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One of the major effects of the financial crisis of the last few years has been extreme volatility in the world's foreign exchange markets.

Uncertainty has propelled currencies way outside of their long-term ranges and in recent months the lack of confidence has driven down the value of Sterling and the Euro as more bad news emerges about the state of several governments' finances.

The volatility being seen on FX markets is not just a result of the strife afflicting Western economies. There are other, more technical drivers adding to the volatility. The volume and influence of derivatives trading has grown exponentially in recent years and this can create a significant trend on a currency, positively or negatively. Ultimately, that increases volatility. Add faster and deeper media output spurring more speculators to take a position on currencies and what we have is prices moving more rapidly than ever before.

Back in April, I addressed the Insurance-Linked Securities Summit conference in London and raised issues around what FX volatility meant for funds that invest in traded life policies, or United States-issued whole of life policies sold before maturity so that the original policyholders can enjoy some of the benefits in their own lifetimes.

Because TLPs are dollar-denominated assets, this means the currency risk must be hedged for Sterling and Euro investors. My issue was that it was imperative for such funds to rethink how they would deal with chronic FX volatility and that they did so as soon as possible. This is because FX volatility now posed the greatest liquidity risk for TLP funds.

I was, of course, speaking in the context of an insurance industry conference. However, the problems associated with FX volatility are not unique to TLP funds: any fund can be affected by currency volatility if the underlying assets are denominated in a different currency to that of the fund's units or shares. All such funds should use a blend of currency hedging solutions in order to deal with the ongoing volatility on FX markets.

However, it is particularly important for funds that invest in TLPs to get the currency risk under control because of their particular characteristics. Such funds are designed to deliver smooth, predictable returns in an investor's base currency. They need to maintain significant cash reserves to continue paying premiums on policies before they mature, so liquidity risk becomes an issue for them too if a fund manager gets the currency hedging wrong, leading to a drain on cash.

So how can funds hedge currency risk? Essentially, currency hedging is used to reduce the risks of investing abroad. If, for example, a UK based investor wishes to buy a US asset but does not wish to invest in the dollar as well then using hedging techniques reduces or even eliminates the currency risk. In effect, it becomes a sterling investment in the US. Hedging allows the investor to transfer currency risk to another party who wishes to take a position in the currency. The investor has to pay this other party to take on the currency exposure, similarly to taking out insurance.

There are two ways in which funds can hedge currency risk. These include using forwards and options.

Forwards lock in the price at which two parties are obligated to buy and sell a specified amount of currency on a particular date and at a set exchange rate. At MPL, we hedge on a monthly basis to coincide with the monthly valuations in our Traded Policies Fund, but the timing can vary from one manager to another.

When purchased in the correct ratio to a currency pair such as Sterling and Dollars, forwards offset any positive or negative currency trend. Forwards are cheap because both parties have a vested interest in reducing currency risk and so they have nominal impact on net asset values.

But a forward either creates cash or consumes cash, depending on whether the dollar strengthens or weakens. For example, if the dollar weakens, then this means our US holdings have gone down in value in sterling terms and the counterparty to the forward would have to compensate us the difference. On the other hand, if the dollar strengthens, then our US assets have increased in value in sterling terms and we would have to compensate the counterparty to the forward for the fall in sterling, using our cash reserves to do so.

In normal trading conditions, as long as there is enough liquidity to cover movements in the currency – say 15 per cent - then futures are the best hedge to use because they are so cheap. Over the long term, if FX rates stay relatively stable, then gains or losses would cancel each other out and the net effect tends towards zero.

But when currencies are as volatile as they are now, with the stability of sterling threatened by the gargantuan public debt and the euro undermined by the Greek, Spanish and Portuguese credit risks, then a much more sophisticated blend of forwards with another type of derivative – options - are needed. Options, as their name suggests, provide the option to buy or sell a currency at a set price in the future.

We purchase options to protect our fund's sterling share class against falls in the dollar in excess of 15 per cent, for example, beyond which the counterparty to a forward contract would not be obliged to compensate us, assuming a liquidity limit of that magnitude.

If, for example, $1 currently exchanged for £1 and we wished to hedge against a fall in excess of 15 per cent, we would buy an option giving us the right to buy sterling at $1.15 on a future date when it might cost $1.20 or $1.25 on the open market. If the exchange rate stayed within the 15% limit then the option would not be exercised.

Options are cheaper the less likely the exchange rate locked in for the option. So, for example, an option protecting us against a fall in the dollar in excess of 15 per cent is much cheaper than one protecting against a 5 per cent fall. By using a combination of forwards and options a fund manager can protect sterling investors against currency movements in a cost effective manner, while keeping a tight control on the risks this poses for the fund's liquidity.

With the advent of the global credit crisis, investment professionals have been motivated to spend more time and energy on understanding and assessing the benefits of alternative, non-correlated asset classes. As a result of this research the investment community has gained greater appetite for TLPs because of their unique potential to deliver smooth, predictable investment returns irrespective of market conditions.

Whilst TLPs are an inherently complex asset class, there are a number of asset managers that have delivered extremely attractive investment solutions to the market. The past two and half years have been an extremely testing period for all asset managers and there has been arguably no better time period in which to assess how well they have dealt with the key management challenges associated with TLPs funds, which are liquidity and currency risk.

The risk issues with TLPs cannot be underestimated nor simplified and it is the joint responsibility of fund managers and financial advisers alike to understand and articulate the risk considerations to an investor to enable them to assess the asset class for suitability. It is all too easy for an uneducated investor to believe they are purchasing an extremely low risk alternative to cash but this is not the case; TLPs are an inherently complicated asset class to manage and there are many reasons why a fund may not deliver upon its intended objectives. One should therefore examine the past performance of a fund to assess its merits and equally understand the liquidity and risk considerations that relate to the asset class.