insightpaper

HEDGING AND SLEDGING: managing currency risk to avoid performance slips

August 2017

Key points

- Given the large allocations to international assets by New Zealand investors and the increasing global interdependence of markets, currency exposure management provides a lever to mitigate losses during large market events, and can be a useful tool for protecting clients' wealth.
- For New Zealand–based investors, holding specific foreign currency exposures can provide some protection during sudden, unexpected shocks to global share markets. However, for more defensive international assets such as bonds and alternatives, a high degree of hedging is usually advantageous.
- Overall, the objectives and timeframe of a portfolio should provide important context for determining the currency management strategy.

For many asset owners today, one of the most important issues to address is their approach to currency management. Along with the strategic asset allocation (SAA) decision, the currency hedging decision has a 'whole of portfolio' impact, so it can have a significant bearing on wealth accumulation and the sustainable level of income that an international investment portfolio can target.

In this article, we discuss how we approach currency management from the perspective of a New Zealand-based investor, with a focus on international equity exposure.

Many investors add diversification and scope to their portfolios through holding international assets. For the investment manager, a crucial question is how much foreign exchange risk to adopt in designing a fund's international asset class holdings. This choice is known as the 'hedging decision'. While adopting a 'set-and-forget' approach to hedging has the advantage of simplicity, the wide range within which the New Zealand dollar (NZD) trades against international currencies over any significant time period argues for a more dynamic approach. Investors in international equities, for example, could have experienced supplementary returns during a phase of kiwi dollar weakness or contrarily, have had their returns diluted by the New Zealand currency rallying at the same time as the international markets they hold.

This investment insight discusses the impact of hedging on New Zealand-based investment funds, summarises some of the key pros and cons, and explains the AMP Capital approach.

To hedge or not to hedge?

From a strategic perspective, the desired level of foreign currency exposure is largely influenced by the goals of the fund and should be based on clear beliefs regarding the benefits and risks of currency exposures. The foreign currency exposure decision needs to be made in the context of the fund's overall mix of exposures and the rationales for those exposures.

In cases where a portfolio's cash flows need to be tightly matched to specific NZD liabilities, fully hedging any currency risk is likely to be appropriate. Some look to extend this line of argument by suggesting that a fund should be fully currency-hedged since investors' future spending will be largely NZD denominated. However this is a myopic view, as New Zealand is a small open economy and exchange rate movements influence cash flows arising from local assets as well as the cost of goods and services consumed by savers and investors. A depreciating NZD will both increase the cost of imports and increase the revenue to New Zealand-based exporters, for instance.

We argue that the currency exposure decision should take account of the following:

> Return benefits from hedging home-currency exposure over the long term,

> Risks associated from exposure to foreign currency, and

> Correlations between returns from foreign currency exposure and the returns in the key asset classes in which the fund is invested.

