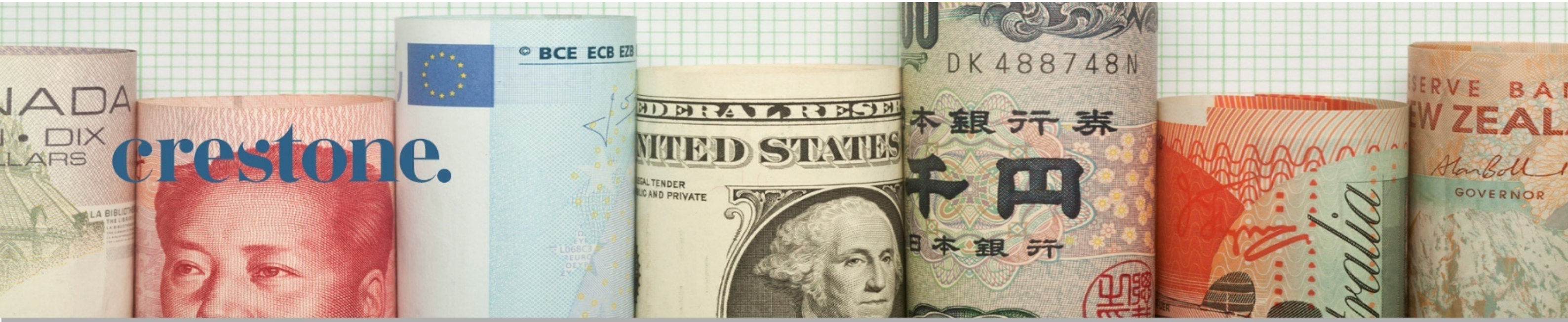

Is it time to re-think *currency hedging strategies?*

SCOTT HASLEM
CHIEF INVESTMENT OFFICER

STAN SHAMU
SENIOR PORTFOLIO STRATEGIST

This month we look at hedging strategies for offshore portfolio exposures. The Australian dollar's trend decline since 2011 has delivered positive return to unhedged global investments. We ask firstly whether this trend will continue and secondly whether there is an optimal hedging strategy. We have also changed our preferences for regional equity markets—while maintaining our overweight to equities, we are now underweight US markets. More details can be found in our report *Changing our regional equity market preferences*.

Institutional and retail investors in Australia have historically favoured domestic assets, a 'home bias' as it has been coined. This has particularly been the case with equities, where Australia's share in global markets at around 2% is often at odds with portfolio allocations of between 40-60%. The extent of this home bias has diminished over the past decade, partly driven by the rapid growth (and sheer size) of Australia's superannuation system relative to available domestic assets and the rise of global mega-companies that increasingly present compelling offshore investment opportunities.

However, investing globally introduces foreign currency into the equation and this can add a layer of complexity to the investment decision. As performance is measured in the home currency, overseas investments must be converted back into the Australian dollar when assessing overall portfolio performance. Currency movements will, therefore, have an impact on portfolio returns.

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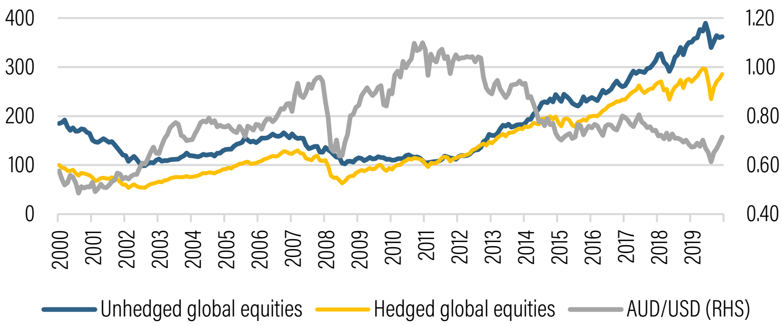
Moreover, currency movements can overwhelm overseas investment returns, as they have in recent years. As the chart below shows, the trend decline in the Australian dollar over the past decade has been a significant tailwind for local investors who have invested (unhedged) offshore. International equities, as measured by the MSCI World index since the AUD/USD's 2011 highs to March 2020, posted an annualised return of 13.4% unhedged compared to 8.8% hedged. The Australian dollar fell around 43% over this period.

