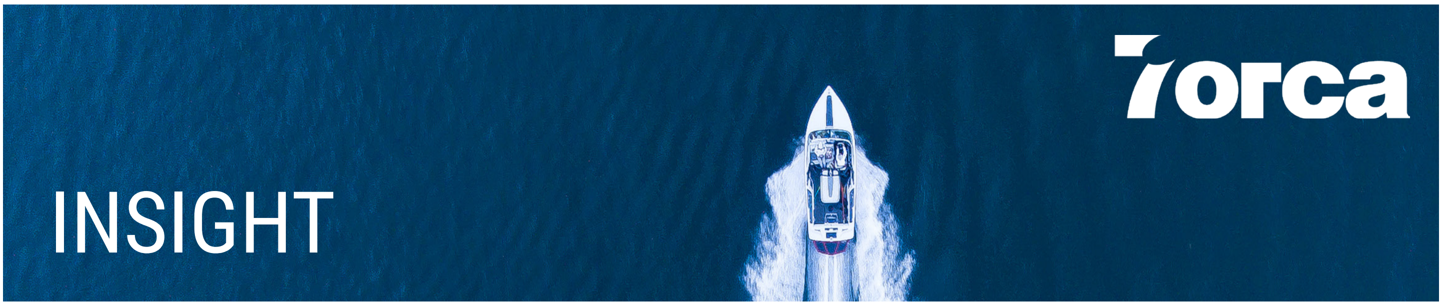

Structural advantages through the mandate of a dedicated currency overlay manager

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The mandate of one dedicated currency overlay manager, who implements a hedging strategy across all currency holdings and investment vehicles, allows for a set-up that opens up extensive efficiency benefits.

A central currency overlay goes far beyond the scope of a traditional asset management mandate. By creating an investment and trading structure, the professional and efficient management of FX positions is enabled.

The structural advantages include

1. Saving of transaction costs through netting
2. Efficient use of liquidity and avoidance of secondary transactions
3. Uncomplicated and quick adaptability of the hedging strategy
4. Customized manager selection
5. Transparency and performance attribution through detailed reports
6. FX expertise and implementation by one dedicated manager

1. Saving of transaction costs through netting

A dedicated currency overlay manager can save transaction costs by taking advantage of netting effects. Netting opportunities arise when the exposure of the same currency has increased in one segment and decreased in another. These exposure fluctuations are the result of changes in asset value and portfolio shifts in different currencies.

Challenge

A portfolio containing liquid investments may require daily hedge adjustments. If the hedge is adjusted, transaction costs are incurred. In case the currency hedge is carried out by different managers, no netting between these managers happens. As the complexity of the investment structure (number of managers and investment vehicles) rises, an increasing number of netting options is abandoned.

Advantage of the dedicated currency overlay manager

A dedicated currency overlay manager, on the other hand, always adjusts the currency hedge based on the total netted exposure per foreign currency. This procedure maximizes the netting possibilities and thus saves transaction costs. Since smaller volumes must be traded, the transaction costs are reduced accordingly.

For the client, netting possibilities arise in many ways: This could be by netting across various segments of the entire portfolio (usually in a master fund structure), across different investment vehicles and across potentially different economic entities. The greater the complexity of the foreign currency holdings, the greater the potential for savings.

2. Efficient use of liquidity and avoidance of secondary transactions

The implementation of a currency hedging strategy requires a liquidity holding. This liquidity is needed to offset market value fluctuations of the FX hedge (at maturity or daily, due to collateral management requirements).

Challenge

Liquidity is always required at the level of the investment vehicle or the segment in which the hedging is carried out. If hedging is performed by different investment managers, it must be available in the corresponding underlying segments. Therefore, if the investment managers are in charge of the FX risk on an individual basis, the currency related liquidity flows from their segments must be funded. This may result in additional costs due to secondary transactions in the underlying investments. When assets are bought or sold to generate liquidity, transaction costs are typically significantly higher than those described in point 1. This is particularly the case when assets are illiquid.

Advantage of the dedicated currency overlay manager

The dedicated currency manager hedges FX risks in the overlay segment only, thus enabling one liquidity holding. In particular, a central FX management can reduce costs through fewer secondary transactions in the underlying investments and use liquidity more efficiently.

The bundling of liquidity flows in the overlay segment is advantageous for two reasons

- Aggregated, due to portfolio effects, less cash has to be kept on hand, so that the investment level of the portfolio can be increased
- Centralized management allows more control over liquidity flows

3. Uncomplicated and quick adaptability of the hedging strategy

For a variety of reasons, it is often necessary to adjust the hedge ratio of currency positions quickly and easily. These range from changes in tactical asset allocation to accounting or regulatory reasons (such as valuation reserves or regulatory ratios) to currency-specific reasons (e.g. impending Brexit).

Challenge

If FX hedging has to be carried out by the individual investment managers of the underlying, it is regulated in their respective investment guidelines and reflected accordingly in the benchmarks of the mandates. However, with a larger number of different investment managers, this tends to lead to an inflexible and rigid construct. A change in the constant hedge ratio would lead to a high administrative effort. The adjustment of both the investment guidelines and the benchmarks may be time consuming.

