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Playing the long game

Long-hold funds offer intriguing possibilities for investors and fund managers – but can a longer investment horizon make it more challenging to hedge against currency volatility? There are bespoke FX strategies out there that ensure you can play the long game without necessarily sacrificing stability.

Joseph Mckenna, Investec – Fund Solutions
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Our clients and the general private equity (PE) market are maturing, broadening the range of strategies they offer beyond the familiar 10 year fund structure. In particular, we see increased interest from both fund managers and investors in long-hold funds.

For managers offering these long-hold funds, finding the right kind of foreign exchange (FX) hedging strategy is critical. Choosing not to hedge can adversely affect performance as the foreign exchange market is unpredictable – and when you have to keep investors happy, that's often a risk too far.

To solve the conundrum, we believe general partners (GPs) need to work with flexible and creative counterparties that can offer innovative solutions – such as Investec's historic rate roll (HRR), which allows GPs to avoid having to draw down on capital commitments to settle an 'out-of-the-money' FX hedge. This allows them to eliminate the cash drag that can result from traditional, rolling hedge programmes.

The case for long-hold funds

So, what are long-hold funds and why are they popular? As the name suggests, long-hold funds allow GPs to invest beyond the typical PE horizon of 10 years, if that's what they think is best.

This provides two main advantages. First, it gives GPs the freedom to stick with successful investments and to wait for the most opportune moment to sell, maximising fund performance. Research from consulting firm Bain & Co, based on model portfolios shows that long-holds can double the performance of a typical buyout fund selling four successive companies over a 24-year period.

Second, long-hold funds allow long-term investors to more closely align the length of their investments with their underlying liabilities. In a low-yield environment, with increased political and economic risk, this is an attractive proposition for these kinds of institutional investors – especially when paired with higher returns.

An expanding market

The obvious disadvantage of long-hold funds is that the investments are illiquid and investors' capital is tied up for a long time. This means long-hold funds are not suitable for all investors. Family offices and private investors may prefer something shorter-term and more liquid. However, used in the right way as part of a diversified portfolio, we believe long-hold funds are a useful addition to the investment toolbox of long-term institutional investors with long-dated liabilities.

We have already seen well-known PE firms such as KKR and CVC Capital Partners launch long-hold funds. We expect more companies to enter the market, and some pension funds and sovereign wealth funds may ask managers to set up bespoke long-hold funds too.

The FX hedging conundrum

The more long-hold funds launch, the clearer it becomes that the right kind of FX hedging strategy is essential to their success.

It is increasingly common for them to invest overseas, so to make the initial investment the fund needs to buy foreign currency. When the fund does this, it simultaneously hedges forward to lock in an exchange rate that will protect its value when it sells the investment many years in the future.

The conundrum for the fund arises if their bank has limited appetite for extending credit to allow the long-hold fund to roll the contract forward each time it expires – especially when, with a 20-year investment horizon, it could mean quite a few rolls. If that hedge is out of the money when the PE fund wants to roll it, most banks will request immediate settlement of the negative mark-to-market position. This takes capital away from investments and earns the fund zero returns. So cumulatively, it has a significant negative impact on performance.

Investec has a tool that allows for hedges to be rolled forward, with any negative mark to market incorporated into the new exchange rate, so capital isn't tied up in FX hedging tools.

"Enabling hedges on long-hold funds to roll while deferring payment until clients exit the underlying position can mean the difference between a successful long-term investment and a long-term drag on returns."

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Creative solutions

As specialist providers, we can be more creative and flexible with extending credit. Investec Fund Solutions take the time to understand GPs, their investments, their investors and their FX exposures, and that makes us more comfortable with offering the kinds of uncollateralised FX hedging strategies they need.

GPs need to establish that their banking counterparties are not going through a box-ticking exercise – because long-hold funds simply aren't going to conform to the rote assessments most bulge brackets banks apply. Looking at their unique attributes enables the more creative provider to use credit, legal and capital markets knowledge to form commercial views about unsecured trading lines – then create structures that utilize credit appetite instead of cash collateral to support their FX hedging strategies.

Historic Rate Roll

A HRR is a Historic Rate Roll. It's when an FX swap is rolled 'off-market' avoiding the need for a client to settle a mark-to-market cash flow. These are particularly useful in the alternatives investments space where funds have to generate a return on capital once they draw down commitments from investors.

Keep capital working with an HRR

Creative approaches to the FX challenges facing long-term investors can produce flexible, efficient solutions, and the HRR offered by Investec Fund Solutions is an excellent case-in-point. Enabling hedges on long-hold funds to roll while deferring payment until clients exit the underlying position can mean the difference between a successful long-term investment and a long-term drag on returns.

The FX market can be a cruel master. But innovations such as the HRR helps protect our clients from its vagaries and allows them to avoid negative cash flow. That way they can keep capital where it should be, working for their investors – even if they are invested for 20 years or more.

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Rolling Hedge Programmes

When a typical rolling hedge programme expires it can be sold back to the market "in" or "out of the money". "Out of the money" is a hedge that has made a loss and banks wouldn't normally want to roll the hedge forward, resulting in the hedger paying the difference. Here at Investec Fund Solutions, we are building on our flexible approach, by allowing hedges to incorporate the negative market loss, should it occur, and carry on your hedge.

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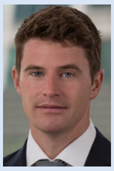

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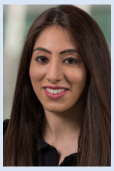

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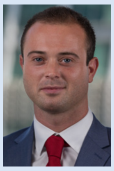

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