7 ESSENTIAL TIPS FOR MANAGING CURRENCY RISK

At a Glance

- Investing offshore gives you access to a larger and more varied investment universe, with opportunities for growth and income that are simply unavailable in Australia. However, international investments expose investors to currency risk.
- While hedging can protect against adverse currency impacts, it can lead to lower returns if the A$ falls. And although hedging can be an effective strategy for reducing the volatility of defensive assets, it can actually increase the volatility of returns from growth assets like international shares.
- Being able to determine where the dollar is trading in comparison to its fair value, then setting your strategy accordingly, can help you to benefit from long-term currency movements.
- Targeting the right hedging level across your total portfolio is the key to achieving an optimal balance between reducing currency risk and maximising returns.

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While international investments have the potential to deliver real benefits they are also exposed to currency fluctuations. Currency can turn a loss into a profit — or vice versa. Fortunately, the right strategy, can help you to not only manage currency movements, but use it to your advantage.

INVESTING OFFSHORE

The Impact of Currency

Allocating funds to international assets has the potential to deliver real benefits — especially at a time when key global markets seem to be gaining momentum. Investing offshore enables access to a vastly larger and more varied investment universe, so you can:

- Access companies, sectors and assets with different economic and growth profiles to those found onshore.
- Benefit from the growth and income-producing potential of industries either underrepresented or unavailable on the Australian market.
- Reduce overall portfolio risk through more effective diversification.
- Resolve the severe concentration risk inherent in Australian investment markets — including an equity market that is heavily dominated by just two sectors, materials and financials.
- Benefit from structural trends across the global economy, including ongoing growth in emerging markets.

Turning Loss Into Profit - or Vice Versa

Yet investing offshore also introduces an important new variable to the investment equation: currency.

Since floating in 1983, the Australian dollar has been one of the most actively traded and most volatile currencies around the globe. In fact, currency movements can sometimes outweigh raw investment returns, turning a loss into a profit — or vice versa. As a result, the total return from an overseas investment effectively has two parts:

Return = Changes in the Foreign Price of the Investment + Exchange Rate Movements

WINNERS AND LOSERS

Hedging Your Exposure

This prompts the question: should you hedge foreign currency exposure, removing the effects of exchange rate movements altogether? Or should you seek to turn it to your advantage?

In some years, hedging a portfolio's exposure to foreign currencies would have boosted returns significantly. Take 2009 for example.

In that year, global equity markets rebounded strongly after the financial crisis. Before allowing for exchange rate movements, international shares were up 26% for the year (as measured by the MSCI World ex-Australia index). However the Australian dollar rebounded so strongly during the year that an unhedged investor would have done well to break even[1] on international shares after allowing for exchange rate movements. As a result, in 2009 hedging would have boosted returns by around 27%[2].

But of course, it also works in reverse. In 2013 international shares had another strong year, rising 29%[3] before allowing for exchange rate movements. However, this time the Australian dollar fell during the year, turning an impressive 29% return into an astounding 48% gain[4] for unhedged Australian investors. In 2013, hedging would have cost over 15% in performance.

To make matters worse, a good hedging decision for an Australian investor is, by definition, a bad decision for an investor in another country. If, in any given year, an Australian investor benefits by holding an unhedged US investment, then a US investor will lose out by holding an unhedged Australian investment. In a year when the Australian dollar rises against the US dollar, by definition the US dollar falls against the Australian dollar.

Figure 1: Hedging Is Not Always a Winning Strategy
Rolling 12 Month Profit or Loss on A$ Hedge MSCI World Ex Australia Portfolio for Australian Investor

Source: SSGA, MSCI.

That brings us to our first two tips for international investors:

TIP 1 Playing short-term currency movements is difficult, even for the experts. Unless you are particularly skilled in foreign exchange, set a long term strategy.

TIP 2 Choose a strategy that suits your base currency. A strategy that suits a US or UK investor may not suit an Australian investor.

SETTING A STRATEGY

Balancing Risk and Return

How, then, do you develop your strategy? The key is to achieve the right balance between the two dimensions of currency strategy: risk and long-term returns.

