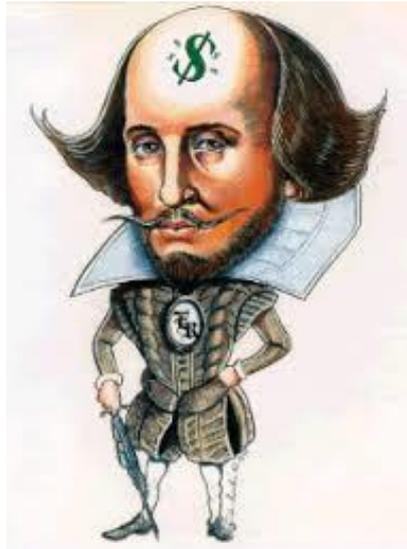


# TO HEDGE OR NOT TO HEDGE THAT IS THE QUESTION

Without being disingenuous to Shakespeare's Hamlet, the question of hedging offshore exposures has again reared its head following the recent drama of the New Zealand dollar. We attempt to dispel some of the beliefs propagated by vested interests, and provide further insights to assist with currency exposures in portfolios.

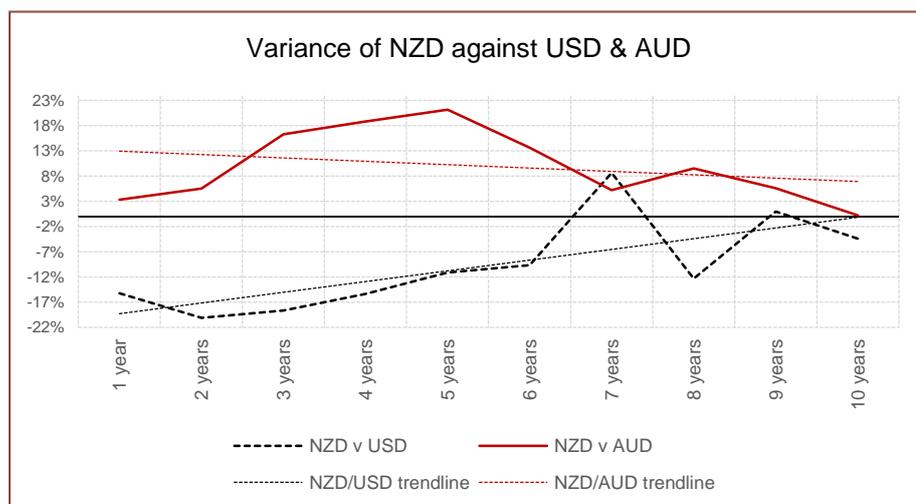
The foreign exchange theatre is one of the largest, most liquid markets in the world with the NZ dollar traded against all other currencies averaging \$250bn per month. Not bad for a country whose GDP is less than 0.30% of the world. The risk that domestic investors have to changes in the value of one currency against another, adds significant volatility to their portfolio and can lead to material changes in their returns. As illustrated, the Kiwi dollar has been a star performer amongst most other developed world currencies since the GFC, having risen over 13% against



Over recent years, fluctuations in the NZ dollar has led to unexpected performance implications for investors, causing the hedging of currency exposures to become an ever important consideration. Whilst the fundamentals of interest parity

interest rate differentials in the shorter term. Over longer time horizons, the hedged mean returns (excluding transaction costs) should be reasonably similar to unhedged mean returns. With this as a backdrop, the decision to hedge or not to hedge should be based on whether it reduces the asset volatility, and if so, whether the effect is large enough to compensate for the cost of hedging the currency risk. In addition to affecting the expected mean return over shorter time frames, currency hedging will influence the overall variance of asset returns, often distorting the diversity that was sought from an offshore exposure in the first place.

The various types of risks are predominately measured through standard deviation, due to its common acceptance in the investment world. Alternative measures of currency risk for portfolios that should also be considered, include: the divergence of returns between hedged and unhedged portfolios over time, the tracking relative to a consumption basket in a particular currency (managing real purchasing-power risk), and the tracking relative to the local asset returns (which has no currency effects). The latter two definitions track the dispersion caused by exchange-rate risk relative to the underlying benchmark, denominated in the local home currency. Due to the small relative size of the New Zealand economy, the arguably stretched domestic equity and debt valuations, and the abundance of offshore opportunities, it is anticipated that decreasing investor "home bias" will continue to hasten portfolio allocations to foreign



the Australian dollar since the end of 2009. But of course, no one can accurately predict the fate of the dollar over the next 3 years.

supporting currency valuations tend to play out over the longer term, movements in the bilateral exchange rate rarely offset returns from the

assets and heighten investor interest in managing a larger foreign-currency exposure.

