Currency management for private assets – the underestimated value driver

Navigating currencies intelligently

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Content

Overview

Currency Risks in Private Asset Portfolios – Classification and Key Issues

Private assets place particular demands on institutional currency management. The following overview outlines the framework within which currency risks in private assets are to be assessed and sets out the key questions addressed in this analysis:

- **What currency risks actually arise in private asset portfolios?**
  Is it sufficient to consider the currency of the fund share class, or is it necessary to look through to the level of the underlying assets?

- **Are currency movements irrelevant in the long term, or are they a risk factor?**
  How significant are exchange rate fluctuations in the context of reporting, regulatory and management requirements?

- **How do valuation cycles and data availability affect the feasibility of currency hedging?**
  At which stages of a private asset portfolio's life cycle are time-delayed valuations critical – and when are they not?

- **What role do liquidity and cash flow structure play in the hedging strategy?**
  Is liquidity requirement a disqualifying factor, or can it be managed in a structured way?

Currency management for private assets – the underestimated value driver.

In recent years, institutional investors have placed an increased focus on the management of currency risks associated with their liquid investments, such as equities and bonds.

By contrast, currency risk management in private asset portfolios has so far played only a secondary role. This was due to, among other things, Private Assets long representing only a smaller proportion of institutional portfolios and the risk therefore being assessed as low. At the same time, many investors benefited from the strength of the US dollar, which appreciated by approximately 30% against the euro since the beginning of 2014 until end of 2024. In many portfolios, the US dollar represents the largest currency risk and has therefore contributed to higher returns. In addition, the investment structure for Private Assets, where capital is committed in advance and drawn down or repaid over a certain period of time, is more complex than for liquid investments.

This structure makes it more difficult to measure the inherent currency risk.

In particular, the combination of low returns from traditional investments, the potential for higher returns and diversification benefits has meant that private assets have become significantly more important in institutional portfolios in recent years. A Willis Towers Watson study[1] covering the 22 largest pension markets shows an increase in the portfolio weighting of private assets from 7% in 2001 to 26% in 2021. The growth in assets under management in this asset class has continued in the years since and, according to an analysis by the data provider Preqin, is set to continue. Preqin forecasts that assets under management worldwide will rise to USD 29.2 trillion by 2029, compared with USD 16.8 trillion at the end of 2023[2].

As around three-quarters of global assets under management in private assets are managed by funds outside Europe, currency risk for European investors is inevitably increasing as investment ratios rise. It is therefore becoming increasingly important for institutional investors to proactively address these risks.

The following analysis aims to raise awareness amongst investors and private asset managers of the growing currency risks and to highlight practical solutions for effective risk management. Commonly held market views regarding currency hedging for private assets will be critically examined.

[1] Source: Global Pension Assets Study 2022 (Thinking Ahead Institute)
[2] Source: Future of Alternatives 2029 (Preqin)

Thesis 1 – Currency movements are a zero-sum game

As private asset investments often involve a decision to invest in foreign currencies, the question arises how to manage currency risks. Some market participants believe that currency movements are not sustainable and that exchange rates will return to their historical averages or fair market values. For long-term investment horizons, such as those typical of private assets, currency hedging is therefore considered to be of secondary importance. Economically, this is justified primarily by the fact that exchange rates express the value of one currency relative to the value of another. Through the trade in homogeneous goods, no traditional risk transfer takes place; consequently, a sustained divergence in exchange rates cannot be justified by a risk premium. The following section examines whether these assumptions and the associated conclusion that currency hedging is unnecessary can be substantiated.

From an investor's perspective, this approach raises three key points:

- Is it always the case that currencies revert to their historical average rate or fair market value and could it be inferred from this that no currency risk arises for the investor?
  Due to reporting requirements, interim exchange rate fluctuations become apparent, even if these movements are not expected to be sustained.
- Many institutional investors are subject to regulatory requirements that limit the proportion of unhedged currency exposure and could therefore prevent potentially lucrative new investments in global assets without currency hedging.