Risk — The First Dimension

No one likes uncertainty. One of the axioms of modern finance theory is that, all other things being equal, investors prefer stable assets to volatile assets. As a result, risk often plays a central role when investors set a currency strategy, especially for defensive assets.

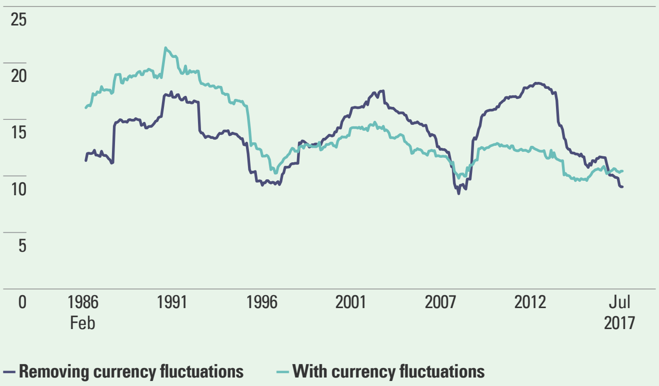
For example, most people who invest in international government bonds choose to hedge their currency exposure. That's because hedging an international bond portfolio dramatically improves the certainty of returns.

Unfortunately, the picture is much less clear for risky assets like international shares. History suggests that international shares remain risky whether or not you hedge the currency exposure.

Figure 2 shows the impact of currency on the riskiness of international shares over each five-year period since the float of the Australian dollar. From the late 1990s, leaving currency exposures untouched has tended to reduce the risk of an international share portfolio.

How is that possible? It happens because the Australian dollar has tended to rise and fall largely in sync with international shares. That has allowed investors to make money from positive currency fluctuations when they are losing on global equities, and to make money on international equities while losing on the currency. However, it is important to understand that:

Figure 2: In Sync: International Shares and the Australian Dollar
Rolling 5 Year Volatility for International Shares (%P.A.) Australian Investor



Source: SSGA, MSCI.

- International shares remain risky regardless of whether you hedge currency or not.
- While the tendency over recent history has been for currency risk to help to reduce overall risk, it is only a tendency, not a law. There have also been periods where currency risk has increased the overall portfolio risk for international equities, and it is quite possible that the relationship observed over the last 20 years may not be sustained in future.
- While this analysis is true for Australian investors, it does not apply to (say) US or UK investors. When considering any analysis of currency and risk, it's essential to ensure that it is appropriate to your own base currency.

TIP 3 Investors commonly hedge 100% of the currency risk for defensive international investments like government bonds. For these assets, history suggests that removing currency fluctuations dramatically improves the stability of returns.

TIP 4 In contrast, Australian-based investors who focus solely on reducing volatility will tend to only hedge a small part, if any, of their international share investments.

Return — The Second Dimension

While volatility is important, it is not the only element to consider. After all, if variability of returns was the only consideration when investing, we would all invest in cash. Clearly potential returns will also play a large part in your investment decisions.

As a result, the unhedged strategy outlined in Tip 4 can be a questionable one, depending on current exchange rates. While remaining unhedged might reduce volatility in an international share portfolio, greater stability can come at a cost. So how do you set a sensible hedging strategy that allows for better longer term returns?

Finding Fair Value

For investors seeking to develop a longer-term currency strategy designed to enhance returns, understanding where the Australian dollar is trading relative to its long term averages is an important first step. We normally expect currencies to revert to their long-term fair value at some point in the future. While it may take years in some cases, we still expect that reversion to occur resulting in return opportunities for investors.

However, you also need to be careful not to assume that the average value of an exchange rate over the last 20 years is in fact its long term fair value. Our research[5] suggests that the longer term fair value between two currencies will be driven by factors like inflation, terms of trade and changes in productivity.

Anecdotally, we saw a number of large investors reduce or remove their currency hedges as the Australian dollar reached new highs in 2011 and 2012, on the expectation that it would fall towards fair value at some point in the future. Similarly, we have seen a number of large investors start to re-introduce currency hedges as the Australian dollar has declined. Whether it has further to fall before it reaches its current fair value remains to be seen.

