Brown Brothers Harriman

5 Questions on Hedging FX for Alternative Funds

Alternative funds have been a fast-growing segment of the asset management industry – in large part due to a search for attractive returns. While alternative funds may offer diversification benefits, they often come with practical complexities, one of which is managing a FX hedging program.

1 What are primary purposes for FX hedging as it relates to alternative funds?

As with any asset class, alternative funds may take positions in international investments and/or have a global investor base, both of which introduce currency risk for investors. Managers may choose to hedge that risk in order to isolate local asset performance and minimize the currency risk that is an uncompensated by-product of investment decisions.

Additionally, managers who aspire to distribute their alternative fund(s) globally may do so using "master/feeder" fund structures. Feeder funds may be established in various currencies, each holding shares of the master fund (denominated in the home currency), which is then translated to the feeder fund currency for valuation purposes thus creating cross-border currency risk. Some investors may find this unintended currency risk a deterrent, creating an incentive for the manager to offer the feeder funds on a hedged basis. For example, the feeder funds could transact FX forwards intended to offset the currency risk and thereby isolate the performance of the master fund.

2 How does the typical master/feeder fund structure of alternative fund products differ from more traditional funds and how does this impact FX hedging implementation?

Managers often establish traditional long-only funds designed for cross-border distribution in the form of Luxembourg or Dublin based UCITS or Cayman Islands unit trusts with multiple share classes. Share classes are a means of allocating a common pool of assets (the investment strategy) across numerous investors, including those investing from multiple currency denominations.

By contrast, managers of alternative fund products often use master/feeder structures to facilitate cross-border distribution. Feeder funds are separate legal entities that own shares of the master fund. Unlike share classes, where each investor is allocated a direct investment in a pro-rata portion of all fund assets, the feeder fund holds the vehicle in which the investments are held, creating a "once removed" relationship to the assets.

In traditional share class FX hedging, while the performance of the hedge is directly attributed to a specific class, the hedge is an obligation of the fund.

In the master/feeder fund structure, the feeder fund directly owns the FX hedge obligation and its only asset or investment from which to create liquidity to meet any losses on the FX hedge are the shares of the master fund. The feeder fund can be subject to the constraints of the master fund (e.g., infrequent redemption cycles or gating) or the master fund's limited ability to raise cash due to the (il)liquidity of the investments.

3 How does the liquidity or illiquidity of assets in a portfolio impact the implementation of the hedging program?

Asset managers may implement currency hedging programs using short term FX forward contracts (typically, 1 to 3-month tenor) where settlement of the net gains or losses occurs on a monthly or quarterly basis. In a master/feeder fund structure where the feeder fund is the counterparty to the FX trade, the feeder fund must have access to sufficient cash to settle any potential obligations. For traditional funds with daily liquidity this isn't a problem. However, where alternative funds have limited access to cash once invested, it's critical that the feeder fund has some other means to make cash available, such as overdraft facilities or holding sufficient cash aside. The inability of the feeder fund to demonstrate access to liquidity can impact its ability to secure FX trading lines.

Jay Moore
Senior Vice President
Foreign Exchange
jay.moore@bbh.com
+1 212 723 4903

Andrew Ritchie
Vice President
Relationship Excellence
andrew.ritchie@bbh.com
+44 207 744 2490

4 Given the non-traditional nature of alternative fund structures, how likely is it that counterparties will demand collateral on the FX hedges based on credit concerns?

Given the potential liquidity challenges mentioned and an increased focus on cost of capital, the willingness of banks (FX counterparties) to extend unsecured credit/trading lines has diminished. As a result, fewer banks are willing to trade with alternative funds on an uncollateralized basis and instead require some form of initial and/or variation margin – most often in the form of cash. There is also the potential that margin may be required by regulations.

5 If the feeder fund is fully hedged, how accurately can I expect the feeder fund performance to track the master fund?

By design, a fully hedged FX program should help mitigate currency risk, thereby isolating the performance of the master fund for investors across various currencies. If the FX program is set to be fully hedged, the profit and loss of the hedge should offset the currency risk of the feeder fund relative to the master fund, subject to various factors such as interest rate differentials, transaction costs and other implementation impacts.

However, excess cash held by the feeder fund to satisfy hedge related obligations can create performance drag. Any amount held back at the feeder fund level is cash that could otherwise be invested in shares of the master fund, which may dilute the performance of the feeder fund. Hence it is important to optimize the hedging program and level set investor expectations.