ACTIVE APPROACHES TO CURRENCY

Hedged or unhedged, foreign exchange exposure can boost returns.

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Currency movements can have a large effect on the returns of international investments, yet many investors neglect careful consideration of currency issues when they determine their investment strategies.

It is our view that:

• Strategic currency hedging policy can be an important risk control measure for funds with international assets;

• Leaving international assets unhedged can be the correct policy decision, but it should not be the default position;

• There is a strong theoretical and empirical case for active currency management;

• The most efficient way to implement active currency management is to separate active currency positions from any underlying asset positions.

Passive currency management

The smaller the allocation of international assets in the portfolio, the smaller the effect of currency hedging on the risk of pension fund's policy portfolio. A rough rule of thumb for international investors is the risk reduction from currency hedging is not significant until about 10% of the policy portfolio is allocated to international assets. Beyond 10%, the policy decision to hedge or not hedge the international assets should be based on the same careful analysis that lead to the decision to invest in international assets. Again, leaving assets unhedged might be the correct policy decision, but it should not be the default position. From a Canadian dollar perspective portfolio risk calculations indicate that it is advantageous not to hedge U.S. equity exposure, but some risk reduction is available from hedging EAFE equities.

Active currency management

In his famous paper, "The Arithmetic of Active Management," William Sharpe demonstrates that the return on the average actively managed dollar of equities must equal the return on the average passively managed dollar of equities. Indeed, consultants have confirmed that (after fees) the average active equity manager has underperformed the major market indexes over long periods of time. In contrast, recent consultant studies have documented the performance of the average currency manager over the past 10 years, and have found that the average manager has consistently added value over their benchmarks. How is this possible, given currency transactions are zero sum? The answer is that some currency market participants must consistently lose money if active currency managers are consistently making money.

A large portion of currency trading is done by market participants who do not trade for profit. Central banks, for example, are important players in the foreign exchange market, and central bank intervention is driven primarily by macroeconomic policy objectives. Central banks typically trade to dampen market volatility and signal policy intentions, not to earn profits. Corporate hedgers and tourists are additional examples of currency market participants who trade currency for good reason, but not necessarily to profit from the transaction.

Lastly, international investors adjust their holding of international assets because of strategic or tactical allocation decisions. It is frequently the case that the allocation decisions are made without regard to the currency component of the transaction. And taken together, the foreign exchange transactions of central banks, corporate hedgers, tourists, and international money managers dwarf the positions of active currency managers.

Given the strong case for active currency management, it is especially important for international investors to separate active currency decisions from active equity or bond market decisions. It might be the case that the best-performing equity markets have depreciating currencies. For example, low real interest rates tend to be associated with depreciating domestic currencies, but low real interest rates also stimulate domestic demand and are frequently associated with increasing stock prices. ▮