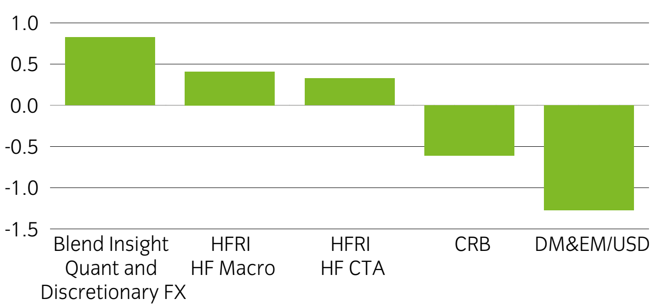


Chart 2: Beta-Adjusted information ratio[1]



[1] Source: Insight as at 30 April 2020.

3. Currency strategies can be highly capital efficient

Unlike with other asset classes where capital needs to be set aside to purchase an underlying asset, investment in currencies only requires enough cash to meet the fluctuations in the net asset value. As such it represents a very capital efficient way to invest and does not meaningfully impact investments in other core assets.

4. Currency markets are the deepest and most liquid markets

According to the latest BIS Triennial Survey of turnover in OTC FX markets published in April 2019, trading in FX markets reached $6.6 trillion per day, up from $5.1 trillion three years earlier. This figure compares with an estimated turnover of $535 billion in 2019 in the US Treasury market and highlights the ease with which macro views can be expressed through active currency management.

THE RETURN TO MORE NORMAL LONG-TERM VOLATILITY LEVELS COULD LEAD TO HIGHER RETURNS

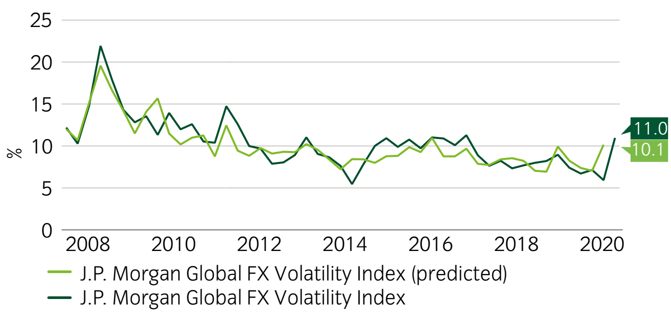
Although recent volatility may subside, it is unlikely to return to 2019 levels

The COVID-19 crisis brought an abrupt halt to a period of remarkably subdued price action in currency markets that existed through 2019: while the S&P closed 2019 with a 28% rally over the year, EUR/USD ended 2019 1.3% below its value of the first trading day of the year. Indeed, FX implied volatility had been gradually trending lower and reached close to all-time lows in the latter part of 2019 (see Chart 3).

As economic activity eventually returns to normal, currency volatility is likely to decline from recently elevated levels, but there are three main reasons to believe that the lows seen during the course of 2019 may not be revisited:

i The economic fallout from the current crisis is likely to be severe and long lasting. Even if activity rebounds as lock downs are eased, the notable deteriorating in fiscal balances and the further accumulation of debt that will ensue is likely to accentuate lingering structural problems for a number of countries and give rise to more cross-country differentiation.

Chart 3: Global FX implied volatility[2]



ii While financial repression and aggressive quantitative easing is likely to be one of the key tools used to meet increasing fiscal needs, it is important to realize that not all central banks will be able to successfully contain market volatility. This could be either due to limitations imposed by differing degrees of central bank credibility or by the inability to run independent monetary policy. Even for those central banks that will successfully contain rate market volatility, it is not clear that currency volatility will follow and the currency markets are likely to act as a 'safety valve' in pricing adverse developments.

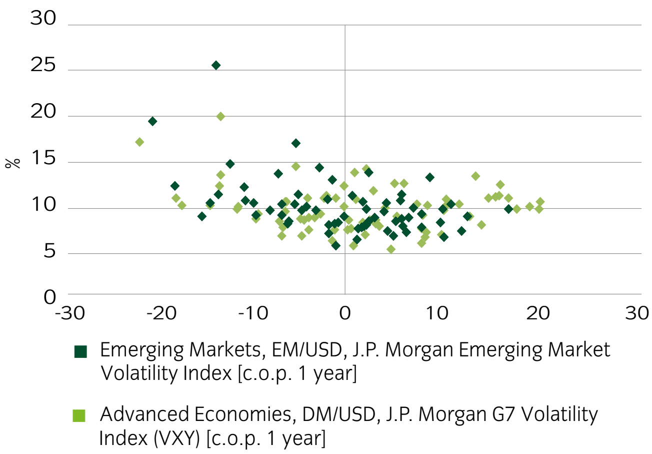
iii The notable rise in trade frictions and uncertainty we have witnessed in the past few years is likely to mean we have seen the peak in globalization. This trend is likely to be further acerbated by increased automation and suggests the correlation in growth across different countries is likely to stabilize, if not decline in the years to come. This should give rise to more cross-market volatility in growth.

