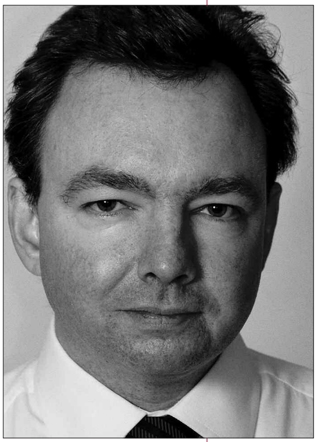
Foreign affairs



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James Stretton looks at the ups and downs of currency fluctuations.

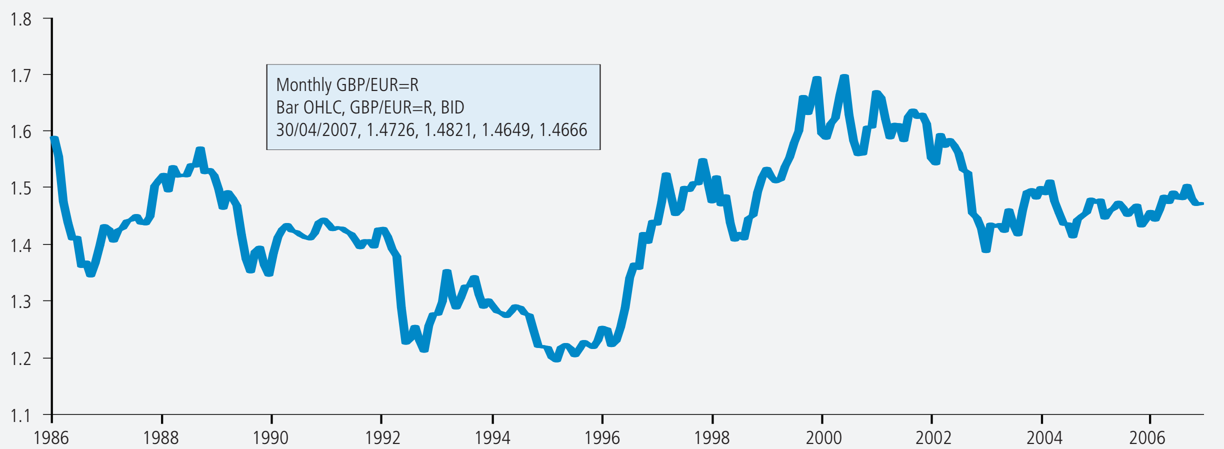
As more property companies and funds seek the enhanced yields of overseas markets, attention naturally focuses on the associated foreign exchange risk implications. While volatility in the foreign exchange markets has, of late, been relatively low, there is, of course, no guarantee that these benign conditions will continue. The GBP/EUR chart below shows the comparative calm of the last three years against the relative volatility of the preceding years. We have chosen to represent the exchange rate as GBP/EUR, rather than the market convention of EUR/GBP since for most readers (as also for most currency traders if the truth be known!) this will be more meaningful.
The recent relative stability of sterling against the euro, compared to the sharp sterling weakness as the UK wrestled with – and lost – its ERM membership in 1992, and the sharp sterling strength as the markets fell quickly out of love with the euro almost immediately after its inception, has prompted relatively little comment, since stable currency pairs rarely attract attention.

Some would say that the UK has achieved the best of both worlds, with GBP/EUR volatility at a remarkably low level without the unacceptable risk – from the perspective of a 'one size fits all' monetary policy – of eurozone membership. We should however reiterate that recent conditions in GBP/EUR have been extraordinarily benign.

As an aside, it is worth noting that levels of implied volatility of EUR/USD in the foreign exchange options market remain higher than those of GBP/USD. Although political enthusiasm for the UK's joining the euro has ebbed virtually to the point of extinction, with time it will, doubtless, resurface. Enthusiasts would do well to note that such a move, although by definition reducing GBP/EUR volatility to zero, would actually increase volatility against the dollar – the international currency of trade. For an economy as open as the UK, it is not at all clear that is a price worth paying.

For the UK investor in the eurozone, perhaps the greatest risk would be some sort of political crisis in Europe, although it is hard to imagine one that would lead to a meltdown of the currency. On the contrary, an increase in the GBP/EUR exchange rate is more likely to be brought about through a resurgence in the value of the USD. Sterling tends to track its value such that a strengthening dollar against the euro tends, albeit to a lesser extent, to coincide with a strengthening pound against the euro.