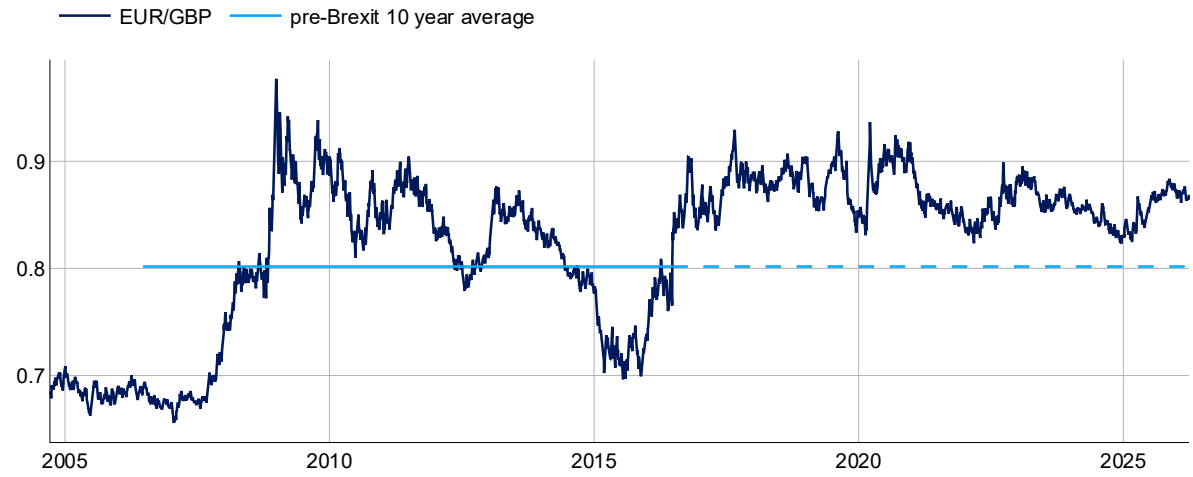
The challenge with focusing solely on average exchange rates is that their levels vary significantly depending on the period under consideration. Figure 1[3] illustrates this using the EUR-USD exchange rate.

EUR-USD exchange rate and average values

[3] Source: Bloomberg, 7orca – own calculations and presentation

The EUR/GBP exchange rate provides a further illustration. As shown in Figure 2[4], it has not returned to its average pre-Brexit level for more than ten years.

EUR-GBP exchange rate and pre-Brexit average



In addition to historical average exchange rates, estimates of fair value based on purchasing power parity (PPP) can also be used. PPP is based on the assumption that identical goods should trade at the same price in different countries. In theory, exchange rates should therefore offset differences in inflation between countries over time. Comparing PPP estimates with observed exchange rates provides a useful indication of whether exchange rates tend to revert towards fair value and over what time horizon. Figure 3[5] illustrates the deviation of the EUR/USD exchange rate from its PPP-implied fair value, based on OECD calculations, and shows that exchange rates can deviate from fair value for prolonged periods.