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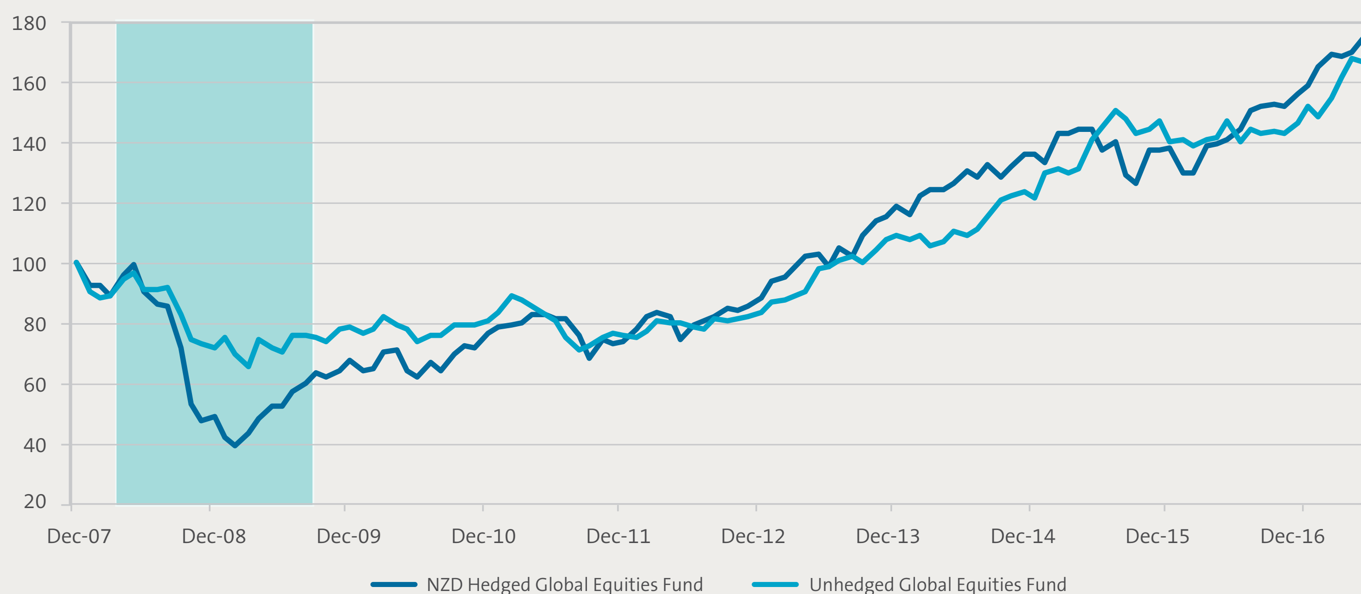
Impact of NZD currency hedging: global equities

Empirical evidence suggests that over the long term, for New Zealand investors, hedging foreign currency exposure has resulted in a meaningful incremental return relative to the decision to remain completely unhedged. To take a sample period of the last decade, which incorporates the most savage months of the Global Financial Crisis (GFC), a fully-NZD hedged international equities fund initiated at the end of 2007 and examined today would have enjoyed a cumulative 9% advantage over its fully-unhedged equivalent. The hedged fund returned a total of 76% while the unhedged fund returned 67% from December 2007 to May 2017.

Chart 1: Over a decade, unhedged international equities fared better in risk-averse periods like the GFC



Source: Bloomberg, AMP Capital

However, the chart above also shows that the benefit from hedging the international equities fund is somewhat erratic over shorter timeframes. A feature of the last 25 years in global capital markets has been the phenomenon of 'flights to safety' during times of persistent turbulence or macroeconomic fear. At such times, global investors have tended to pull funds out of smaller and more volatile countries and to sell those countries' currencies simultaneously. This 'double-whammy' effect was potent in the Asian Crisis of 1997-98, and recurred again in the GFC of 2008-09.

The benefit of foreign currency exposure can be most pronounced in periods of severe market dislocation. For instance, at the height of the risk-on/risk-off era of the past decade, the diversifying characteristics of foreign currency were particularly noticeable, as unhedged global equities exhibited lower volatility than hedged global equities. This reflects a range of causes, but the tendency of markets to engage in 'flight-to-quality' at times of extreme stress – quickly selling out of their peripheral portfolio holdings in small or volatile markets – has led to periodic sharp weakening in the NZD.

During phases when the NZD is falling alongside the value of the global equity markets, the corresponding strengthening of the 'safe haven' US dollar provided something of an offset for New Zealand investors during the first couple of years of the equity bear market, resulting in a maximum point-to-point loss of value (also known as 'maximum drawdown') of -30% for the unhedged fund compared to -60% for the fully-hedged vehicle (shaded area in chart 1).

Thus, being less-than-fully NZD hedged can dampen the downside over periods when difficult market conditions are prevailing globally. The lower drawdowns likely in such periods can have the highly beneficial effect of preventing individual investor panic, which often leads to selling at the bottom of a market phase, and prevents full participation in the subsequent recoveries which can unfold rapidly at times, particularly when global monetary authorities are assisting.

However, note that once the equity market recovery got underway after 2009, the incremental gains from hedging gradually led to the hedged global equities fund's returns outstripping those from the unhedged version. This owes much to the impact of the 'hedge premium' – the additional return we receive for holding forward foreign exchange contracts, which tends historically to contribute positively to the New Zealand-based investor's total return.

