The long term advantage

Five year forward may be an attractive alternative

For years, Australian investors could rely on a strong positive interest rate 'carry' in their hedging program. As interest rate spread differentials between the RBA and the other central banks, specifically the US Federal Reserve (the Fed), narrowed in 2018, the positive rate 'carry' disappeared. Between 2000 and 2018, Australian investors earned on average 2.56% in positive 'carry' on a MSCI World currency hedging program. Between 2019 and the end of 2021, the average carry has been a negative 7bps. The US Dollar has been the biggest driver of lower carry. Since 2018, the average 'carry' on just the US Dollar has averaged -43bps per annum.

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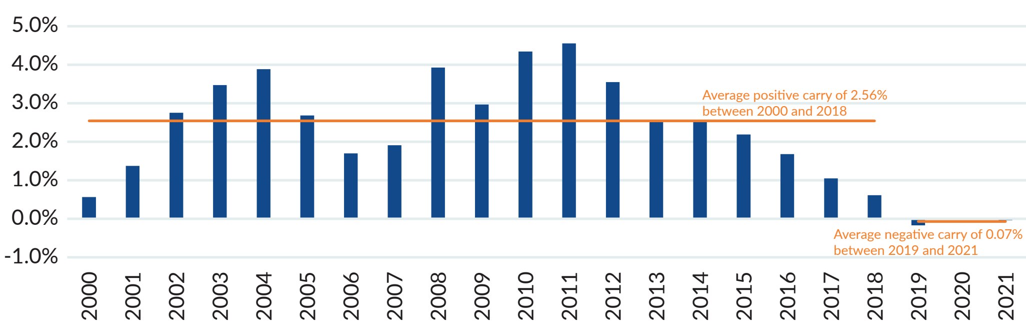
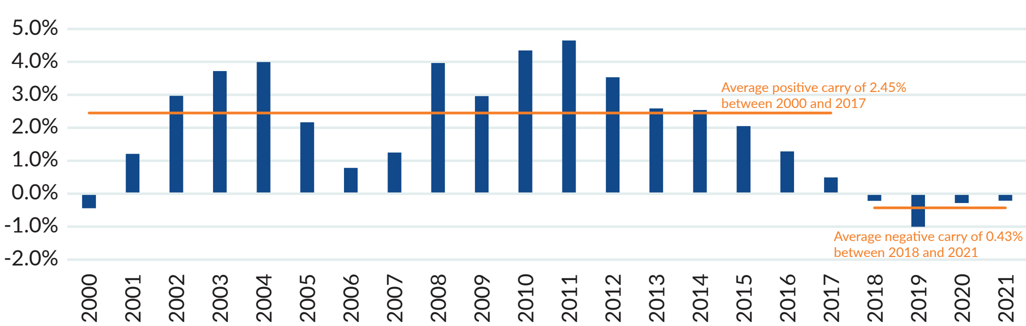
FIGURE 1: **ANNUAL MSCI WORLD CARRY**



Source: Bloomberg. Past performance is not necessarily indicative of future results. Actual results may materially differ.

US Dollar has been the biggest driver of lower carry

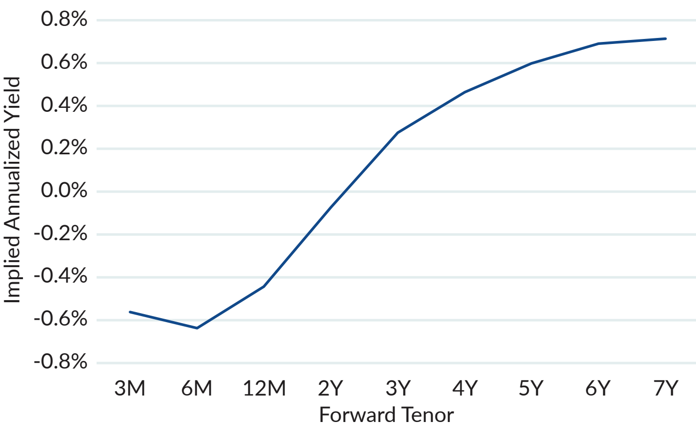
FIGURE 2: **ANNUAL AUD/USD CARRY**



Source: Bloomberg. Past performance is not necessarily indicative of future results. Actual results may materially differ.

Currently, the average implied carry on a 3-month currency forward is approximately negative 77bps (as of 14 March 2022). However, the annualized 'carry' on a 5 year forward is approximately positive 61bps. Although 61bps is a far cry from the average positive 'carry' of 2.56%, it may be an attractive alternative for those who believe the Fed will continue to be more aggressive in hiking rates in the foreseeable future. In Chart 3, we illustrate annualized carry across tenors. The 'carry' turns positive around year 3. Shorter tenors continue to have negative carry, which will drag overall portfolio performance.

FIGURE 3: **IMPLIED ANNUALIZED CARRY BY TENOR**



Source: Bloomberg. Past performance is not necessarily indicative of future results. Actual results may materially differ.

Based on ASX 30 Day Interbank Cash Rate Futures, the implied rate change for Australia by year-end is +128bps, whereas the implied rate change for the US, based on the 30 Day Fed Funds futures, is +175bps resulting in a further divergence between Australian and US rates. This divergence may result in investors continuing to incur negative 'carry' costs.

Over the past 20 years, the average spread between the annualized carry on a 3 month forward and a 5 year forward has been +52bps, which means the implied carry on the 3 month forward has been on average 52bps higher than a 5 year forward. Currently, the spread between the annualized 'carry' on a 3 month forward and a 5 year forward is approximately -120bps, **near the all-time low over the past 20 years**, as illustrated in Chart 4.

FIGURE 4: **ANNUALIZED CARRY – SPREAD BETWEEN 3 MONTH AND 5 YEAR FORWARD**

Source: Bloomberg. Past performance is not necessarily indicative of future results. Actual results may materially differ.

Although the 5 year forward currently appears to be more attractive than short-dated forwards, there are some risks investors need to take into consideration. First, the RBA may raise rates more aggressively than the Fed in the future. In this scenario, investors locked into the 5 year forward wouldn't participate in the favorable changes in the implied 'carry.' Investors will introduce tracking error, which could be positive or negative, into their program. This might not be tolerable with the emphasis on benchmarking surrounding Your Future, Your Super.

In our experience the majority of Australian superannuation funds do not collateralize their currency hedging program. The majority of funds utilize short-dated forwards which avoid the need to exchange collateral on a daily basis and consequently avoid a potential drag on liquidity. Investors considering a 5 year forward will need to be comfortable exchanging variation margin since the bank counterparties will require it.

If you are interested in learning more about the utilization of longer dated forwards to potentially capture the current positive 'carry' for your fund, please contact Mesirow Currency Management.

About Warakirri Asset Management

Warakirri is a multi-boutique asset management firm established in 1993 with specialist investment offerings for institutional and retail investors across multiple asset classes, including agriculture, equities, cash and specialised U.S real estate. Warakirri's equities offerings provide access to ethical investing across domestic and global equities, emerging markets and in partnership with Flinders Investment Partners Pty Ltd, to small cap equities. Warakirri also has a distribution partnership with Mesirow Financial Investment Management Inc providing institutional investors access to currency management services and direct U.S. real estate investments. Warakirri is also a leader in Australian agricultural investment management with extensive experience in acquiring, developing and operating agricultural assets on behalf of investors. Warakirri is based in Melbourne and is 100% owned by its directors and employees.

About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture. To learn more, visit mesirow.com and follow us on LinkedIn.

For further information on Mesirow's currency management solutions available in Australia, please contact:

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