

Make or Break Returns

Mitigating the downside – rationale behind currency hedging

BY ROMANA KING

Thirty years ago, currency management was little more than the introduction of a free-floating exchange rate. Now currency management is the pinnacle of global portfolio construction – the latest risk management tool of many financial analysts.

“Currency management is about mitigating risk, not about generating returns,” explains Zainul Ali, a senior asset consultant at Towers Perrin. By employing currency management, “you may give up a lot of upside, but you minimize risk; you give up the return, but you mitigate the downside.”

• Kenneth Froot opts to leave currency unhedged.

Yann Depin, vice-president, currency management, State Street Global Advisors, believes that currency management is a key factor in maintaining a successful investment strategy. He was part of a three-person panel organized by the Toronto CFA society in June. “Maintaining a successful currency strategy in periods of uncertainty requires an examination of several economic factors, including the long-term prospects for the Canadian dollar,” Depin explains. “The recent rise of the loonie and the removal of the foreign content limit may prompt plan [managers] to revisit their approach to currency management.”

Depin explains that though the prospects for higher commodity prices, rising interest rates, strong fiscal and current account surpluses, and rising productivity all signal continued strength for the Canadian dollar, a rising domestic currency will dampen the impact on returns from investments abroad. This means that any portfolio that takes advantage of diversification opportunities (created by the recent removal of the foreign content restriction) will be “subject to even more currency volatility.” In order to minimize this risk, Depin suggests that all portfolio managers and financial planners develop a strategic approach to currency hedging.

“Currency risk cannot be adequately monitored by the simple application of a static hedge ratio,” explains Depin. Instead, currency hedging should be a well-defined plan, rather than an afterthought – and it should, first and foremost, be a “risk-reducing strategy,” that takes the mid- to long-

term perspective in an investment portfolio.

This is the approach York University’s Pension Plan recently adopted, adds Leona Fields, manager of the plan. In fact, many institutional investors are now examining whether or not to hedge their portfolios (which is significant as many retail trends start out on the institutional side).

“We looked at currency overlay as part of a larger review in 2006,” says Fields. “Yet [at that time] a lack of consensus at the committee led to no change.” Within a year, however, York University’s

Pension Plan Investment Principles and Policies documentation “clearly separated passive currency hedging and active currency management and allowed for investment strategies and tools that may be needed if, and when, the plan was ready to implement change.”

As outlined by Depin, the two reasons that prompted the examination was the increased foreign exposure and the rapid appreciation of the Canadian dollar, explains Fields.

When the decision to manage currency exchange rate movements was made later in 2007, the goal was to “manage added volatility of returns from currency movements, not necessarily to add value.”

One reason why it took so long for York’s pension plan committee to agree to currency hedging was the differing opinions on what is the optimal currency hedging target ratio.

According to all three panelists, the optimal ratio really depends on the plan or manager’s risk tolerance.

“For example,” says Depin, “a plan with a 50% hedging policy for its international currency exposure could allow discretion to the currency manager to position the currency portfolio within a hedging range of 30% to 70%. The manager’s objective would be to limit the downside risk of a weakening currency without sacrificing the upside.”

As Depin explains: “The tactical hedging program allows the diversification of a plan’s currency risk. Hedge ratios are established by the manager’s assessment of the risk profile of each currency pair and are applied to the respective

currency exposure of the plan’s underlying assets. The tactical hedging program allows the strategy to adjust to changing market conditions and monitor explicitly the pension plan currency risk positions. [Thereby matching] a trustees’ risk tolerance for currency volatility and the manager’s investment management philosophy.”

Ali observes, however, that the incremental risk associated with currency exposure is not necessarily compensated for additional returns when hedging. It does, however, mitigate the downside – which is the primary reason currency management should be implemented in a portfolio.

Fields explains that York’s plan decided on a 50% hedge ratio after managers examined the data from long-observed currency patterns. At first, Fields was skeptical of the ratio.

“I thought [the 50/50 ratio] was a big cop-out.” Then a colleague provided data, known as the Volatility Smile, that offered historical evidence that a 50/50 hedge ratio provided the best risk management in relation to return on equity. “When I saw that data, it really helped me support the decision. [According to the Volatility Smile data] the 50% hedge had the lowest volatility returns [over that historical period].”

