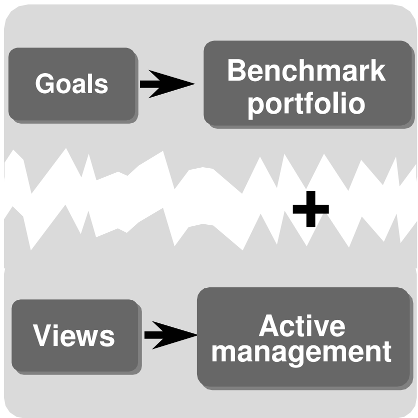
Long-term strategy vs. near-term trading/hedging



automatic pilot designed to achieve long-term goals

deviation from benchmark to benefit from market opportunities

Benchmarks must capture strategic goals

Passive management requires replicability

Beating the benchmark requires information on inherent risks

To determine the value of FX to global portfolios, we should distinguish between a portfolio's **benchmark** (its long-term strategy) and its **tactical exposures** (shorter-term deviations from this benchmark due to views on assets or requirement to hedge near-term event risks).

A benchmark is the portfolio of assets whose long-run performance best meets the investor's long-term goals, without requiring investors to formulate views on assets' short-term performance. For example, a pension fund with long-term, fixed liabilities would likely choose a long-duration government bond index as its benchmark, since the performance of those securities provides the income stream needed to meet future payouts to policyholders. Over the short and medium-term horizon, a plan sponsor may still choose to deviate from this benchmark to exploit perceived opportunities in the market or to hedge event risks that pose a threat. But the purpose of the benchmark is to assure that the investor's shorter-term investment decisions do not take the portfolio too far from what is optimal in the longer run.