

understanding currency hedging

INTRODUCTION

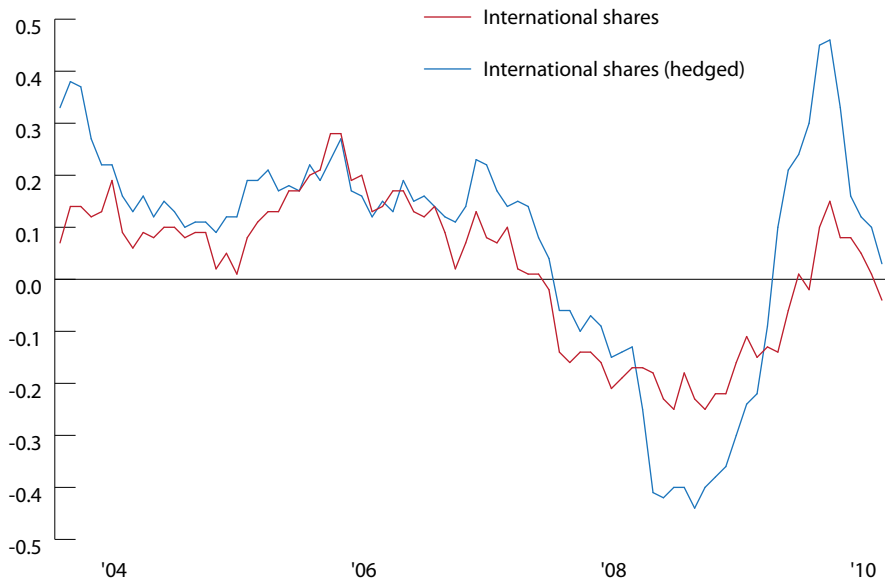
Investing in international assets exposes investors to currency risk. Hedging international investments can be a prudent strategy to help protect the investment from adverse foreign exchange movements, as well as to stabilise returns and increase diversification.

WHY HEDGE?

Currencies change value relative to each other all the time. It is extremely difficult to predict which way a currency will move and the magnitude of the move. When the A\$ is rising compared to a foreign currency, it means that any returns earned in that foreign currency will be diminished when the returns are converted back into A\$. Conversely, if the A\$ is falling compared with the foreign currency, any returns earned in that foreign currency will appear to improve when the returns are converted back into A\$. This currency effect can be very significant.

Some currencies are more volatile than others. Graph 1 below shows the relationship of the Australian dollar compared to the US dollar, the UK pound and the Euro. Graph 2 shows the performance of both the hedged and unhedged

Graph 2: International share returns (rolling annual return %pa)



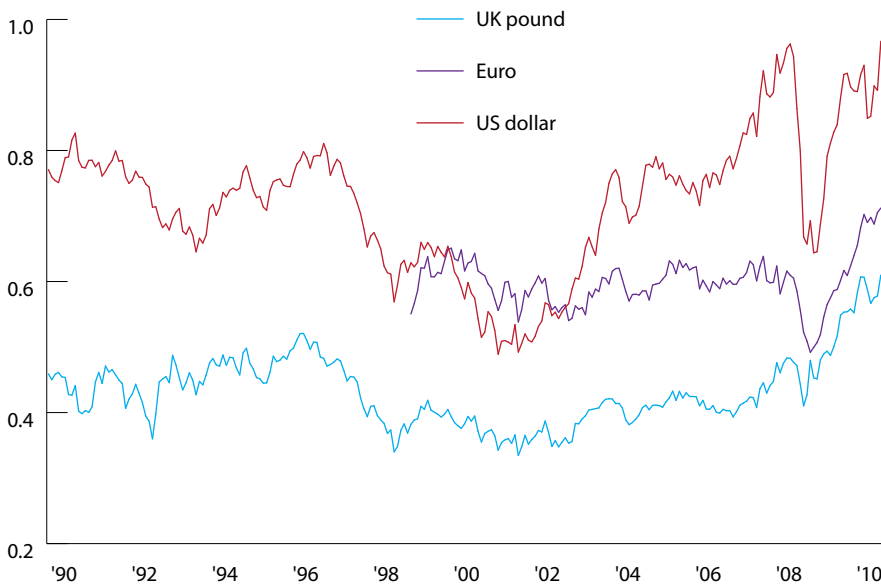
MSCI international share indices from January 1995 to May 2010. The chart clearly highlights the wide dispersion of returns over this period.

MANAGING RISK

Hedging should be considered primarily to be a risk management tool. While small adverse currency movements

are tolerable, currencies can exhibit large and prolonged movements which can erode returns over the medium term. These large movements can cause problems for investors, who tend to focus on the returns expressed in their local currency where most of their assets and liabilities are denominated. Consequently, most investors use hedging to insure at

Graph 1: A\$ currency movements



Source: Reserve bank of Australia



This article by Patrick Bennett (above), Head of Research.

least a portion of their portfolios against these currency gyrations.

