

Local Currency Hedge Funds Expand Marketing and Investment Opportunities, but Involve Currency Hedging and Other Challenges

By Jennifer Banzaca

Traditionally, hedge funds have scoured the globe for investments. To an increasing degree, hedge funds are scouring the globe for investors. There are various macroeconomic reasons for this trend, including but not limited to: political and economic progress in developing countries generally and the so-called BRIC (Brazil, Russia, India, China) countries specifically; high savings rates, especially in China and Japan; the recent credit crisis, and the resulting loss of wealth in the U.S. and Eurozone countries; record deficit spending in the U.S., and resulting concerns about inflation and interest rates; etc. At a more practical level, 2008 and 2009 witnessed significant outflows from hedge funds, and managers have been looking for new capital wherever they can find it – even if that new capital comes from places other than the usual suspect jurisdictions.

As more hedge fund capital comes from more places, hedge fund managers have been exploring and, in some cases, launching funds denominated in local currencies. Local currency hedge funds have two chief advantages over funds denominated in U.S. Dollars or another “reserve” currency: they facilitate marketing to a wider range of institutions and individuals, and they enable investments in assets that otherwise would be inaccessible or difficult to access. In addition, local currency funds enable managers to avoid, in some cases, certain of the administrative and legal brain damage involved in other approaches to managing currency issues. At the same time, local currency funds implicate certain unique risks.

This article describes the four primary ways in which hedge fund managers approach multicurrency issues, one of which involves the use of local currency funds, and details the risks and benefits of each. In particular, this article drills down on the practical and legal challenges involved in hedging currency risk, and discusses the special case of China’s new limited partnership law.

Four Approaches to Managing Currency Risk

Broadly – and with significant variation in unique circumstances – hedge fund managers employ four approaches to managing multicurrency issues.

Conversion Without Hedging

First is conversion without hedging. Under this approach, a manager accepts investments from qualified investors from any jurisdiction. Those investors give the manager capital in their local currency and the manager converts that capital into the currency of the fund, makes investments in the fund currency, then converts back to the investors’ currency when the investors seek to redeem. As Gray Smith, a Partner

with global offshore legal, fiduciary and administration service provider Appleby, explained, in many cases, a hedge fund has a “basic currency, so whatever you invest in the fund will be converted into that fund’s currency and the fund will then make trades in that currency. The currency will be converted back into the investor’s currency for valuations of the payments out.”

This approach involves two potential downsides: (1) currency changes can adversely affect returns for one group of investors, and (2) a manager has to adequately disclose the potential effect of currency swings on fund returns for certain investors. On the first point, Jeffrey Blumberg, a Partner at Drinker, Biddle & Reath LLP, noted that “if someone in the U.K. invested in a Dollar-denominated fund, then the currency risk is all on the investor. If they want to hedge that risk, it would be their responsibility to do so.”

Hedging for Investors in a Specific Currency

Second, to manage adverse currency swings, a hedge fund manager will sometimes promise to hedge currency risk for all investors that invest in a specific currency. For example, a manager may promise three Japanese pension funds that it will use forwards, futures or swaps to ensure that any gain or loss on the investment is based on the investment thesis and not currency changes.

This approach also involves at least two potential downsides: (1) the hedge may not work perfectly, which the manager should disclose among the fund risk factors, and (2) administrative costs, which consist of either internal resources or external resources, e.g., payments to the fund administrator or prime broker to execute and maintain hedges. In many cases, such costs are borne by the entire fund, but only benefit a discrete group of investors, which can raise fiduciary duty issues. A third potential downside of this approach could arise if the manager promises to manage currency risk for one investor (for example, in a side letter), but does not promise to manage such risk for other similarly situated investors. For example, if the manager in the foregoing hypothetical promised to hedge currency risk for one Japanese pension fund, but not the other two, and the Yen strengthened against the Dollar during the pension funds’ investment term (thus reducing the Yen value of the unhedged investors’ returns), the unhedged pension funds might complain that they received a worse deal.

Local Currency Share Class

Third, a manager may launch a local currency share class of a broader fund. For example, a manager may launch a Yen share class of a Cayman Islands fund that otherwise is denominated in U.S. Dollars.

The potential downsides of this approach include the following: (1) if the manager hedges the share class, the hedge may not work perfectly, which the manager should disclose among the fund risk factors; (2) if the manager does not hedge the share class, the class may be ineligible for certain investments only available in the primary currency of the fund (this should also be disclosed, probably in both the risk factors and strategy sections of the private placement memorandum); (3) it involves administrative costs; (4) unless otherwise provided, those costs may be borne by the entire fund while benefiting only the specific share class; (5) cross-class liability.