EUR-USD purchasing power parity

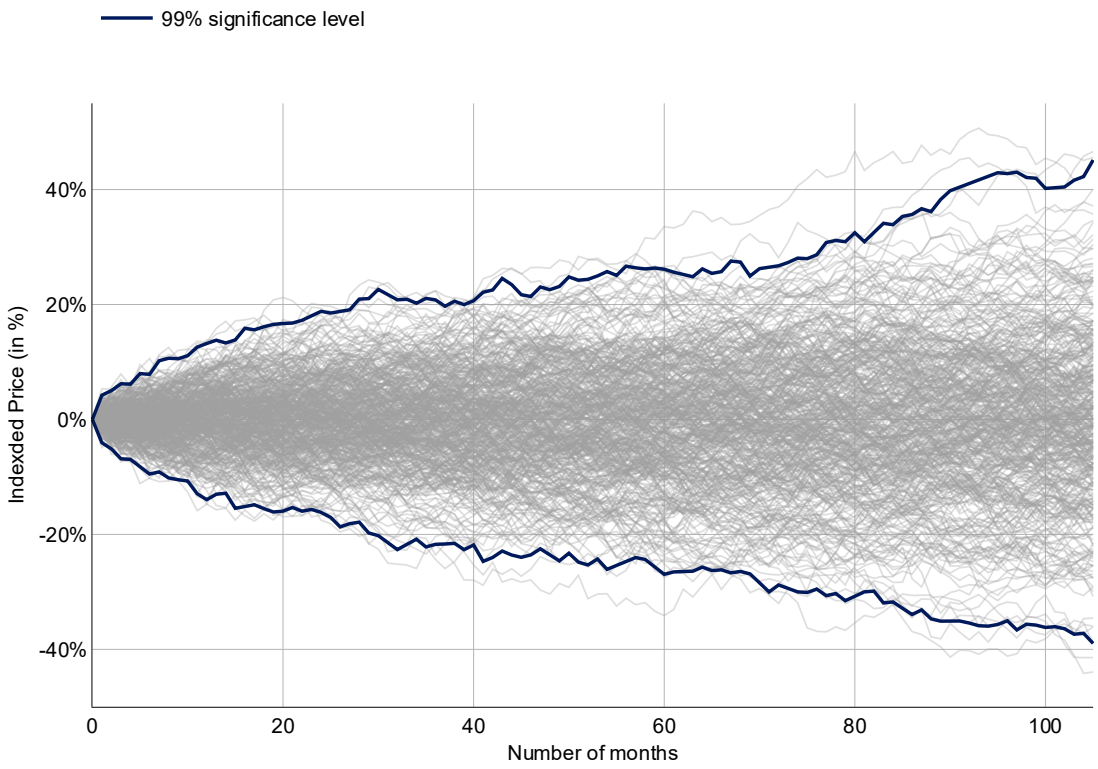
Furthermore, when considering these approaches, the question arises as to the exchange rate at which a currency was acquired. The investment decision is based solely on the attractiveness of the private assets. The purchase of the currency in which the respective private asset is traded is a necessary follow-up transaction and is usually carried out independently of current currency movements.

[4] Source: Bloomberg, 7orca – own calculations and presentation
[5] Source: Bloomberg, 7orca – own calculations and presentation

Regardless of whether exchange rates return to their long-term averages or to fair market prices, this assessment distracts from the extent to which interim risks may arise. Most institutional investors, as well as fund managers, are subject to reporting obligations under which they must account for the performance of their investments. Consequently, an interim depreciation of the currency is highly relevant.

Figure 4[6] shows how large performance deviations can be over time.

