RETHINKING CURRENCY HEDGING POLICY
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Currency hedging policy is a topic for which investors have a wide range of views. Even what appear to be fairly straightforward ideas can lead to different conclusions and confound investors. For example, no one wants to bear “uncompensated risk”. For some, this concept leads to a 100% currency hedging policy absent other considerations. An opposing view maintains that foreign currency exposure provides diversification, so hedging is unnecessary. How does an investor make sense of all of this?

It is helpful to revisit established investment policies from time to time and retest various investment beliefs.

**REGARDING CURRENCY HEDGING, ARE EITHER OF THE FOLLOWING POLICIES IN EFFECT FOR YOUR FUND?**

- A uniform currency policy hedge ratio (e.g., 50%) is applied with respect to all foreign currencies (perhaps with the exception of emerging markets currencies).
- Different currency hedging policies apply to different asset classes (for example, leaving USD exposure unhedged with respect to US equity exposure, but hedging 100% of USD exposure with respect to US fixed income investments).

**DO YOU OR YOUR ORGANIZATION HOLD EITHER OF THE FOLLOWING BELIEFS?**

- The impact of currency is expected to “wash out” over the long term.
- There is little, if anything, to be gained by actively managing currency hedge ratios because it is extremely difficult to predict short term currency movements.
UNIFORM POLICY HEDGE RATIOS
The last 10 years or so has provided evidence of two important items which should be considered with respect to setting currency policy. First, experience during the financial crisis of 2008-2009 (in particular) has reinforced the status of the USD as the key currency which investors flock to in times of crisis. Second, it has demonstrated how the perception of currencies and movements of currencies can change over time (e.g., the perception of the Euro changed from being a safe-haven currency to a currency under crisis, and the Yen experienced a significant depreciation in 2012 and 2013).

Putting aside return experience for a moment, the impact on portfolio risk (in terms of either downside risk or volatility) of unhedged USD exposure versus, say, unhedged Australian dollar exposure has been significantly different. Unhedged USD exposure has generally helped buffer typical Canadian portfolio returns in times of equity market stress (given the flight-to-quality feature of the USD), and unhedged AUD exposure has had the opposite effect (given the positive correlation of the AUD to economic growth and commodity price strength). This should give investors pause to at least consider the merits of establishing different policy hedge ratios for different foreign currencies.

DIFFERENT POLICIES FOR DIFFERENT ASSET CLASSES
Many investors and advisors have strongly held views on whether or not it is sensible to have different currency policies for different asset classes. Some investors have established different hedge ratios for different asset classes, even when the same currency is involved. Consider the example of an investor that hedges 100% of USD exposure with respect to US fixed income investments and leaves USD exposure unhedged with respect to US equity investments. Each decision on its own might appear to be sensible, however investors should consider portfolios as a whole, and decisions should be made considering the impact on the total portfolio. For example, in a total portfolio context, it does not matter whether USD exposure arises from the equity portfolio or from the fixed income portfolio. Investors who have decided on different policies for different asset classes should ensure that they consider how these policies come together at a total portfolio level.

MANY INVESTORS WOULD ANSWER IN THE AFFIRMATIVE TO AT LEAST ONE OF THESE ITEMS, IN WHICH CASE IT COULD BE WORTHWHILE TO REVISIT THE BELIEFS RELATED TO THESE ITEMS AND THE RESULTING IMPLICATIONS.
DO CURRENCY EFFECTS WASH OUT OVER TIME?
Canadians’ most familiar point of reference for foreign currencies is the exchange rate with the USD. The CAD/USD exchange rate first began to float in 1973. At that time the exchange rate was close to parity. The exchange rate then steadily dropped to roughly $0.72 USD per CAD in 1986, rose to $0.88 USD in 1991, then steadily fell again until 2002, reaching a low of $0.63 USD in 2002. Since 2002, it has rebounded strongly, once again reaching parity in 2007. The CAD then dipped again during the financial crisis of 2008, but rebounded to parity in 2011 and 2012. Consequently, over the roughly 40 years ending 2012, the net movement was close to zero, which offers some support for the belief that currency effects wash out over time. Since the end of 2012 the CAD has declined again, and sharply since September 2013, falling to $0.90 USD as of January 31, 2014.