With respect to the last-listed risk category, George Mazin, a Partner at Dechert LLP, noted that if a hedge is “significant, with some real exposure and you have multiple classes, you may have concerns about cross-class liability. If your hedge against the Euro goes very badly and you lose a ton of money, do creditors have recourse against the Dollar share class and the assets attributable to that class?”

Local Currency Funds

Fourth are local currency funds. From a structuring point of view, such funds can address various of the “commingling” problems identified with respect to the foregoing approaches. Notably, because local currency funds only include investors in one currency, the returns of different investors will not be affected differently by currency effects.

However, such funds come in two very different stripes. The first – and significantly more straightforward – is a local currency fund that invests in opportunities in the local currency. The second is a local currency fund that invests in opportunities in any currency. Broadly, the first category does not require investor-level or investment-level hedging, whereas the second category does require investment-level hedging; and hedging implicates various categories of risks.

Hedging Risk

The purpose of hedging is to offset any gains or losses in the relevant currency so that the performance of investment reflects the gain or loss on an asset as opposed to the movement of the relevant currency. Mechanically, currency hedging can be accomplished through the use of forwards, futures, swaps or certain other derivatives, as well as short sales. Jeffrey Blumberg, a Partner at Drinker, Biddle & Reath LLP, explained that “when you’re hedging currency risk, if you’re long in a stock in dollars, you’re going to want to go short dollars against the denominating currency in your hedge, so if the dollar fell it wouldn’t offset any gains your investments made.

For local currency funds that pursue investment opportunities in the jurisdiction of the currency as well as other jurisdictions, currency hedging is necessary to ensure that returns are generated by the investment strategy as opposed to currency movements. However, currency hedging involves at least four categories of risk.

Execution Risk

The first and most pervasive is execution risk, the risk that the hedge simply will not work as intended. To Blumberg, “the biggest risk is how you implement the currency hedge. The easiest way to hedge is to exactly match your hedge to your risk, but doing so can be difficult. If you have a million Dollar portfolio and you want to hedge 100 percent of that portfolio Dollar to Yen, you would do a one million Dollar to Yen swap. But, if the next day your portfolio is now worth one million and one, do you go out and change your hedge or let it be? So, the first part of any hedging strategy is deciding how closely you want your hedge to match your exposure.”

Collateral Risk

The second risk is the risk that the assets required to collateralize the hedge may reduce returns. “In most cases,” noted Dechert’s Mazin, “you have to collateralize the hedging that you’re doing, either in cash or with other assets, and so there are always going to be issues as to how you’re going to collateralize it. Is there going to be a drag on returns because you have cash tied up as collateral?”

Lack of Experience

Another risk highlighted by Mazin is that the party doing the hedging does not fully understand the process. Other than funds with a currency investment strategy, many fund managers do not have direct experience with currency hedging. Even in cases where managers outsource such hedging – for example, to an administrator or prime broker – the outsourcee may not have adequate experience with hedging. Such a lack of experience can exacerbate the first-listed risk, execution risk.

Counterparty Risk

While futures are traded on exchanges, which mitigate counterparty risk, forwards and swaps generally are traded over the counter and thus involve counterparty risk, that is, the risk that the party on the other side of the forward or swap will not be able to perform. Blumberg noted, “a lot of these currency hedges are done off exchange using forwards and swaps, so counterparty credit risk is a much bigger concern than it was even two years ago.” In reducing counterparty credit risk, fund managers should review credit ratings, the counterparty’s equity price activity and its capital levels; should only trade with the most financially sound banks and broker-dealers; and should limit the concentration of exposure to any single counterparty. For more on mitigating counterparty risk see, [“Hedge Funds See Counterparty Risk as a Threat to Global Markets, Expect Another Major Bank Failure,”](#) The Hedge Fund Law Report, Vol. 1, No. 20 (Sep. 4, 2008); [“How Can Hedge Funds Structure Their Prime Brokerage Arrangements to Protect Themselves?,”](#) The Hedge Fund Law Report, Vol. 1, No. 22 (Oct. 10, 2008); see also [“Will the Proposed Out-of-Court Plan Help or Hinder Efforts of Hedge Fund Creditors to Recover Assets from Lehman Brothers International Europe?,”](#) The Hedge Fund Law Report, Vol. 2, No. 41 (Oct. 15, 2008).