Given their long-term investment horizons, mitigating risk is essential for institutional investors, explained Fields. “We made the decision to hedge, not to add value or to increase returns but to manage expected volatility.”

It should be, first and foremost, a risk-reducing strategy.

Depin concedes that currency management is not a new topic for institutional investors. It is, however, newer in the retail investment space. Given the recent rise of the loonie, the problems innate to a passive approach to currency management became quite clear and a look at past performance numbers explains why, says Depin.

“Over the last five years, the value of the Canadian dollar affected annual returns on foreign investments anywhere from -25% to +10%. The currency component entailed in the ownership of

THOUGHTS ON CURRENCY HEDGING:

- Commodity prices have increased by 43% over the past year and 188% over the past five years.
- The growth in commodities cannot be explained “purely (or even mostly) by increases in real demand for commodities,” says Depin.
- In a paper written by Andre Perold and Evan Shulman, the two finance academics recommend 100% currency hedging.

• Fisher Black suggests 30% to 70% for equities and 90% to 100% for bonds.

- Authors Gardner and Wuilloud (and authors Gormaine and Qiam) favour the “least regret” ratio of 50%.
- In the 1990s high equity returns dominated the return from currency and the restricted foreign property rule (at 20%) mitigated any negative currency impact; today, the expectation of lower equity returns and greater foreign exposure means a small movement in a currency can have significant impact on equity/total fund returns.

these international holdings can significantly enhance or detract from overall returns, adding a source of volatility. So it’s no surprise that managers have undertaken currency hedging strategies to neutralize the currency risk component of their international investments.”

The problem with a passive approach to currency overlay is that it applies the same hedge ratio for each currency, irrespective of the currencies’ value, explains Depin. While the adoption of a passive approach is a more efficient risk budget than an unhedged strategy, Depin believes that active hedging, through a ratio strategy, is essential for maximum downside protection.

“While a passive hedging approach may be effective, its success may rely solely on the strength of the domestic currency or on the weakness of only a few currencies,” says Depin. “For example, an analysis of the MSCI EAFE index, 100% hedged to the Canadian dollar over the last 15 years, demonstrates that close to 80% of the outperformance of the hedge resulted from the weakness of the Japanese yen.” This is because the index is comprised of the six major currencies (the euro, British pound, Japanese yen, Canadian dollar, Swiss franc, and Swedish krona), where each currency is weighted according to its trade with the United States. Yet, since 2002, the weak performance of the U.S. dollar against a basket of currencies, where the euro represented more than 50% of the index and the Canadian dollar only 9%, was essentially equal to the performance of the CAD/USD exchange rate.

“There is strong evidence that the contribution of the Canadian dollar’s appreciation to the total index was effectively neutral. Thus, the index’s rise is more a reflection of a general weakness of

the U.S. dollar than the strength of the Canadian dollar. In order for a passive hedging program to be effective and keep the hedge ratio constant across all currencies, a strong domestic currency is required.”

This is the primary reason for active currency management, says Depin, though not the only reason.

“A strategic currency overlay program [regardless of the precise ratio], in which discretion is given to a currency manager to effectively position the currency portfolio according to a well-defined investment management process, can alleviate trustees’ concerns of an optimal hedge ratio.”

Considering portfolio managers and institutional investors are feeling a great deal of anxiety lately, due to the widening gap between hedged and unhedged portfolios, Ali is not surprised that currency management and currency risk is now a primary factor in investment decisions.

Ali cautions, however, that “volatility can be a good thing.”

He argues, “You have to look at extreme outcomes, not just volatility.” By hedging, a manager is able to remove the extremes on the tail side of the returns. While that also means that the extreme upside is dampened, Ali believes that in a volatile global market – such as the current environment – a more strategic approach is required.

“Volatility changes all the time,” says Ali. “If you take volatility over the last 20 years, it’s different than the volatility over the next 10 years – and [this historical comparison] can lead you astray.” For that reason, Ali disagrees with the Volatility Smile results that show 50% as the optimal currency hedging ratio.

“There is no formula,” explains Ali. “Hedging is an art, rather than a science.”