EUR/USD path simulation



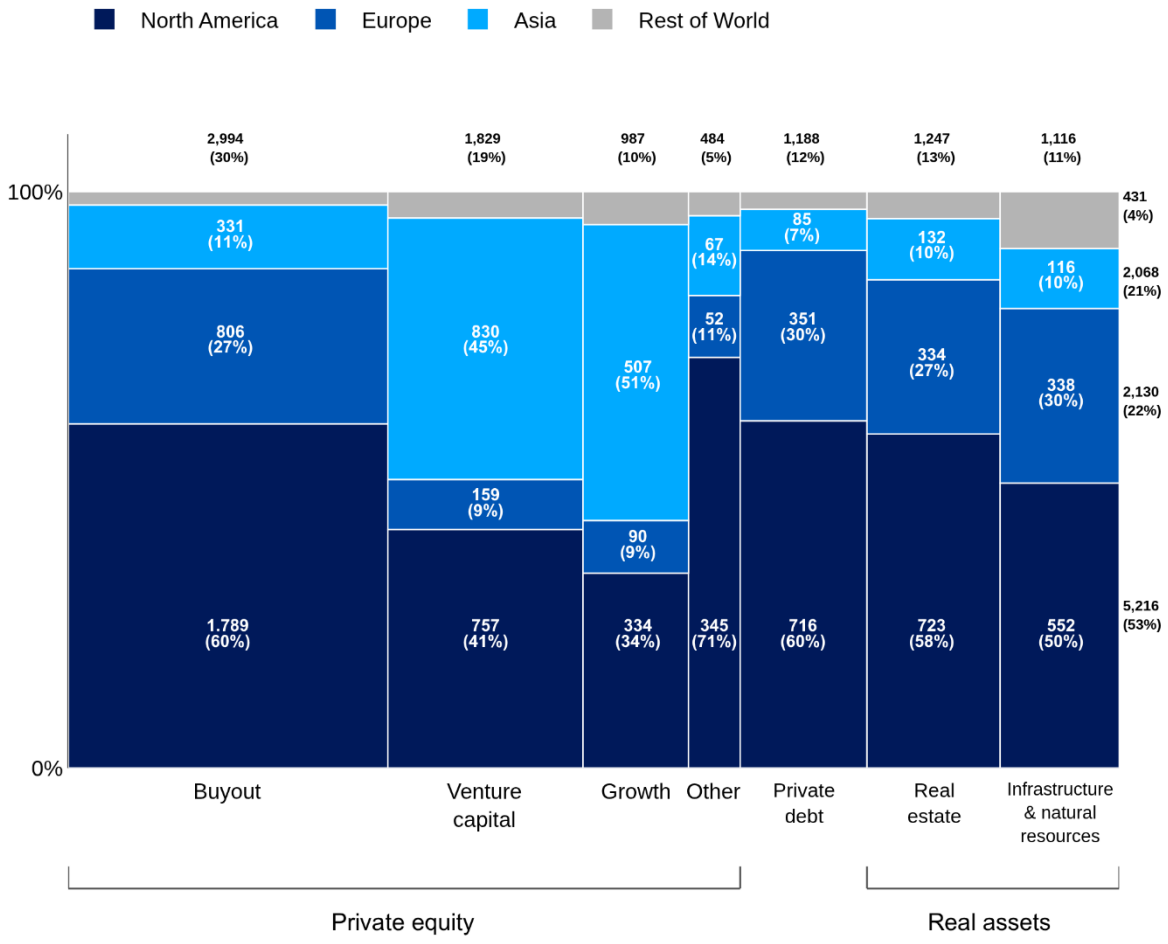
Regulatory requirements present a further challenge for many investors. They limit the proportion of unhedged currency investments. As mentioned at the outset, the proportion of private assets has risen significantly in recent years, and with it the currency component of the portfolio. As a result, many investors must either hedge their positions to continue meeting regulatory requirements or forego potentially lucrative investments in global assets.

[6] Source: Bloomberg, 7orca – own calculations and presentation

Thesis 2 – Currency hedging at the share class is sufficient

Despite an existing home-market bias among many investors based in the euro area, the growing proportion of private assets indicates an increasing focus on markets outside the euro area. Figure 5 below refers to a 2022 analysis by McKinsey[7] . It underlines the dominance of the US dollar as an investment currency in Private Assets. More than half of global Private Asset investments are made in North America.

Private Markets: Assets under Management worldwide
(1st half of 2021, in billions of USD)



Internationally oriented funds often invest in different currency areas, which do not necessarily correspond to the currency of the fund's share class. For example, an investor based in the eurozone could invest in a private equity fund with a base currency of the US dollar, which in turn invests in projects denominated in various currencies such as the Australian dollar, the euro and the British pound.

This example highlights two key aspects. Firstly, the ongoing internationalisation is leading to an increase in investments in funds whose share classes are not denominated in euros. Secondly, it shows that an analysis of currency risk focused solely on the currency of the share class is insufficient to fully capture the actual risks of an investment.