The currency has been a tailwind for unhedged offshore equity returns



Source: Crestone, Bloomberg.

For those willing to take unhedged offshore equity positions over the past decade, the Australian dollar's trend has been very favourable.

Given the Australian dollar is below its historic average, and improving fundamentals are leading analysts to forecast appreciation...

...will fully unhedged positions be as beneficial in the coming decade?

Recent trends in the Australian dollar

The Australian dollar is one of the more volatile international developed market currencies. Having averaged around USD 0.76 since its float in December 1983, intra-year volatility has averaged around USD 0.13, or about 10-20% per year. Despite this, for those willing to take unhedged offshore equity positions over the past decade, the Australian dollar's trend has been very favourable, having fallen from around USD 1.10 during the 2011-2012 European sovereign bond crisis to around USD 0.70 currently.

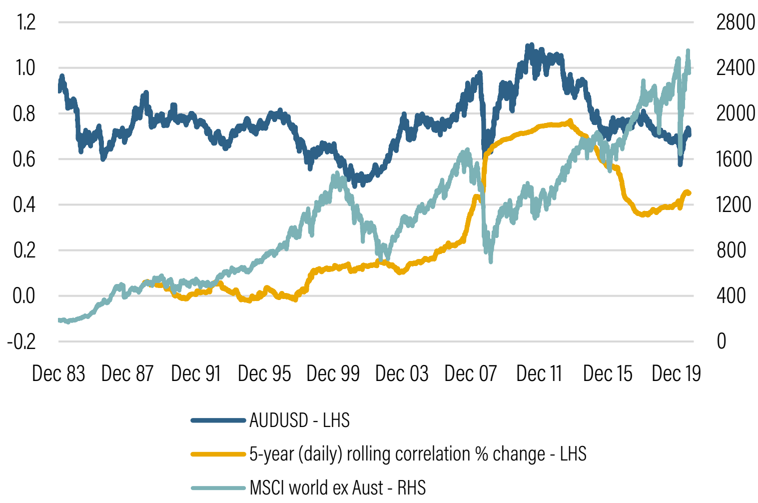
Looking out over the next three to five years, one needs to consider whether that tailwind will continue to be in play, i.e. will the Australian dollar continue to trend lower? Of course, forecasting currencies is unusually difficult. There is a large body of research that highlights the extreme challenge of making an exchange rate forecast that outperforms a statistical random walk.

With the Australian dollar likely to retain much of its risk-on/risk-off qualities, we believe it remains vulnerable to a near-term pull-back given the risk the current equity market pull-back deepens or President Trump is re-elected (raising the spectre of renewed US-China trade tension). But, as we recently highlighted in our article *Does Aussie dollar outlook argue for a bit more hedging?* which appeared in the Australian Financial Review, both the short-term (multi-year global recovery and low US interest rates) and longer-term fundamentals (improving trade and relative debt positions) argue a relatively positive outlook for the currency. It's no surprise some analysts are forecasting its rise over the coming years. Consensus targets USD 0.77 by end-2022 (a level CBA expects by mid-2021). There are two further key points to note:

Firstly, hedging away currency exposure can increase portfolio total risk—the correlation between domestic equities and unhedged international equities has typically been positive. In fact, the correlation between the S&P/ASX 200 and the MSCI World ex-Australia index hedged back into Australian dollars is 0.77, much higher than the correlation between the S&P/ASX 200 and the MSCI World ex-Australia index unhedged at 0.53. As shown in the first chart, unhedged foreign currency exposure has less downside capture in risk-off environments.

Secondly, the positive correlation has been diminishing—the positive correlation between the Australian dollar and offshore equities (on a rolling five-year basis) has been declining (from around 0.75% a decade ago to 0.45% now), questioning whether the extent of 'protection' from a fully unhedged global equity portfolio is as significant as it has been in the past.

