PAVILION

CURRENCY EXPOSURE
DIVERSIFIER OR UNREWARDED RISK?

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Currency movements have the potential to impact significantly the return and risk profiles of globally-invested portfolios, especially in an environment of renewed talk of currency wars. In parallel, fears over the state of affairs in China and other developing economies have led to a flight of capital into perceived “safe haven” currencies such as the US Dollar or the Japanese Yen. The currencies of commodity exporting, or otherwise cyclical economies, have been caught in this maelstrom; in particular the Canadian dollar sold off sharply along with the price of oil.

In this context, and in an environment where risk management policies are of paramount importance, it may be appropriate for institutional investors to conduct a formal review of their investment policy statements with respect to embedded foreign currency exposures. Most investment policies 1) remain silent on currency management, 2) specify a static hedging ratio such as 100% or a middle-ground compromise of 50%. A minority have gone further and 3) implemented active hedging programs or 4) included active currency management strategies as an alpha source. (We define active hedging as a strategy that will apply a 0% to 100% hedge of the currency exposures within the underlying portfolio without going “net long or short”. Active currency management strategies are unconstrained and can deploy sizeable, long and short positions in various currencies with the objective of generating return with no consideration given to the underlying currency exposures.)

It is our view that active hedging and active currency are two active strategies that should be evaluated along with other trading-based strategies and perhaps involving instruments beyond currencies. Trading-based strategies include Global Macro, Global Tactical Asset Allocation (GTAA), and other trading-based approaches such as Carry, Trend Following, and Volatility.

Our discussion here will focus on a review of the arguments behind the first two investment policy-driven approaches from an asset allocation and risk management perspective.

The “remain silent” or unhedged approach

Proponents of the unhedged approach argue that currency returns, at least among the major developed markets, balance out over time and, therefore, will not impact long-term expected returns. They also argue that **asset prices, in particular equity prices, should discount currency movements, especially when looking at the shares of multinational companies whose businesses and internal hedging practices already take these risks into consideration. Thus, currency hedging is counterproductive and an unhedged policy is appropriate, simple and cost-free.**

Another argument in favor of the unhedged approach is that foreign currency exposure can provide valuable diversification to a portfolio and is an integral rationale for investing in foreign markets in the first place. However, this point is the subject of some debate depending on where your sit, literally. Holding unhedged global equity portfolios has been beneficial over the past decade to investors in countries such as Canada. There, investors have benefitted from the appreciating value of foreign-currency-denominated assets that has offset some of the losses suffered in stressed market environments such as 2008 or 2015. Investors in other countries, notably the U.S., have seen losses on foreign assets amplified by the appreciation of the USD during these same low return periods.

Table 1 : MSCI World Index expressed in local currency and in US and Canadian Dollars

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	10-yr Annualized Returns	15-yr Annualized Returns
MSCI World in USD	-16.8	-19.9	33.1	14.7	9.5	20.1	9.0	-40.7	30.0	11.8	-5.5	15.8	26.7	4.9	-0.9	4.3	5.0
MSCI World in CAD	-11.6	-20.7	8.9	6.4	6.7	19.6	-7.5	-25.8	10.4	5.9	-3.2	13.3	35.2	14.4	18.9	5.4	3.6
MSCI World in local currency	-13.9	-23.8	25.5	11.8	16.3	16.1	5.2	-38.3	26.5	10.6	-5.0	16.4	29.6	10.4	2.6	4.7	4.7

Source: eVestment

So is it as simple as saying that a U.S. investor should hedge foreign currency exposure while a Canadian investor should not? In part, yes, but with some caution. If one agrees with the observation that currencies balance out over the long term, the U.S. investor would have benefitted from longer periods of small currency gains before being subjected to sharp losses in times of crisis, whereas the Canadian investor would have had to endure multiple years of losses on foreign currency exposures in the hope of benefitting from protection in risk-off environments, which may not materialize as was the case in 2002. (Suppose the latest downturn wasn't influenced by reduced Chinese growth which dragged down demand for Canadian resources or that the world no longer viewed the U.S. as a safe place to park its money in times of crisis).

The last observation most often is referenced by those advocating currency hedging. If indeed currencies have no expected return over the long term, but introduce time-varying volatility, which may or may not occur at opportune times, unhedged currency exposures would amount to unrewarded risks that should be hedged (or at least managed).