Advantages of Local Currency Funds

As discussed, local currency funds offer a significant structuring advantage over funds that accept investments in different currencies or offer share classes denominated in different currencies. Since all investors in the local currency fund invest in the same currency, investor-level hedging is not required, and the various administrative problems raised by hedging are obviated.

Beyond the structuring advantage, the two chief business advantages offered by local currency funds are that they expand the range of potential investors and investments. Drinker Biddle’s Blumberg explained the marketing advantage as follows: “If I’m selling to someone in Japan or South America or Europe and I can say I have a fund denominated in that local currency, that may make it easier to make that sale

because investors don't have to convert their currency to dollars to make that investment and when they redeem they will be paid in their local currency and not dollars."

Moreover, local currency funds may enable marketing to pension funds who are either restricted by regulations or bylaws from investing in funds outside of their home currencies, or who do not have the infrastructure to perform their own hedging. As Appleby's Smith noted, "since pension funds are reluctant to enter into their own currency hedges, the fund offering local currencies will do the hedging themselves. Managers now have a much broader area of investors they can market to." Smith also noted the potential benefit from the investor perspective: "For investors, it broadens the number of managers they can invest in because they don't have the currency risk to worry about."

At a practical level, many investors may be scared away by the complexity involved in hedges and may simply be more comfortable investing in their own currency. These "soft" advantages of local currency funds can, other things being equal, make the difference between a commitment and a pass by a material investor.

Moreover, certain investments may only be available in the local currency, as is often the case in China, or (as a legal or practical matter) to investors organized in the local jurisdiction. Such investments may be quite interesting, yet inaccessible to funds outside of the local currency. Local currency funds can thereby enlarge the range of potential assets to which a manager may obtain exposure.

While traditionally many hedge funds have been denominated in U.S. Dollars, local currency funds generally are denominated in G7 or G20 currencies. According to Mazin, "it would be rare to see a local currency fund denominated in an emerging market currency."

Potential Downsides of Local Currency Funds

Local currency funds that invest in opportunities beyond the jurisdiction of the fund's currency generally are required to hedge, which implicates the various risks described above. For such funds, and even for funds only investing in the jurisdiction of the fund's currency, there is another risk: regulatory and political risk. Generally, a local currency fund is required to be organized in the local jurisdiction. Frequently, being organized in the relevant jurisdiction offers access to unique opportunities and sourcing, but it also subjects the fund to local regulation, which can be difficult to predict and can have a profound effect. For example, a jurisdiction can enact, without warning, a confiscatory tax regime, difficult employment laws or severe restrictions on investments. Such risks remain idiosyncratic, and an unfortunate concomitant of being close to many of the better opportunities.

In addition to regulatory risk, there is cost: opening and maintaining an office in a local jurisdiction involves various categories of costs, including but by no means limited to: monitoring, licensing, rent and utilities, communications, local service providers (especially lawyers and accountants), etc. Another notable category of costs, identified by Blumberg, are fees payable to local agents who help market the local currency fund or who help source opportunities.

Taking Advantage of China's New Limited Partnership Law

Many hedge funds and other types of private funds have set their sights on China, given its massive consumer market, huge reservoir of savings and fast-paced GDP growth. Accessing the Chinese market historically has been difficult because of regulatory restrictions on investments by foreign investment companies. To circumvent such restrictions, some private fund managers have launched local currency funds in China, often with joint venture partners. For example, The Blackstone Group recently signed a joint venture with Shanghai's municipal government to launch Blackstone's first Chinese currency-denominated fund, The Blackstone Zhonghua Development Investment Fund.

To further ease the ability of foreign funds to invest in Chinese companies, China's State Council recently issued the Measures for the Administration of the Establishment of Partnership Enterprises by Foreign Enterprises or Individuals in the PRC, which will allow foreign enterprises and individuals to set up foreign-invested partnership enterprises in China.

Fund managers have also been gaining access to investment opportunities in China via Collective Investment Management Schemes (CIMS), which are a means of pooling money with other investors to enable investors to participate in a wider range of China-based investments than they could individually. For more on CIMS, see "[Do Collective Investment Management Schemes Offer a Means for Hedge Fund Managers to Access the Potentially Vast China Market?](#)," The Hedge Fund Law Report, Vol. 2, No. 36 (Sep. 9, 2009).