Advantage of the dedicated currency overlay manager

When implementing a central FX overlay, the process for adapting the hedge ratio is defined in advance. Doing so creates the necessary flexibility for an uncomplicated revision at any time, with the overlay manager as the sole contact person. This set-up makes it possible to react quickly and purposefully to changing conditions.

4. Customized manager selection

The implementation of a central currency overlay does not limit the flexibility of an efficient manager selection. On the contrary, the overlay is supportive and at the same time fulfills the advantages of central FX control described above.

Challenge

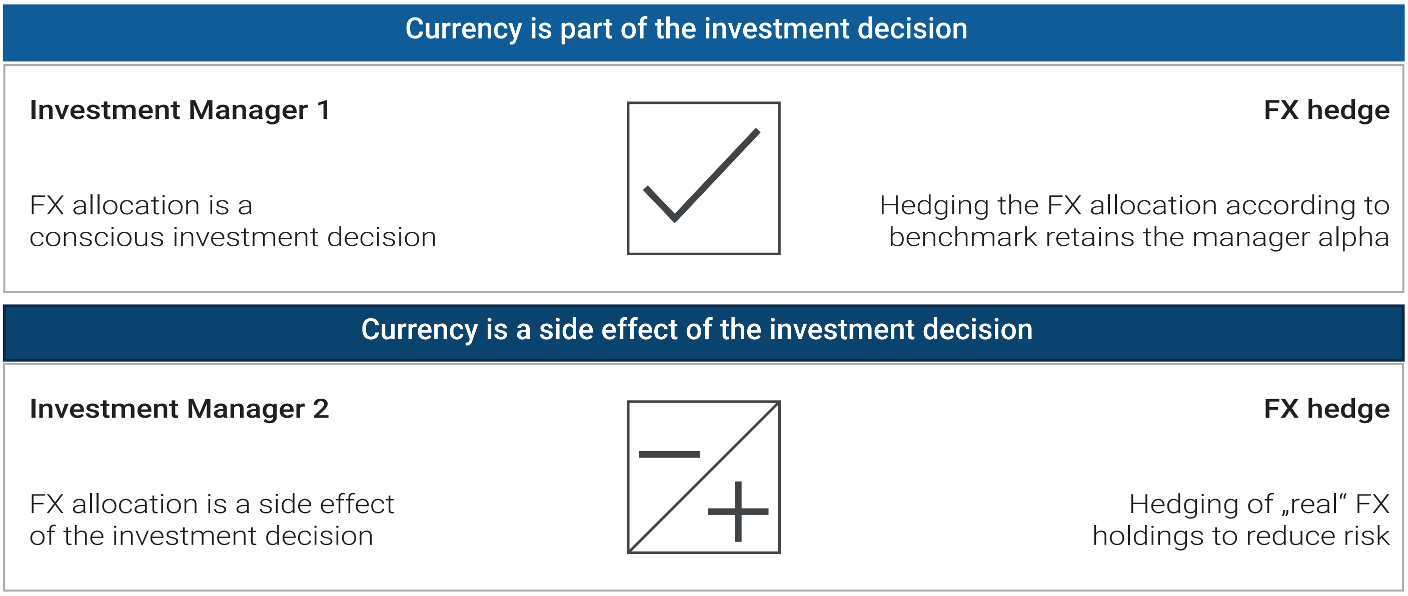
There are two possible scenarios for the manager selection. The first scenario focuses on the investment style of the respective investment manager and the second scenario describes the interaction of the dedicated FX manager with an additional currency manager who can offer special expertise in selected currency pairs.

The investment objectives of the respective investment managers may have an influence on the amounts to be hedged. For example, an investment manager's decision to overweight or underweight a currency may be a clear investment decision. Currency hedging would potentially level the manager's alpha. For other investment managers, currency weighting may be a random result of their allocation.

These differences should be identified during the mandate implementation to define whether the currency allocation of the benchmark or the real FX risk should be hedged. Using a currency overlay manager to make the currency hedging process more efficient, the investment managers are not restricted in their choice of action. Figure 1 on the following page shows the differences in currency hedging depending on investment styles.

The integration of an additional currency manager, which offers an additional expertise (e.g. in the active management of certain currencies), can also be implemented in the central currency overlay.

Fig. 1: FX view from investment managers' perspective



Source: 7orca Asset Management AG. (November 2020)

The corresponding currency holdings are taken into account in the overlay segment. According to the agreement, the second FX manager can unwind an existing hedge within defined ranges.

Advantage of the central currency overlay manager

The modular structure enables the selection and mandate of the most suitable investment managers and other competent currency managers. The effective set-up allows adjustments to be made in the event of a change in investment strategy or unsatisfactory performance. These can be realised in individual building blocks, as well as in a quick and uncomplicated exchange of managers of the underlying investments and currencies.

5. Transparency and performance attribution through detailed reports

Transparent and quickly available presentations are the prerequisite for important investment and management decisions.