The Australian dollar's positive correlation has fallen



Source: Crestone, RBA, Bloomberg.

For investors, it is near-impossible to predict the direction of the Australian dollar for any sustained period. But given its decline through the past decade, its now below average level, and the more positive fundamental drivers supporting its valuation, the argument can be made that the prior strong positive return benefits from fully unhedged offshore equity positions may be less significant over the coming cycle than they have been in recent years.

"With all the confusing academic recommendations floating around, the 'least-regret' hedge ratio of 50% has been quite popular among practitioners."

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Hedging—what are the options?

There are differing views on the benefits of hedging part or all of a portfolio's offshore exposure, but there are essentially four options that can be adopted, which we have listed below. The extent to which an investor wishes to hedge will depend on the extent to which they wish to minimise the unpredictability of portfolio returns and unexpected sharp currency movements.

Fully unhedged—Investors with a long investment horizon and an appetite for foreign currency risk tend to be more comfortable with this approach. This supports the argument that long-term currency exposure has little effect on portfolio returns. This is most relevant for equities, where currency volatility is typically less than the volatility of the underlying asset.

Passive hedging—A number of less sophisticated strategies utilise a passive approach, which essentially involves adopting a static hedge ratio of typically 50:50 or 60:40. As BCA Research notes, adopting this simple benchmark is at times deemed a 'least-regret' approach, as it reduces risk from currency moves without severely jeopardising returns.

Active hedging—Sophisticated hedging strategies set a strategic benchmark hedging level and then apply tactical tilts around this benchmark depending on market conditions. While such 'dynamic hedging strategies' can lead to better outcomes for the portfolio, it demands sophistication in determining changes in valuation and sentiment across currency markets. In practice, timing exchange rate movements has proved complex and often fraught. Additionally, a dynamic hedging strategy can come with mounting hedging costs and is least appropriate for all but the most sophisticated investor.

Completely hedged—Investors with a relatively short investment horizon and low appetite for foreign currency risk tend to prefer this approach.

Different asset classes call for different approaches

Typically, there is a strong preference for **international fixed income** to be completely hedged. As a traditionally defensive asset, the volatility of exchange rates on an unhedged position will likely overwhelm the asset's defensive benefits. As such, the impact of that volatility on returns would be sub-optimal. Vanguard estimates currency to account for more than two thirds of international fixed income volatility. Analysis also reveals a positive correlation between the Australian dollar and bond prices, arguing hedged fixed income positions may positively impact return and volatility outcomes.

Within **equities**, investors typically utilise the full gambit of approaches as previously discussed, depending on their risk tolerance. It is worth noting that the cost of hedging is much lower for developed markets than for developing markets. In light of this, decisions to partially hedge portfolios are likely to be utilised in the developed market segment of an equity portfolio.

Hedging currency exposure within **illiquid alternatives** tends to be more challenging. Within defensive alternatives, the typical approach is to apply a full hedge, but within growth alternatives, it is more usual to apply a partial hedge. The primary challenge with hedging illiquid growth alternatives is the risk of having to settle periodically negative hedge positions, likely requiring recourse to funding this from more liquid assets within a portfolio.

The hedging decision should depend the objectives, risk appetite and investment timeframe of an investor's portfolio, and should be part of the strategic investment policy statement.

Is there an optimal hedging strategy?