Looking Beyond the US

We'll start by observing that international shares involve more than just the US. While for many investors the current level of the Australian dollar simply means the Australian dollar/US dollar (AUD/USD) exchange rate, the reality is that only half of a typical international share portfolio is invested in the US. The other half will be exposed to currencies like the Japanese Yen (JPY), UK Pound (GBP) and the Euro (EUR).

All of these currencies have traded in a large range against the Australian dollar over the last 25 years. Some of those changes have been sharp and sudden, as shown in Figure 3 — and only a few have occurred in sync with similar fluctuations in other currencies.

TIP 5 Be aware of whether the Australian dollar is at long-term highs or lows when setting a currency strategy. Remember to consider the GBP, EUR and JPY exchange rates as well as the USD — and be aware that 'long term' in this case means a decade, not a year.

TIP 6 Be patient. Currencies can move away from fair value for long periods of time, and picking short term currency movements is notoriously difficult. Currencies can move quickly in both directions. Unless you are a foreign exchange expert, avoid rebalancing too often or too quickly in response to currency movements.

Figure 3: Australian Dollar Exchange Rates Can Vary Dramatically Across Currencies

Source: SSGA, MSCI.

BRINGING IT TOGETHER

Setting the Right Level of Exposure

Having determined a preferred balance between risk and return, there is one more important step you need to take before putting that strategy into action.

When experienced institutional investors assess currency risk, they think about its impact at the total portfolio level, not its effect on each asset class. Instead, they aim for a pre-determined level of currency exposure across the entire portfolio, then hedge individual asset classes accordingly.

Understanding the overall level of foreign currency exposure you want to achieve can be much more important than setting the hedge ratio for each asset class. For example, the decision to hedge 50% of your international growth assets has a much greater impact than the choice to implement the hedge in the holdings of international property, rather than the international shares or infrastructure assets.

That brings us to our final essential tip for international investors.

TIP 7 Understand how much foreign currency exposure you have across your entire portfolio. Consider the impact of exchange rate movements at the portfolio level, rather than just within individual asset classes.

EARNING INTEREST ON YOUR CURRENCY HEDGE

Most investors understand that a currency hedge protects them against adverse interest rate movements by paying a return when the exchange rate moves against them. But many don't realise that a currency hedge can offer a second kind of return, a bit like earning hidden interest. This is sometimes called the 'carry' part of the return, and it can make hedging much more attractive for Australian investors[6].

When an investor takes out a currency hedge, they earn interest at their local ('base') rate, while paying interest at the foreign rate. Since Australia has had higher interest rates than most other developed nations for many years, the carry earned by Australian investors has historically been positive. As at July 2017, it is currently around 1.2% pa[7].

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Figure 4: Featured Funds

	SPDR® S&P® World ex Australia Fund	SPDR® S&P® World ex Australia (Hedged) Fund
ASX Code	WXOZ	WXHG
Benchmark	S&P Developed ex Australia LargeMidCap AUD Index	S&P Developed ex Australia LargeMidCap AUD Hedged Index
Hedging Ratio	0%	100%
Inception Date	18 March 2013	8 July 2013
Management Costs	0.3%	0.35%
Currency	Australian dollar	Australian dollar
Net Return Since Inception*	16.33%	12.00%

* Returns as at 31 July 2017. Past performance is not a an indication of future results.

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- Diversified international exposure
- The simplicity and transparency of an investment in Australian shares
- A choice of hedged and unhedged investments, giving you the ability to adjust currency exposure across your portfolio
- The ability to adjust asset allocations, increase or decrease exposure and rebalance portfolios quickly and easily
- No need to research, select, monitor and trade shares across unfamiliar markets

[1] MSCI World ex Australia Index return (net of WHT) for 2009 was -0.30%.

[2] MSCI World ex Australia A$ Hedged Index return (net of WHT) was 26.71% for 2009.

[3] MSCI World ex Australia Index return (net of WHT) in local currency return 29.18%.

[4] MSCI World ex Australia Index return (net of WHT) in Australian dollar return 48.03%.

[5] Colin Crownover, "The new rules for when to hedge a currency", IQ, Autumn 2014, State Street Global Advisors.

[6] Investors should also consider the fees and costs associated with hedging investments.

[7] Bloomberg, MSCI.

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