More normal long-term levels of volatility should present more opportunities

In Chart 4, we highlight one-year US dollar returns versus both emerging and developed market currencies mapped against levels of implied volatility in currency markets. As can be seen, some of the most notable trends in the US dollar have taken place against a backdrop of moderate rather than extreme volatility. Indeed, we have observed that falling volatility with a drift can lead to some of the most lucrative trading environments. A return of volatility to levels more in line with historical averages, may be a precursor to a change in the trend of US dollar strength that has persisted over recent years.

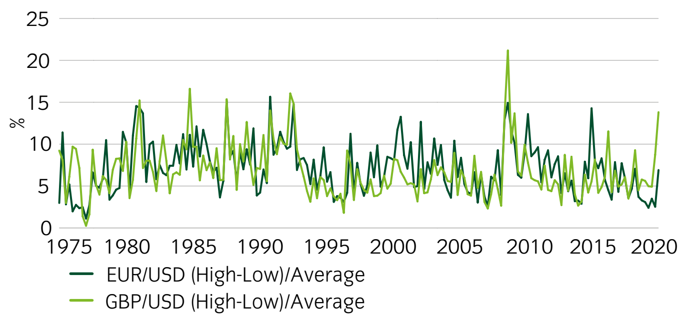
As globalisation turns to deglobalisation, we also believe that the number of interesting idiosyncratic stories will increase. For example, in 2019, although the euro traded within a tight range against the US dollar, the trading range of Sterling was far higher as a result of negotiations with the EU on their future trade relationship (see Chart 5).

Chart 4: Currency returns in EM and DM currency vs the USD by change in implied volatility[3]



[2] Source: Macrobond. As at 31 March 2020.
[3] Insight, JP Morgan and Bloomberg. Data between 31 December 2000 and 31 January 2020.

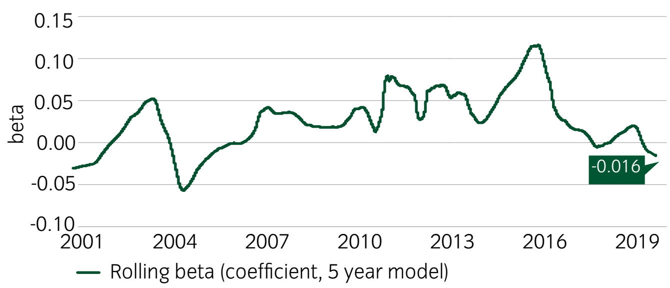
Chart 5: Quarterly trading ranges[4]



CURRENCY ALPHA IS NOT THE SAME AS CURRENCY MANAGEMENT WITHIN GLOBAL FIXED INCOME

Many global bond portfolios take an element of currency risk, but this is very different to a pure currency alpha strategy. Under the umbrella of a broader fixed income portfolio, currency management tends to be led primarily by the relative attractiveness of underlying bond markets. Although interest rate differentials are a driver of flows in currency markets, they are only one element of the broad information set this is required to invest in currency for pure alpha generation. When we examine the beta of the US dollar versus other developed market currencies relative to five-year interest rate differentials, we can see that the relationship can vary significantly (see Chart 6) as issues other than interest rates vary in importance over time.

Chart 6: Relationship between interest differentials and the dollar[5]



INSIGHTS APPROACH TO CURRENCY ALPHA

Insight Quantitative Currency Alpha

At Insight, we believe that investment returns can be generated via awareness of a number of persistent behavioural features that occur within currency markets. By utilising a systematic approach to capturing these behavioural features, we believe that it is possible to achieve reliable and repeatable returns over time. This is the bedrock of our investment process across a range of solutions, from alpha generation to hedging, and is detailed in our paper – A factor-based approach to currency management.

The ultimate output of this process combines the factors in such a way that each equally contributes to the volatility of the portfolio. The size of positions is then scaled to meet a client's risk and return objectives.

Insight Discretionary Currency Alpha

Our discretionary currency alpha strategy introduces greater management discretion on positions and position sizing. We tap into Insight's deep pool of cross-strategy investment expertise to pinpoint developments that we can exploit. These generally fall into four categories:

- Global themes, big picture trends that tend to impact specific baskets of currencies, for example commodity price changes
- Idiosyncratic trades, focusing on specific issues impacting an individual currency
- Deep value trades, seeking to exploit extreme valuation overshoots
- Tactical positions to exploit market dislocations

Trades are combined in such a way that reflects both the strength of our view as well as practical tactical considerations such as expected gains vs losses.

Combining these approaches can enhance returns

To understand how our strategies have performance over longer time horizons, we have categorised the 20-years to the end of 2019 into four different economic categories[6].