The hedge premium has provided a persistent boost to returns over time

The hedge premium is essentially the difference between New Zealand and global short-term interest rates. It equals the excess return earned on hedged versus unhedged assets, absent a permanent devaluation in the currency:

NZ hedge premium ≈ NZ cash rate premium = NZ cash rate – global cash rate

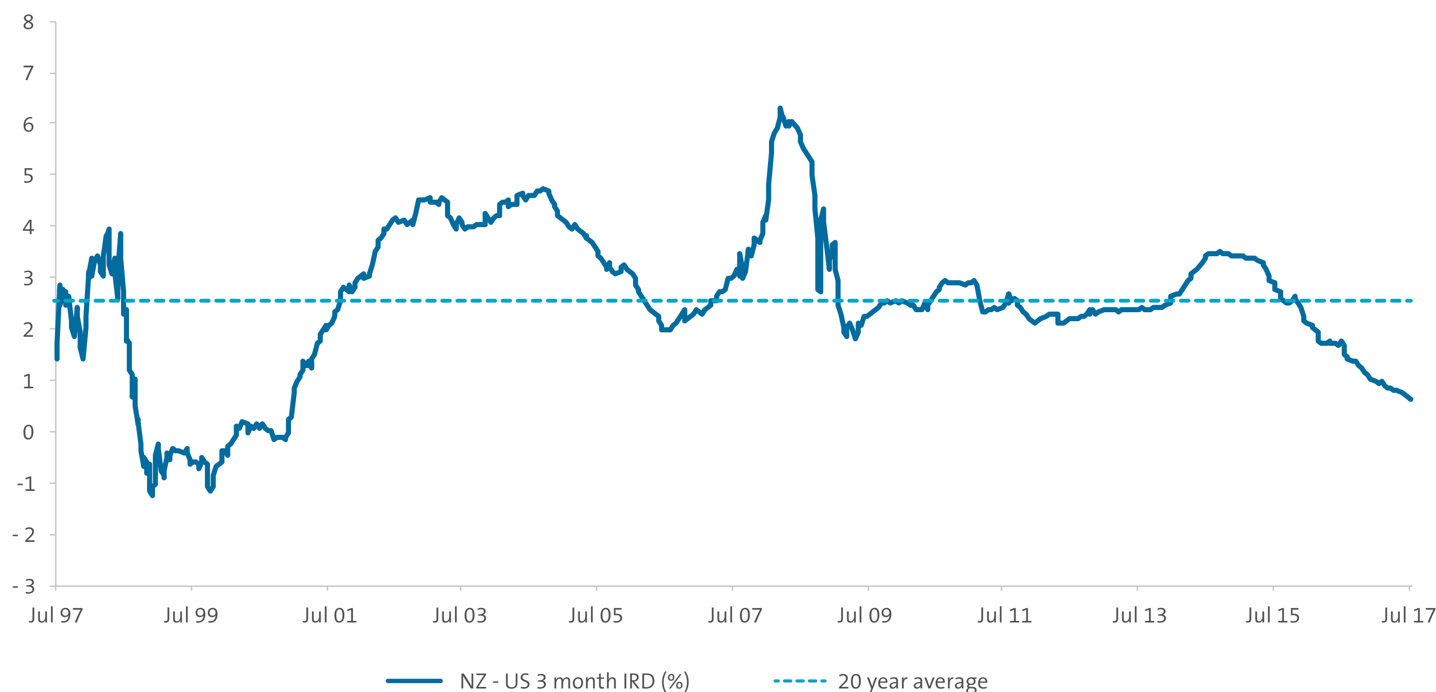
The MSCI-weighted New Zealand cash rate premium over the last 20 years averages in excess of 2.5%. Looking at a much longer time-frame, the difference between the New Zealand and US cash rate since 1900 has been 1.6%. This persistently-higher New Zealand cash interest rate has been attributed to many causes, including New Zealand's need to attract short-term foreign capital to fund our current account deficits, our low level of savings compared to investments, and even a 'small-country risk premium' essentially guaranteed by our determination to keep our own dollar, rather than join a larger currency bloc along with Australia.