Hedging reduces the impact of currency movements on returns obtained from overseas investments. If an investment is fully hedged, that is all currency impacts are eliminated, the investment will significantly outperform a similar unhedged investment when the A\$ is rising against a foreign currency. However, it will underperform the unhedged investment when the A\$ falls relative to the foreign currency. Conversely an unhedged investment will appear to be a very mediocre performer if the A\$ is rising, but will appear to deliver exceptional returns if the A\$ falls (see Graph 3).

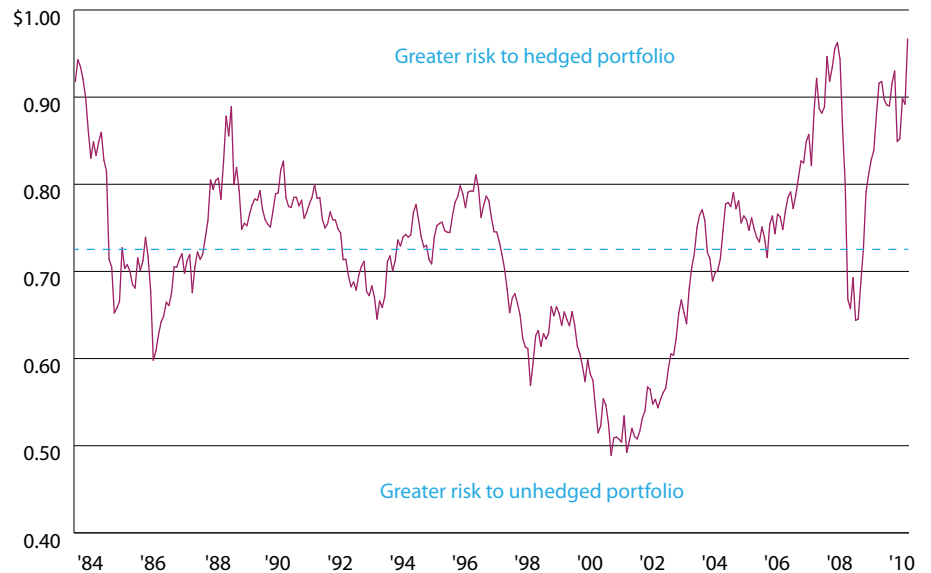
THE IMPACT ON VOLATILITY

A global portfolio of currencies is clearly more diversified than a portfolio composed only of the local currency. But currencies are inherently volatile in themselves and add another layer of volatility to a portfolio. The volatility of the underlying assets in a global equity portfolio is high relative to currency volatilities, so the effects of hedging on the volatility of the overall portfolio are minimal.

LIMITATIONS

There is not a strong argument for using currency hedging as a way of generating better investment returns. The evidence shows that hedged and unhedged portfolios outperform each other at different times over different time horizons. Neither a fully hedged nor a fully unhedged equity portfolio could assure higher returns over the longer term. Unfortunately, experience indicates that attempting to time in and out of hedging on global equity portfolios may increase the risk without a commensurate reward. In hindsight there may be long term trends that could have been exploited, but there are also periods

Graph 3: Exchange rate A\$ versus US\$



within the long term trend when the currency cycle is not consistent.

There are some limitations on what can be practically hedged. A hedging strategy involves some cost to the portfolio. Typically the cost of a passive hedging strategy is between 0.3% - 0.6% per year. However, the cost of hedging a basket of emerging markets currencies is prohibitively expensive so emerging market portfolios tend not to be hedged.

OUR RECOMMENDATION

While it would be nice to think that we can predict currency movements and perfectly time when to hedge and when not to hedge, the fact is currency movements can be very volatile in both direction and timing. Even experts are continually surprised with the speed and direction of currency changes.

We believe a prudent strategy for managing currency risk in international shares and REITs is a broadly even split with 50% of portfolio hedged and 50%

unhedged. This avoids the potential for large underperformance that can result from either a totally hedged or unhedged position, although the opportunity for large outperformance also is foregone. It is a simple but effective way to help protect returns over the long term.

We prefer to employ hedging on a strategic rather than a tactical basis, given the demonstrated difficulty to forecast currencies with any accuracy and the damage that might be wrought on your portfolio by poor timing decisions.

We recommend that all international fixed interest exposures be fully hedged. Currency volatility can be of such magnitude that it will swamp the returns of the underlying fixed income assets, which are relatively stable.

Currency hedging applied to foreign fixed interest investments also produces a more meaningful reduction in volatility than when applied to international equities.



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