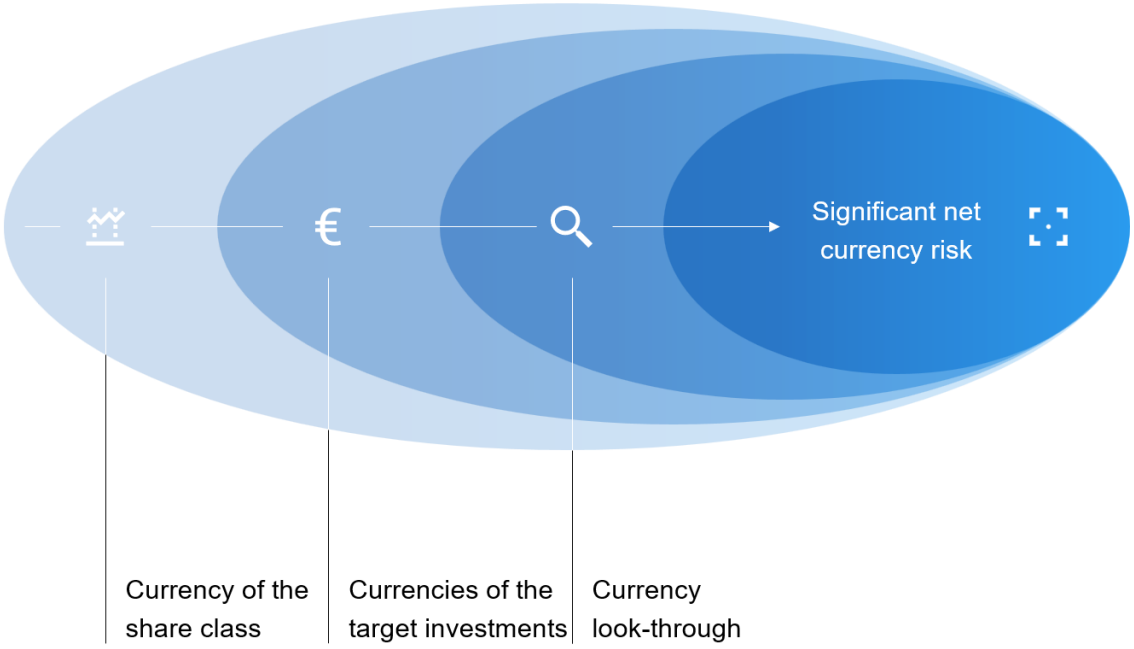
[7] Source: 7orca – own chart based on the McKinsey Global Private Markets Review 2022 (McKinsey & Company)

Globally oriented private asset funds that invest in companies or projects whose revenues and costs are denominated in currencies other than the fund's currency, often give rise to currency risks that are not always transparent. This frequently leads to a situation where investors are exposed to additional currency risks without being explicitly aware of them.

In order to transparently map the foreign exchange risk of the investments made, it is crucial to determine the economic currency risk by looking through the fund structure of the underlying investments.

Figure 6[8] below illustrates the various levels involved in determining the relevant currency risk. Such an analysis ensures that the investor takes account not only of the currency of the share class, but also of the currency risks at the level of the underlying assets.

Determining the relevant net currency risk



The first step in identifying currency risks in private asset funds is to determine the currencies in which the fund's investments are held. In this context, it is crucial to analyse in which countries the fund's underlying assets are located and in which currencies they are valued. It is also necessary to determine whether the fund manager has already taken measures to reduce currency risk. One such measure is borrowing in the currency of the investment. This strategy, known as 'natural hedging', reduces the risk in the respective currency. In addition, the fund manager may pursue an explicit currency hedging strategy that must be taken into account in the determination.

Only by incorporating all this information can the investor determine the relevant net currency risk. For this reason, it is essential to carry out a comprehensive analysis of the fund and not to focus solely on the currency of the share class.

These observations must be monitored continuously and the measures derived from them regularly adjusted in order to be able to respond to possible changes in the risk position.

[8] Source: 7orca – own chart

In some cases, the analysis may indicate that the share class currency provides a sufficient approximation of the underlying currency risk. In most cases, however, this is not the case.

Table 1[9] illustrates this point. It compares the distribution of currency risks based solely on the share class currency with the distribution obtained after determining the relevant net currency positions. The analysis, based on around 500 private asset funds held by investors from the DACH region, shows that a detailed assessment of the underlying currency positions results in a significantly more granular currency profile. Rather than being concentrated in the euro and the US dollar, currency exposure is distributed across a much broader range of currencies.