However, counterexamples can be found. Just consider the Japanese yen (JPY). Over the last 40 years, the JPY/CAD exchange rate has fallen from roughly 300 JPY per CAD to 92 as of January 31, 2014. This refutes the belief that currency effects wash out over time.
So how might this belief statement be recast into something that holds up better to historical scrutiny? One approach would be to recognize that this belief statement really only works with respect to developed currency pairs where the inflation rates in the respective countries are very similar (as has typically been the case between the US and Canada). If we take this concept a little further, we quickly arrive at the theory of Purchasing Power Parity (PPP). PPP is a theory of long-term equilibrium exchange rates based on the relative price levels of two countries. In the “relative” version, the difference in inflation rates equates to the percentage depreciation or appreciation of the exchange rate. While PPP often does not hold true over shorter periods of time, the long-term historical linkage between currencies and inflation over the long term is strong.

Investors should consider whether or not they believe in PPP (and over what timeframe) and how this could factor into their framework of investment beliefs and into subsequent policy implications.

IT IS DIFFICULT TO PREDICT SHORT TERM CURRENCY MOVEMENTS
The difficulty in predicting short term currency movements is not the item of debate. The issue is the implication of this belief. This belief leads some to conclude that active management of currency hedge ratios should not be undertaken (however, if the time horizon is extended a little, some specialist active currency managers have demonstrated the ability to add value). On the other hand, this belief in the difficulty in predicting short term movements (which is supported by historical evidence) is exactly what gives power to the Carry Trade. The currency Carry Trade refers to a strategy of borrowing low-yielding currencies and investing in high-yielding currencies. The currency Carry Trade is far from foolproof, but has generally added value over the long term.

If an investor believes that the best estimate of the future spot exchange rate is the current exchange rate, then one can identify opportunities based on the forward premium or discount embedded in currency forward rates. In essence, this belief provides the framework to support hedging when one gets paid to do it (i.e., domestic short term interest rates are higher than foreign short term interest rates) and to avoid (or reduce) hedging when it is costly.

Carry trade signals are currently quite weak because widespread central bank policies are keeping short term interest rates very low which has resulted in modest forward premiums and discounts for many developed market currency pairs. However, investors should be monitoring when these opportunities could resurface in the future.

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1 For example, see Elroy Dimson, Paul Marsh and Mike Staunton (all of the London Business School), Currency Matters, Credit Suisse Global Investment Returns Yearbook 2012
WHAT CURRENCY RISKS ARE OF GREATEST CONCERN?
A final observation is that currency risk can take on different dimensions and mean different things to different investors. What risk(s) do investors want to target through currency hedging policy – reducing overall portfolio volatility, individual asset class volatility, downside risk, the risk of experiencing a significant movement in exchange rates and being on the wrong side of the hedge (which many Canadian investors who had unhedged USD exposure experienced during the mid-2000s), etc.? It is important to understand what currency hedging policy is intended to achieve in order to devise an appropriate policy. Materiality, cash flow concerns related to the settling of currency forward contracts, and governance and implementation resources may also factor into final decisions.

CONCLUSIONS
Currently, many Canadian investors have adopted static, uniform, foreign currency hedge ratios. In addition, different hedge ratios may apply for different asset classes. Investors should spend some time revisiting their currency beliefs and determining the extent to which their current policies may not be fully consistent with the implications of their beliefs. In our view, there is merit in considering different hedge ratios for different currencies and taking into account currency valuation measures (e.g., PPP) along with the cost of, or carry from, hedging (with a key consideration being the forward premium or discount). Since the latter two items change over time, this naturally leads to consideration of dynamic currency hedging policies versus static ones. Finally, as with other investment exercises, investors should consider currency policy in the context of the entire portfolio and not only from an individual asset class perspective.

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