Figure 1: GBP/EUR Spot rate – monthly close



Source: Reuters

The USD has received a battering on the exchanges in recent months. While there are a number of reasons to sell the greenback, not least the twin current account and public sector deficits, with the (very debatable) perception in the market that the Fed is at the end of its tightening cycle and the persistent rumours that the Chinese are about to diversify their foreign exchange reserves, the dollar doomsters' arguments are well-rehearsed and, as such, have been thoroughly absorbed by the markets. In short, with so much bearish sentiment, it is not surprising that so far this year, the dollar has actually appreciated. Even so, with Germany's economy picking up strongly and euro interest rates rising, an argument for a sustained recovery in the dollar may appear to lack credibility from a short term perspective. Property, however, is rarely a short term investment and any investors who remain exposed to a weaker euro would be well advised to take advantage of any short term strength in the single currency in order to effect hedging at a potentially advantageous rate.

Natural hedges

Given that the vagaries of the currency markets have the potential to adversely affect the sterling value of a euro-denominated investment, it is reasonable to ask what can be done. Particularly for larger property companies investing on their own account, hedging against adverse currency movements is often relatively easy. Denominating term debt in the same currency as the asset provides a natural hedge, while many companies are in a position to provide equity through the use of a foreign currency-denominated overdraft facility which, again, acts as a natural hedge.

Retail investors and enhanced returns

For property funds however, particularly those offering investment opportunities for retail investors, equity invested will be at risk from a depreciation in the currency of the investment (often euro) versus the investors' currency of account (often sterling or the dollar).

In such a case, careful consideration should be given to hedging the foreign exchange exposure with derivative instruments. There is a fairly widespread assumption that hedging against foreign exchange risk always involves a cost. However, if interest rates in the currency of the investment are lower than those of the accounting currency, investors will actually see their return enhanced through locking into the current foreign exchange rate. For example, UK-based investors into the eurozone currently enjoy a yield enhancement of some 1.5% as a result of protecting themselves against foreign exchange risk.

Some managers of property funds with retail investors have said that not hedging is a deliberate policy since the managers' anticipation is that the euro will appreciate against the pound. That is a perfectly reasonable view; however, if it is genuinely felt, it should be expressed in the relevant prospectus so that investors have a full understanding of what they are committing themselves to. The vast majority of retail investors and, indeed, a large number of – particularly US-based – institutional investors leap at the chance to hedge foreign exchange risk on overseas property investment.

The significance of credit

Although the market currently pays UK investors to hedge their investments wherever interest rates are lower than those in the UK, for example in the eurozone, a crucial factor in the hedging process is that of credit. With the exception of bought vanilla options, a feature of all foreign exchange hedging products is that they are consumers of this scarce resource.

Particularly in the case where a 'beauty parade' of banks is invited to tender for the provision of debt facilities, lenders will nearly always be inclined to offer more generous terms on a credit line to hedge foreign exchange risk if the hedging line is negotiated at the outset as part of the package for the term debt facility. Otherwise, a facility ends up being negotiated without allowance for forex hedging and the subsequent consumption of credit for hedging purposes eats into the debt facility, reducing the fund's ability to gear up its equity. This point is particularly relevant for funds with an aggressive forecast IRR.

Hedging anticipated returns

The hedging of anticipated returns, given their unpredictability in terms of both timing and quantum, requires a high degree of flexibility to be incorporated into any hedging strategy. In practice, such flexibility can only be achieved through the use of 'long only' option strategies, though there are various means by which option premium can be reduced or deferred.

A false sense of security

Many investors, particularly in Eastern Europe, assume wrongly that by purchasing property in euro and charging euro-denominated rents they will be immune from currency risk. Counter-intuitively, this is not the case, since, should the local currency devalue against the euro, the property will have a tendency to become 'over-rented.' The better the tenant and the longer the lease, the more resistant will be the property to a reduction in value. However, property let on shorter leases to less creditworthy tenants will tend to trade more in line with property that is bought, sold and let in local currency. Unfortunately, in many countries where the market perceives there to be a serious risk of potential devaluation, interest rates are significantly higher than in the UK for that very reason. This implies a commensurate cost to any hedging strategy and it is currently impractically expensive to hedge property investment in Hungary, for example, where the market is trading on the basis of a 25% chance of a depreciation in the EUR/HUF rate from 253.60 to above 324.20 over the next three years. In such circumstances, the foreign exchange risk can only be avoided by not investing in the country. That said, short term protection could be achieved through the purchase of options if there was a perception, not yet in the market, that the domestic currency was about to come under pressure.

To hedge or not to hedge

The benefits of hedging must be considered against the cost, either in terms of option premium or credit usage. Investors are often prepared to forgo some potential return in exchange for protecting their original investment so those funds offering investors the choice of being hedged will typically attract capital more easily than those that do not. However, as some investors regard the foreign exchange exposure as being desirable as part of a balanced portfolio, many funds are now offering 'hedged' and 'unhedged' investor sub-classes, in order that investors may choose whether or not to hedge their foreign exchange risk.

Finally, whatever hedging structure is chosen, rates should be independently benchmarked against the market, in order to ensure competitive pricing. This is particularly important when more complex, option-based hedging structures are being considered, as these inevitably lack transparency compared with simpler structures.