Analysis of the actual currency position

Currency	Distribution by share class	Breakdown by currency breakdown
Euro	54.53%	41.53%
US dollar	44.72%	41.10%
British pound	0.54%	10.12%
Swiss franc	0.10%	1.11%
Chinese yuan	0.00%	1.06%
Canadian dollar	0.00%	1.02%
Danish krone	0.00%	0.98%
Australian dollar	0.00%	0.97%
Indian rupee	0.00%	0.85%
Polish zloty	0.00%	0.80%
Swedish krona	0.10%	0.78%
Brazilian real	0.00%	0.71%
Other*	0.00%	3.17%

* Remaining = 45 other currencies with a share of <0.5%

This result highlights the importance of a comprehensive analysis to accurately determine the actual currency position.

[9] Source: 7orca – own calculations based on KVG and Manager data

Thesis 3 – Effective currency hedging requires timely valuation data.

A frequently discussed topic in connection with currency hedging for private assets concerns the valuation methods for this asset class. Compared with liquid investments, the valuation of illiquid investments differs fundamentally. The key differences in valuation are longer valuation cycles, more complex structures and more limited transparency.

Criticism is levelled particularly at the low frequency of valuations, as well as the long time span between the valuation date and the publication of valuation data for private assets. Whilst funds that invest in liquid assets such as shares or bonds are generally subject to daily price fluctuations, illiquid investments are often valued only quarterly. Furthermore, the period between the valuation date and the publication of the relevant data varies considerably. This interval is usually between 30 and 90 days, but can also be considerably longer.

A frequently voiced criticism is that this considerable delay in the publication of data makes it difficult to implement currency hedging strategies effectively. In fact, this delay only partially limits the effectiveness of hedging. The practical relevance of this limitation depends largely on the stage of the portfolio's life cycle.

During the build-up phase, timely information is particularly important. Frequent capital calls and new investments can lead to significant changes in the portfolio's currency allocation. Close communication with fund managers and administrators is therefore essential to ensure that hedging positions reflect the underlying currency exposure as accurately as possible. This is equally important during the divestment phase, when investments are sold and capital is returned, potentially resulting in rapid changes to the portfolio's currency profile.

By contrast, the holding phase is typically characterised by a relatively stable currency allocation. Although exchange rates may fluctuate between valuation dates, structural changes to the portfolio generally occur less frequently. As a result, the impact of valuation delays is typically lower during this stage. Hedging strategies should nevertheless be designed so that temporary valuation differences do not result in materially negative market values. At portfolio level, capital returned from mature investments is often offset by capital deployed into new funds, further reducing changes in the overall currency allocation. Even so, regular communication with managers and administrators remains advisable, particularly when significant portfolio restructurings take place.

The effectiveness of currency hedging should therefore not be assessed solely on the basis of valuation frequency. Rather, it depends on how the underlying currency exposure evolves over the life cycle of the portfolio and on the availability of timely information when material changes occur.

However, if investors opt for currency hedging, they should also be aware of the challenges arising from the relatively long valuation intervals of private assets. The following example is simplified and does not cover all possible scenarios. It relates to a euro-based investor who invests in a euro-denominated private asset fund. This fund, in turn, invests in private assets outside the eurozone.

If the currency exposure is hedged outside the fund – for example, through an investment vehicle that pools liquid assets – a timing mismatch arises between the valuation of the currency hedge and the currency effects of the underlying assets. While the currency hedge is valued daily, the currency effects on the underlying assets are reflected only when the assets are revalued. If, for example, the currency in which the private asset investment is denominated appreciates, losses on the currency hedge become relevant for valuation purposes immediately.

Corresponding positive currency effects only become apparent at the fund's next valuation and are passed on to the investor with a time lag. This discrepancy in valuation requires additional adjustments in performance reporting. To improve transparency, investors should therefore supplement standard performance reporting with dedicated reports that identify currency effects that have already occurred economically but have not yet been reflected in the valuation of the underlying assets.

Thesis 4 – High liquidity requirements make currency hedging unattractive

A currency hedging strategy may shift risk from market risk to liquidity risk. The following example illustrates the situation. A euro-based investor hedges their US dollar investment using a derivative by selling US dollars against euros. When the derivative matures, the transactions must be rolled over. An appreciation of the US dollar against the euro results in a negative market value of the hedge, which must be offset. This can be problematic for illiquid investments, as the assets are difficult to sell – and are likely to be sold at significant discounts – in order to balance the market values.