Whatever the cause, the NZD hedge premium has proved a useful tool by which asset managers have boosted returns. In the case of global bond markets, were it not for the hedge premium component of returns (also known as the 'carry') it would be difficult to make a significant strategic allocation to them in multi-asset portfolios because their yield is historically (and currently) significantly lower than New Zealand bond yields.

We should be careful, however, to avoid simple extrapolation of historical experience. We are now in a low-yield world with flatter yield curves, and policy makers in many countries are hindered by the zero 'lower bound' on interest rates. It seems reasonable to anticipate a lower real cash rate premium in New Zealand over the next few years, so the average return pick-up from hedging could well be lower. This means that forgoing the additional returns potentially available from a weakening NZD in the medium-term is simply not as well-compensated as in the past.

The probability of such a period has risen recently, with the US Federal Reserve suggesting more strongly that the decade of artificially-repressed interest rates is close to its expiry date. At the same time, the Reserve Bank of New Zealand shows no inclination to raise domestic interest rates for some time, and years of fiscal discipline has diluted much of the 'small-country risk premium' for New Zealand bonds and bills. The practical implication is an ever-diminishing interest rate differential (IRD) between New Zealand and US interest rates (chart 2 below) which is now compacting the hedge premium.

Chart 2: The interest rate differential (IRD) providing hedging income is shrinking



Source: Bloomberg, AMP Capital

Costs and benefits

> The currency hedge premium is a significant addition to offshore asset expected returns, especially in a 'low yield' environment.

> Foreign currency brings some diversification and downside-mitigation improvements to portfolios, but with an opportunity cost. Recent interest rate dynamics have lowered this opportunity cost, compared to history.

> On balance, we believe investor portfolios should have some allocation to foreign currency. In the balanced fund landscape, this is most easily achieved by establishing a base foreign exchange exposure level expressed via global equities. Another method is applying currency overlays at total portfolio level, though that is more resource-intensive.

> Studies carried out by AMP Capital's Multi Asset Group specialists show that if an investor seeks to minimize risk, over a medium or long-term investment horizon, then more foreign currency exposure should be held. If an investor seeks to maximize returns against risk, then no foreign currency exposure should be held. This is because the expected Sharpe Ratio of the portfolio gently declines, as exposure to a basket of foreign currencies rises. It should be stressed, though, that the scale of the decline in the expected risk-adjusted return from holding more foreign exchange is fairly mild.

Foreign currency exposure for a typical balanced fund at approximately 20% -30% of total portfolio value, represents a step toward risk reduction. There appears to be a convergence among New Zealand funds managers towards this. Our approach is based on utilising the risk reduction features of sub-100% hedging of international equities, more than on presuming any substantial permanent source of additional income based on the historical ranges of the hedge premium and the interest rate differentials defining it.

While we conclude the benefits of hedging largely outweighs the opportunity costs, flexibility around the currency exposure provides scope to add value from mean reversion of the New Zealand dollar at times when it is judged to be materially mispriced. The strategic hedging levels within actively managed multi asset portfolios should therefore be always open to adjustment, but only be significantly adjusted at times when a multi-year shift in the drivers of currency exchange rates (such as interest rate differentials) is found to be underway.

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Acknowledgments to AMP Capital (Australia) for research incorporated in this investment insight.

In summary

It is important to employ a structured approach to managing foreign currency exposure. Factors to consider include:

> Objectives of the fund and characteristics of its members in terms of both risk tolerance and investment horizons.

> Potential additional diversification benefits, given the fund's current asset allocation.

> Potential of foreign currency exposure to act as a hedge during large market events.

> Likelihood of a multi-year shift in the fundamental drivers of currency valuations, given the macro outlook.

> Potential regime changes in economic policy management that might impact historical relationships (eg a coordinated attempt by major economies to affect the direction of a given currency for reasons of trade policy).

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