INVESTMENT

Widening the net

As portfolios become more diverse across asset types and geographies, the need for FX cost-saving opportunities increases and the case for agency trading grows

The concept of centralised execution and FX netting is not new, for some time, asset owners have been well-informed of the scope to create cost savings and process efficiencies. The drivers have perhaps changed; counterparty risk and cost savings remain important, the evolving regulatory and reporting landscape, plus imminent US equities move to T+1, all play a role.

In this article, **Katie Renouf** – Senior Vice President on **Mesirow's** Global Investment Management Distribution team, based in London – explores how a rapidly evolving investment landscape, and subsequent FX netting opportunities, has led to increased interest in agency models.

When I think back to the start of my FX career, some 20 years ago, it's fair to say the industry has come a long way.

Wide margins, and a lack of transparency around price methodology and source, underpinned by basic documentation, were commonplace. This led to a fundamental lack of trust – forming the basis for a number of regulatory shifts, principally designed to create a fairer and more stable marketplace.

We have reached a point where competitive pricing is largely accessible to all - where counterparties and third-party providers are required to provide granular detail around pricing source and methodology.

However, when it comes to execution counterparty / liquidity providers, there remains scope for improvement. The FX price might look competitive on a single trade basis, but unless you are considering all FX exposures on a portfolio basis you are missing the full picture.

This is often the case when clients delegate FX to their administrator or custodian.

Each provider adheres to the best execution in context of the managed portfolio(s), but a lack of visibility to see the underlying client's full portfolio and FX exposures hampers order aggregation or netting opportunities.

Additionally, many custodians provide a principal-only execution model – meaning that clients face a single execution counterparty from both a risk and pricing perspective. Not only is this inefficient and expensive, but it can also create a "locked-in" element to the relationship – where FX revenue is used to balance underperforming revenue products such as global custody. This can make it very difficult to extract FX from the relationship in the future.

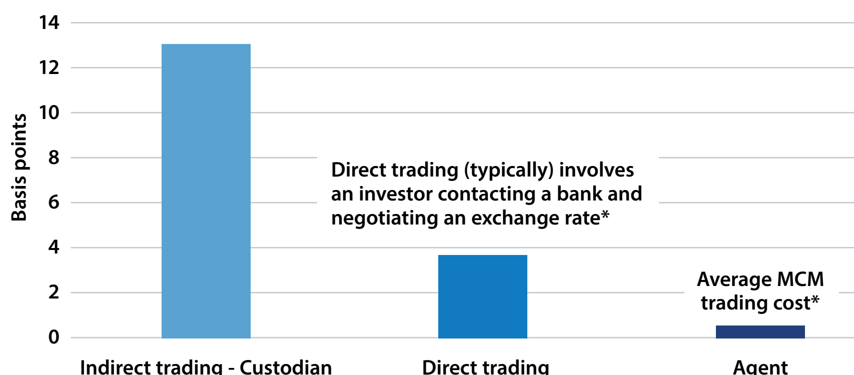
Having a specialist provider adopt a third-party "birds eye" view of all portfolios can be highly beneficial. By establishing an open architecture framework, connected to delegated managers and service providers, a fiduciary agent can achieve best execution across the asset owner's entire book.

This is particularly topical when we consider the ongoing shift from defined benefit to defined contribution, underlying portfolios are becoming increasingly diverse from both an asset and geography standpoint. Assuming that delegated managers are being used, at least some of the time, this has potential to create an ever-increasing number of siloed currency exposures.

Let's consider an example, Asset Owner A wishes to increase their global equity exposure and re- duce their global bond book, keeping base currencies in GBP for simplicity.

The equities manager liquidates a portion of their portfolio, realising multi-currency cashflows back to GBP, all of which require FX. At the time of writing, the non-GBP exposure of the MSCI World index is more than 96%.

The bond manager also implements the increase to their portfolio accordingly. Currently, the GBP component of the Bloomberg Global Aggregate Bond Index is just



over 4%.

Whilst both managers could be achieving strong FX execution and pricing terms on an individual basis, their inability to see the other's activity results in far greater FX volumes than needed.

Whilst the currency composition of each index is not identical, applying netting to both portfolios could reduce the execution figure significantly.

Furthermore, the compressed ticket size(s) reduces market impact, typically resulting in tighter spreads.

If you scale up this concept across an ever-increasing number of sub-funds and asset classes, the argument for netting becomes increasingly compelling.

FX execution cost savings generated through an agency provider netting solution can exceed 30% in some cases.

The above scenario could be further complicated by the forthcoming US equities move to T+1; many managers have yet to establish FX trading processes that accommodate this.

The compressed timeframe for settlement means that they may have to act upon unmatched trade estimates – creating enhanced risk of error – or, alternatively, maintain long USD positions to provide liquidity to settle late trades. Neither of these options are particularly efficient from a risk, process or return perspective.

There will also be a marked impact on the huge proportion of managers who settle their trades via CLS. CLS deadlines cannot accommodate the move to T+1, meaning that gross settlement will lead to clients having to maintain larger USD cash reserves.

Again, using a third party agent can be beneficial in this situation. By taking a cross-portfolio view on currency exposure, the agent condenses the net execution figure as far as possible. This compresses not only cost but also counterparty risk, and potentially reduces the USD balance level that needs to be maintained.

Where long USD overnight positions need to be held, Mesirow's cash equitization service can reduce portfolio performance drag. We sweep residual balances into index-linked futures, generating a return far closer to the portfolio benchmark than holding cash.

Many clients are not set up to trade futures, so the cost of implementing this themselves prevents it from being a viable option. Through our strong market positioning, we have access to more competitive pricing terms than many clients can access.

There are asset owners that already centralise their FX execution in-house. Granted, for those names, some of the points highlighted above are not relevant. They are already achieving an efficient level of FX trade netting.

However, the process of establishing and maintaining a broker execution panel is problematic. There are numerous legal documents and credit facilities to consider, combined with the cost and risk aspect of undertaking the process in-house. An FX back office that historically required 2-3 FTE's is now likely to require more.

Furthermore, there is always a critical mass – where volumes become sizeable enough for in-house management to appear the more attractive option. However, due to the points mentioned above and the subsequent cost base increase, this figure now looks a lot higher than in previous years.

One final angle to consider is regulatory reporting. For example, recent changes to EMIR reporting requirements ("EMIR refit") increased the number of reported fields per trade from 129 to 203. Many clients choose to delegate this task, and by reducing the total number of trades, the cost base is reduced accordingly.

Whilst evolving regulation is integral to protecting the interests of market participants, it requires constant monitoring and resource; making it preferable to delegate this element to a third-party FX provider.

To learn more about Mesirow's Fiduciary FX capabilities, contact:
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