Furthermore, the use of collateral for currency derivatives has become standard practice in asset management. For illiquid assets, collateralisation via variation margin and initial margin is common, which entails high capital requirements. If the market value of the currency hedge is negative, collateral must be provided immediately.

Hedging currency risks can therefore place a significant strain on liquidity due to the provision of collateral and the settlement of realised cash flows. The following section outlines approaches to minimising this strain on liquidity. Most of these approaches can be implemented at both the Limited Partner (LP) and General Partner (GP) levels. A few of the measures outlined below apply to only one of the two.

One simple option is to hold free liquidity within the fund. However, this approach is not optimal for the return on investment, as the liquidity cannot be channelled into the investment process.

Although collateralisation is common for FX forward transactions, no initial or variation margin is required by regulation. In principle, it is possible to refrain from posting collateral. To simplify the process, the negotiation of margin exemptions can be carried out with banking partners such as custodians and lending banks, which regularly assess the risks of the fund and have therefore already completed the credit review.

Another possible method for optimising collateral obligations is the introduction of a collateral annex based on net asset value (NAV). In this context, a percentage of the current NAV is defined up to which no collateral is required. Once the negative market value exceeds this threshold, the difference must be posted as collateral. By working with several derivative counterparties and optimising the allocation of the hedging volume, the liquidity burden can be significantly reduced.
Collateral payments or cash flows when hedges are rolled can also be provided through existing revolving credit facilities. Mature funds can also use NAV financing, where loans are granted on the basis of the NAV of their portfolio. These loans are collateralised by the assets in the fund and generally serve to generate liquidity without requiring assets to be sold at a discount.

Another way to minimise negative cash flows is to apply an active overlay, which adjusts the hedge ratio in a market-adaptive manner. In the event of favourable price movements, the hedge is opened in order to enable participation in the rising currency market and minimise the cash flow burden. In the event of negative price developments, the hedge ratio is increased gradually.

Following the optimisation of collateral, structuring cash flows may be appropriate. The staggering method is used to tranche the currency risk and distribute it across different maturities with the aim of creating a more even liquidity burden. In cash flow matching, the maturities of derivatives are planned so that they correspond to the payment dates of known cash flows. The early extension of hedging transactions, known as forward rolling, manages the liquidity burden in a targeted manner.

All three methods aim to optimise liquidity requirements and ensure that sufficient funds are available for hedging transactions at all times.

Another option is for GPs to agree additional capital commitments with LPs to meet cash flow requirements arising from derivatives. These can be drawn down by the GP as required to cover negative market values.

LPs generally have greater flexibility when it comes to structuring the hedging. An example of such an approach is the hedging of private assets in a liquid vehicle such as a German master fund. Performance attribution for the collateralisation can be carried out via detailed reporting.

If the collateral is to be held in an illiquid vehicle that holds the private asset funds, the collateral may consist of securities contributed to the vehicle by the LP. This option significantly reduces the need for free liquidity.

Conclusion and final considerations

With the increasing internationalisation of investments, the issue of currency hedging for private assets is gaining in importance. Many market participants hold differing views on how currency risks can be managed most effectively. This paper aims to examine these arguments in greater detail and to analyse various aspects of currency management in the context of private assets.

In the private assets sector, currency management presents a complex challenge due to its specific characteristics. To make well-informed decisions, it may be appropriate to consult a specialist in currency management. Such an adviser can specifically analyse and assess issues such as the optimal level for currency management (GP or LP level), the most appropriate structure and the required degree of transparency, as well as the choice between active and passive approaches to risk management.

Given the growing importance of private assets in institutional portfolios and the continuing dominance of investments outside the eurozone, this topic remains highly relevant. Investors will increasingly need to develop and implement a suitable strategy for managing currency risks.

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This document was prepared by 7orca Asset Management AG, Hamburg.
Source and data set for all information, unless otherwise stated:
7orca Asset Management AG (31 March 2026)

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