1. Growth is contracting/economic momentum is improving
2. Growth is expanding/economic momentum is improving
3. Growth is expanding/economic momentum is deteriorating
4. Growth is contracting/economic momentum is deteriorating

Generally, we have observed that the quantitative strategy, utilising our factor-based approach, tends to perform well in most economic environments, while the discretionary strategy adds value predominantly when growth is contracting and worsening.

By blending both the discretionary and quantitative alpha streams, we can achieve a distribution that generates alpha across the economic cycle.

[4] Source: Insight and Bloomberg. Data as at 31 December 2020.
[5] Source: Insight and Bloomberg. Data as at 30 April 2020. Beta of US dollar versus 5-year yield differentials in developed market currencies, calculated using a 2-year rolling regression.
[6] Based on the World Manufacturing Purchasing Managers Index between 31 December 1999 and 31 December 2019.

Chart 7: Sharpe Ratio in different economic conditions[7]

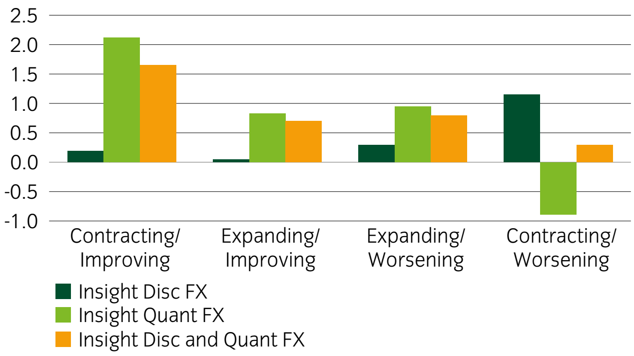
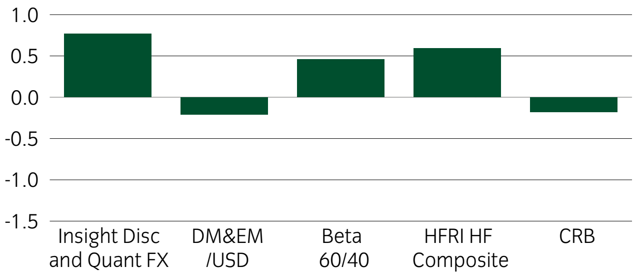


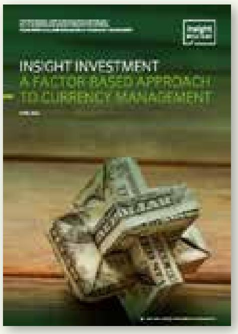
Chart 8: Sharpe Ratio versus other assets[8]



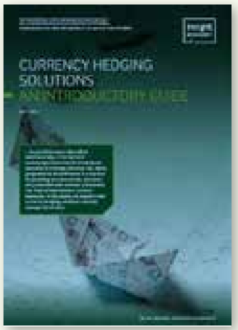
ACCESSING INSIGHT'S CURRENCY SOLUTIONS

Although we have built our investment process to capture the complexities of investing in active currency management, we are very cognizant of the fact that clients are not a homogenous entity. Our solutions can be fully tailored to clients' specific needs, this means not only adjusting parameters such as the appetite for risk or loss, but also choosing which, if not all, the strategies and factors can be included. Our solutions designers will work with clients to 'pick and mix' the desired currency drivers and construct a that will be a valuable addition to any diversified portfolio.

We provide further information on accessing Insight's currency solutions and how we can tailor a strategy to suit your objectives in two white papers, both of which are available on our website, or can be obtained from your Insight contact.



A Factor-based approach to Currency Management



Currency hedging solutions – an introductory guide

CONTRIBUTORS

Francesca Fornasari,
Head of Currency Solutions,
Insight Investment

Simon Down,
Senior Content Specialist,
Insight Investment

[7]Source: Insight Investment and Bloomberg. Data between 30 April 2007 and 31 January 2020.
[8]Insight Investment and Bloomberg. Data between 30 April 2007 and 31 January 2020.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Currency risk management

Currency hedging techniques aim to eliminate the effects of changes in the exchange rate between the currency of the underlying investments and the base currency (i.e. the reporting currency) of the portfolio. These techniques may not eliminate all the currency risk.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Where leverage is used through the use of swaps and other derivative instruments, this can increase the overall volatility. Any event that adversely affects the value of an investment would be magnified if leverage is employed by the portfolio and losses would be greater than if leverage were not employed.

FIND OUT MORE

Institutional Business Development
businessdevelopment@insightinvestment.com
+44 20 7321 1552

European Business Development
europe@insightinvestment.com
+49 69 12014 2650
+44 20 7321 1928

Consultant Relationship Management
consultantrelations@insightinvestment.com
+44 20 7321 1023

@InsightInvestIM

company/insight-investment

www.insightinvestment.com

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