

## **The rise of share classes denominated in local currencies**

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The ongoing shift in economic power from West to east is well known. Western governments are now relatively more indebted than those of Asia, which is reflected in credit rating downgrades, most notably that of the United States. There are many consequences to this but what we are seeing in the international investment market is a growing number of fund share classes being denominated in the currencies of what have been deemed as 'emerging' for some time.

The emerging markets of Asia are different from those of other regions. This is because countries in Latin America and the Middle East still largely peg their currencies to the US dollar. Furthermore, In the Middle East there is a different driver because investors there are very cautious about investing locally because of the state of the market, especially in the Emirates. There is a moral and cultural requirement to invest locally but they do wish to spread their investment overseas and are happy to do so in Western currencies.

But it is notable that Asia is going through a different economic cycle to the West. While what is happening in Europe and the US impacts Asia, the fact remains that Asia remains a highly cash-rich region now. But these wealthy investors take a lot of risk if they invest via western currencies. There are several key reasons for this.

First, they are now less reliant on western currencies, which are going through a highly volatile period and have become discredited. It makes no sense to buy Euro-denominated assets, for example, as they have no idea what will happen to the Euro. It is debt ridden currency and very difficult to predict how it will perform.

Second, foreign currency investing is always carries more risk and with Asian interest rates starting to rise, the risk becomes even greater. Higher interest rates mean a stronger currency in the future and that means foreign assets become worth comparatively less when their values are converted back into domestic currency.

Third, the actual mechanics of currency hedging should also be considered. Take for example, a Malaysian investing in a dollar asset. What a financial forward does is it simulates placing the ringgit on deposit with a bank and receiving interest at base rate in ringgit and then using the collateral to borrow US dollars and paying interest on it at the dollar rate while using these borrowed dollars to buy the asset. If the Malaysian ringgit base rate is 3% and the dollar is 0.25%, in addition to making a gain on the asset you have bought in dollars we have hedged out the currency risk and made a gain on the interest differential between the currency pair. The differential between the ringgit and dollar interest rates is 2.75%, meaning you would make that gain just on the derivative. By having the Malaysian ringgit share class and investing in a dollar asset delivering 9% then the ringgit investor will enjoy enhanced returns of 9% plus 2.75%, or 11.75%.

Fourth, exchange controls are an issue. Historically, there have been a lot of controls in Asian countries on investing in overseas assets. It was only because of the limited range of investment opportunities in their own currencies that those Asian investors who could invest in Western currency-denominated assets have done so. Exchange controls still do exist and the reality is that to deliver an investment opportunity in local currency is absolutely key. It is pretty much the only route to market.

Asian investors are not greedy. They are happy with 6% per annum and minimal risk. If you can offer them an asset class that delivers steady, incremental returns then why would they want that in any other currency than their own.?