The hedged approach

A straightforward argument in favour of hedging currency exposures can be made with regard to strategies such as Fixed Income, Direct Real Estate, or Hedge Funds, where the volatility of the currency movements might be greater than that of the underlying strategy. **Take for example a risk-managed Hedge Fund (USD base currency), which is expected to yield a 6% absolute return with limited volatility, but could lose 15%+ in a year as a result of currency movements from the perspective of a Canadian investor. This type of currency exposure would not be a desirable proposition and would result in an investment that is highly correlated to currency movements, rather than the uncorrelated investment being sought.** That being said, an argument could be made in favour of maintaining currency exposures in equity investments, which typically are accompanied by higher volatility and longer investment horizons, allowing the currency cycle to play out while benefitting from some diversification.

Determine objectives

The extent to which currency exposures should be managed is therefore a function of our beliefs regarding the anticipated and free diversification benefit that can be obtained from currency exposures. By "free" we mean that the currency exposure, conveniently, is embedded within the underlying asset at no extra cost. In fact, removing the exposure is the costly proposition.

The optimal hedge ratio for each asset class or strategy can be mathematically determined through fairly simple analysis, though the outcome will be dependent on the risk, correlation, regime change or simulation assumptions one uses. Therefore, it is important to conduct scenario analysis to stress test the assumptions and determine how likely the desirable and undesirable outcomes are to occur. One would suspect that the above-mentioned Hedge Fund investment would be a candidate for full hedging.

Practical considerations, however, also come to mind when implementing a hedging strategy as large cash flows might be required to cover losses on a currency program should the investor's base currency depreciate significantly. Foreign assets may need to be sold to raise the cash required to settle the currency positions. That's assuming liquidity is available, which may not be the case for illiquid assets such as Direct Real Estate, Infrastructure, Private Equity or Hedge Funds. A further practical consideration is that hedging mechanisms or vehicles may be too complex, costly, or unavailable depending on the size of the exposures, or that we may not have the required transparency into the underlying currency exposures of an investment vehicle, making it difficult to manage the hedging strategy in a timely manner. Finally, some currencies may be very difficult or costly to hedge, thus leaving an unhedged exposure as the only realistic alternative.

In reality, the arguments about unhedged vs. hedged are imperfect in that they assume that one is looking at the risks and benefits of currency exposures in isolation, on a strategy-by-strategy basis. Both approaches suffer from the lack of a holistic and deliberate mechanism for budgeting the risk exposures that result from the time-varying levels of volatility and the "tail risks" present in currency markets. While equity markets also suffer from time-varying volatility, one could argue that equity investors are compensated for bearing that risk through the equity risk premium. This is not the case for currency markets where the expected long-term return is 0%.

Therefore, we believe that the best outcomes can be achieved by taking a holistic view of the composition of the portfolio when considering a currency hedging program. That is, one needs to look at the strategy and currency allocation decisions separately. Doing so allows for currency exposures to be viewed as a desirable and diversifying benefit within otherwise volatile portfolios, such as ones heavily levered to equity risk and global growth. It also allows for the possibility that currency exposures may not be desirable exposures for more conservative portfolios seeking less volatile returns in the investor's base currency. As such, and perhaps counterintuitively, a Canadian investor with a longer-time horizon and higher tolerance for volatility may wish to leave its USD-denominated Hedge Fund allocation unhedged as a cost-free means of obtaining additional USD exposure at the portfolio level if deemed appropriate, while a more conservative portfolio might wish to hedge its exposure back to Canadian dollars in order to preserve its desired risk-return profile.

Therefore, we consider it prudent for investors to be deliberate in assessing the risks and benefits that flow from exposures to foreign currencies within their global portfolios. The views that flow from this assessment should be documented in a series of investment belief statements that underscore:

- The diversification benefit that can be gained through exposure to foreign currencies, even in the absence of an expected long-term return;
- An acknowledgement of the time-varying volatility and asymmetric return patterns (such as a large number of small gains and a small number of very large losses, or vice versa) resulting from currency movements, including an assessment of the size and timing of potential losses; and
- An analytical framework to assess the appropriate level of exposure to foreign currencies at the overall portfolio level, taking into consideration the portfolio's objectives and composition (equities, Hedge Funds, Direct Real Estate, etc.), and the operational limitations of instituting a hedging program.

Currency exposures can have a significant impact on the performance of a portfolio, particularly during periods of market stress and in an environment of significant monetary policy intervention. If left unmanaged, currency risks thus have the potential to cause unexpected outcomes which may be highly detrimental to the portfolio. Developing a coherent set of beliefs when it comes to managing a portfolio's currency exposures is time well spent.

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