FX positions are allocated across the entire portfolio (and possibly various investment vehicles). Similarly, economic foreign currency risks sometimes differ from the reported currency. Therefore, a transparent overview of all foreign currency positions and risks is often not inherently apparent.

Challenges

The complexity of many institutional portfolios imply the necessity to aggregate currency positions across different segments and investment vehicles in order to derive the overall FX positioning. Currency risks can also be hidden, as the economic risks differ from the reported portfolios. This is particularly common with fund or ETF investments. In the case of funds, the additional complexity stems from FX hedges being partly implemented in the investment vehicles.

Advantages of the dedicated currency overlay manager

A dedicated currency overlay manager increases the performance transparency of FX positions. The manager provides his client with a uniform, customized currency report across all vehicles and segments.

This report can be customized multi-dimensionally: the customer determines the scope, content and level of detail of the report. The report can also show the performance contribution of the individual segments as well as the performance attribution relative to the defined benchmark.

This creates focused transparency and enables a significant comparison of the FX performance of the individual segments. In addition, the reporting requirements are developed in cooperation with a third party, which then produces the reports on an independent basis.

The decisive advantage is that it can conform to a uniform reporting standard.

6. Currency expertise and implementation by a dedicated contact person

Often, currency positions are among the largest individual risk drivers in an institutional portfolio.

Challenge

If the risk/return profile of FX positions is not managed and optimized according to individual requirements, these positions can significantly drive the risk contribution of an institutional portfolio.

Advantage of the dedicated currency overlay manager

Due to this, it is advisable to have a central contact person for all currency-specific issues. This contact person also makes adjustments in the event of structural changes.

7orca sees itself not only as an advisor and sparring partner, but also as a proactive guide in all currency-related topics. Part of our service in implementing dedicated FX overlay solutions is also to control, coordinate and document the agreed processes. In addition to the comprehensive planning of the process, the central success factor is the communication with all parties, such as the client, the capital management company, the depository and the managers of the underlying investments. By doing so, the client is relieved of a considerable amount of operational work after the initial set-up.

7orca is your specialized and independent FX overlay manager for all currency issues

In addition to the aspect of „structure creation“ discussed in this paper, there are further advantages of a dedicated currency overlay manager, which can be subsumed under the headings „specialization“ and „independence“ of the FX manager. 7orca is happy to present the relevant aspects to you as well.

Disclaimer
The strategy presented in this document for hedging currency risks (currency overlay management) is aimed exclusively at professional clients according to the German Securities Trading Act (WpHG) and can only be implemented for such clients (typically in a fund structure). All assumptions, forecasts and disclosures are based on the standardised set-up of the currency overlay management strategy, which was carried out at average market costs. Further information on this standard investment process can be found in the Generic RfP, which is available from 7orca Asset Management AG upon request. Due to the different investor needs and situations as well as the resulting specific pricing, further individual costs for administration and custody are not taken into account. However, 7orca Asset Management AG will be pleased to provide you with a specific offer that reflects your individual requirements and conditions. The investment strategy of an active currency hedging has a trend-following character. It should therefore lead to the same results under the same market conditions. Since market conditions repeat themselves regularly, but not in identical form, the hedge ratios and performance indicators listed in this document can illustrate the characteristics of our strategy. **However, they refer to past price developments of currency pairs and are therefore not a reliable indicator of future results**. All information in this document has been compiled to the best of our knowledge based on the data available to us. However, no civil liability can be assumed in this respect. References to specific financial instruments are purely exemplary and should under no circumstances be construed as recommendations in the sense of investment advice. A publication of 7orca Asset Management AG. (25.11.2020)

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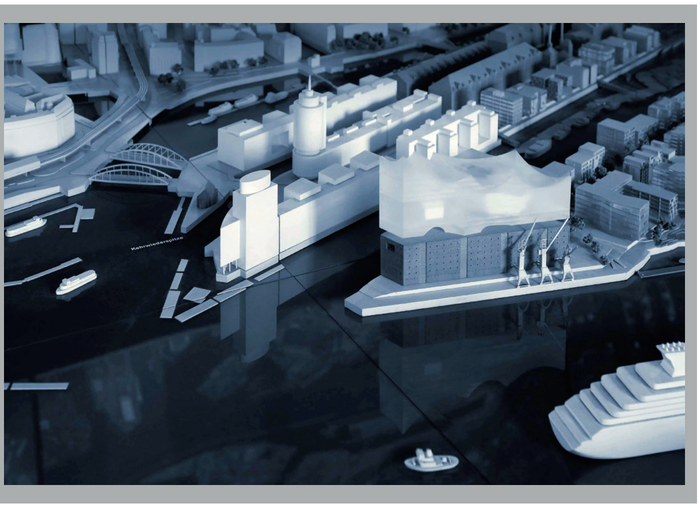

7orca Asset Management AG is an independent, systematic and well-focused asset manager. With its experienced team, the company serves institutional clients with overlay management and short volatility strategies. More information at www.7orca.com