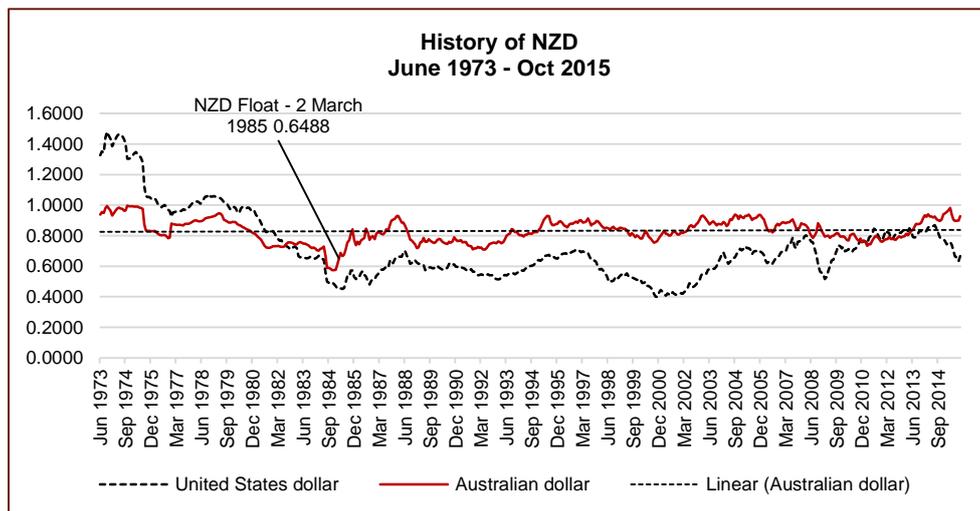
When determining the offshore currency allocation, NZ investors should consider whether it is more accurate to define their NZ dollar exposure as a “safe-haven” currency or something that is more volatile than other foreign currencies that they could be exposed to. Accordingly, a partial hedging of the overall portfolio allocation may be a reasonable compromise, allowing for a targeted approach to currency without reducing the underlying portfolio’s diversification potential.

Currency can be managed either actively (often referred to as Dynamic Currency Hedging) or passively through regular and predictable currency resets. Forward contracts, money market instruments such as foreign exchange swaps, and futures are common instruments used to manage exchange risk. In the case of futures, they are similar to forward contracts, except they are exchange-traded, or defined on standardised assets. Futures typically have interim partial settlements, or “true-ups,” in margin requirements. A key consideration is that currency strategies aiming to maximise portfolio returns will differ from strategies that seek to reduce overall portfolio risk. Whatever the objective, the currency strategy should be consistently designed, implemented, and evaluated against the primary objectives of either enhancing returns or mitigating risk. These may require a strategic versus a tactical approach to currency management. Either way, the weight of research demonstrates that short-term currency movements will remain unpredictable and difficult to forecast accurately, questioning the justification for a short-term tactical approach to currency management. The simplest measure to oust the currency-charlatans is to review the

net contribution to performance and / or volatility management to determine if they have the necessary skills to add value (and justify the direct and indirect costs).

An additional dilemma occurs due to the taxation regime governing those funds that are domiciled in Australia. The effect of the law is firstly that the fund must distribute all its realised

hedging costs being a significant component. Whilst some will argue that the explicit expense ratio and implicit transaction costs of having currency hedging are fairly certain, the benefits are less certain. Whilst the case for hedging an equity allocation is less apparent, the lower volatility of offshore fixed income orientated assets obtains meaningful benefits from having the impact of



**It is expected that the long-run returns of a hedged offshore equity portfolio will be less than the long-run returns for the same unhedged portfolio**

income in the financial year, with gains/losses from currency hedges taxable on a realisation basis. So whilst changes in the value of the underlying securities are not distributable until the asset is realised, hedges used to hedge currency risk on foreign currency

denominated assets are. These are typically rolling three month forward contracts, which are realised on a much more frequent basis than the underlying asset, causing a timing mismatch between the gains/losses resulting from the hedges and the gains/losses from the underlying asset.

It is expected that the long-run returns of a hedged offshore equity portfolio will be less than the long-run returns for the same unhedged portfolio, all other things being equal, with any

currency neutralised. Global debt investors are likely to have a preference for lower volatility on their returns, with currency interest rate swaps being appropriate mechanisms for hedging bonds.

In conclusion, rising portfolio allocations to offshore assets will continue to amplify Kiwi investor interest in the accompanying currency exposures. Foreign currency affects both the return and – more importantly – the risk characteristics of a portfolio. Due to the hedging costs (not to mention the opportunity costs associated with currency meddling) it is expected that the long-run returns of a hedged offshore equity portfolio will be less than the long-run returns of the same unhedged portfolio. Any hedging decisions will tend to favour limiting the risks associated with global fixed income allocations. So before eliminating the potential *currency crisis* that is often espoused by those who are seeking your business, it is worth remaining mindful of the overall benefits that an offshore currency exposure can provide to portfolio construction.