Research Programme

AT A GLANCE
APRIL 2018

MANAGING CURRENCY RISK IN INTERNATIONAL REAL ESTATE INVESTMENT

Exchange rate fluctuations can lead to substantial changes in the domestic currency value of cash flows from international real estate investment. Currency movements lead to additional uncertainty about future returns and currency movements can dominate underlying property returns. This study analyses market practice in the management of currency risk.

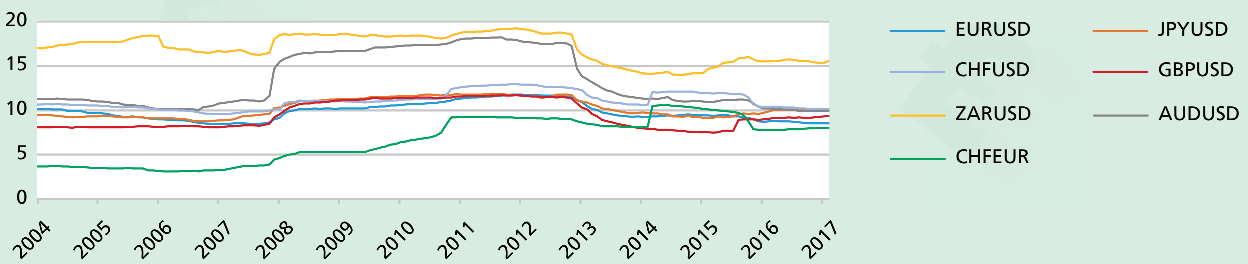
Currency Impact in 2016

	Local currency property returns (%)	Currency movement against GBP (%)	GBP property returns (%)
Sweden	13.9	10.7	24.6
Australia	11.8	18.7	30.5
South Africa	11.1	35.2	46.3
Netherland	10.3	15.8	26.1
France	7.8	15.8	23.6
USA	7.5	19.3	26.8
Japan	6.3	23.0	29.3
UK	3.9	n/a	3.9
High-Low range	**10.0**		**42.4**

Source: MSCI, Datastream

Currency movements can be substantial and unpredictable. In 2016, they increased the dispersion in property returns between major markets by between 10% and over 40%.

5 year rolling annualised currency volatility



Even on a five year basis currency volatility is high.

Simulation Results: European Investor

Scenario	No Hedging	Rolling Forward Hedging	Swap Hedging
Base Case			
Mean	6.83%	6.48%	6.56%
Standard deviation	3.65%	0.68%	0.30%
Coefficient of variation	0.534	0.106	0.045
Boom/Upside Case			
Mean	11.78%	11.46%	11.47%
Standard deviation	3.84%	0.99%	1.24%
Coefficient of variation	0.326	0.087	0.108
Crash/Downside Case			
Mean	2.39%	1.99%	2.08%
Standard deviation	3.54%	0.42%	0.84%
Coefficient of variation	1.48	0.211	0.403

Simulation analysis indicates that hedging, using forwards or swaps, leads to a substantial reduction in risk and higher risk-adjusted returns.

Key Points

- Almost 80% of managers and investors surveyed hedge currency risk and most (69%) have a currency hedging policy but, even where clear procedures are in place, exceptions may be made.
- A range of approaches are available to reduce the impact of currency movement on future returns: forwards (favoured for their simplicity and flexibility) are the most common instrument but swaps, options and local leverage are all used extensively.
- Some managers show a bias away from managing currency risk where hedging is costly, e.g. for currencies with higher interest rates, and currency management may be used selectively to boost returns as much as manage risk. However, countries whose currencies are expected to depreciate typically do not do so smoothly and currency is likely to have a substantial effect on the delivered returns.
- Typically, currency hedging is a treasury function rather than one undertaken jointly by central and real estate teams and real estate fund managers may not integrate the costs of hedging or the impact of currency risk on their portfolios.
- Where leverage is increased to reduce foreign exchange risk, this may result in property market and finance-related risks being amplified.
- What a real estate investor/manager should do, including which instruments to use, to manage currency risk will depend upon the individual investor's objectives, tolerance for different risks, domicile, outlook for specific markets, as well as hedging costs amongst a range of factors. Specialist expertise or advice (whether internal or external) is needed and access to live market data and pricing is essential to minimise transaction costs.
- A clear and transparent policy is needed, setting out what is hedged and what is not, as well as why and in what circumstances variation is allowed. Potential currency effects on returns and risk need to be explicitly integrated in making investment decisions, whilst the extent to which currency risk management has removed the impact of currency movement in line with expectations should be monitored on a regular basis.

The full report may be downloaded from the IPF website: **www.ipf.org.uk**.

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