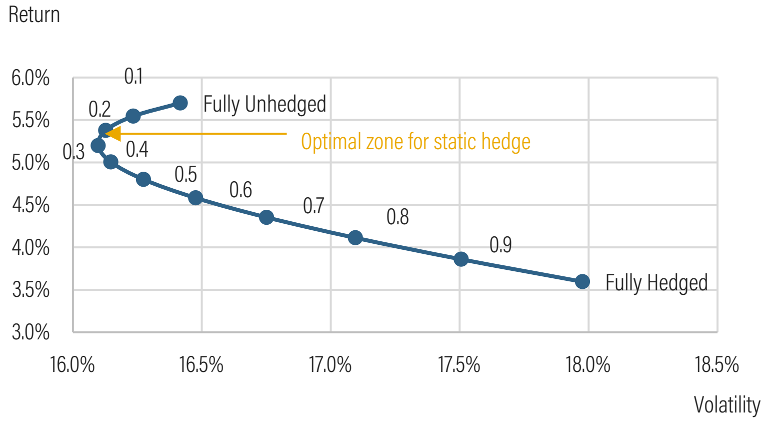
While some investors are comfortable with currency dominating portfolio returns (and thus remain completely unhedged), others find it an undesirable driver of performance (and choose to be completely hedged). In contrast, some investors take a middle ground and seek to gain exposure from some, but not all, of the currency risk via a strategic fixed hedge ratio.

Determining an ideal hedge ratio is never straightforward and historically many have adopted a least-regret hedge ratio of 50:50 or 60:40. According to BCA Research, the strategic hedge at its core should be viewed through the lens of currency volatility reduction as opposed to a positive return driver.

Ironically, with the benefit of hindsight, the best currency hedge ratio for Australian investors from the perspective of maximising returns will always be either completely hedged or completely unhedged. This is because the currency tends to go through defined risk-off and risk-on periods. But, in practice of course, the future is uncertain and currencies unpredictable.

Therefore, a preferred approach for hedging international equities within a portfolio domiciled in Australia is to calculate a fixed static hedging rate that delivers the maximum reduction in volatility for the minimum reduction in risk-adjusted returns (rather than simply defaulting to a 50:50 style ratio of 'least regret'). Our analysis based on history shows this to be around the 20-30% hedging mark (see the chart over the page). This level achieves the lowest annualised portfolio volatility by reducing foreign exchange exposure without sacrificing much of the diversification benefits.

Assessing the optimal level of hedging for international equities



Source: Crestone.

Hedging should be thought of as a mechanism to reduce volatility, not as a driver of long-term returns.

Now may be the time to consider a level of hedging

Currency remains one of the few diversifiers or risk controls left in portfolios, given historic low bond yields and fewer shock absorbers in economies and equity markets. In that context, hedging away currency exposure in growth assets can increase portfolio total risk, particularly given hedging should be thought of as a mechanism to reduce overall volatility, and not viewed as a driver of long-term returns.

For Australian investors, that portfolio diversification has been particularly driven by the Australian dollar's negative correlation to domestic equity returns. And while not evident in all periods through history, the currency's downtrend over the past decade has actually contributed to portfolio return.

We believe that for some investors, the reduction in volatility from a static hedge of up to 30% may be attractive, given only a modest negative impact on long-term returns.

However, there is increasing uncertainty over whether that will continue to be the case, particularly given improving longer-term fundamentals for the Australian dollar (notably against the US dollar). Some forecasters see the currency approaching USD 0.80 by end-2022. There is also some evidence to suggest the negative correlation with offshore equities has diminished.

In cases where currency hedging is required, it is difficult to have a one-size- fits-all approach. The hedging decision should depend on the objectives, risk appetite and investment timeframe of an investor's portfolio, and should be part of the strategic investment policy statement, to minimise the potential for reactionary sub-optimal decisions during times of extreme market volatility.

For most investors, running sophisticated dynamic currency overlays will not be an option. But we note that the cost of using many hedged versus unhedged managed funds is often below 4 basis points (bps) per annum and can be as low as 2bps for exchange-traded-funds. With this in mind, we believe that, for some investors, the reduction in volatility from a static hedge of 20-30% may be attractive given only a modest negative impact on long-term returns (at a little over 0.3% per annum).

Finally, from a tactical perspective, and for those who have not previously considered hedging growth assets, this may be an optimal time to consider a level of hedging for offshore developed market growth assets, given the currency is below its long-run average. Of course, issues around minimising tax events, incurring switching costs or the cost impost from partial hedging, may warrant a progressive move over time to the desired target level.