



# CURRENCY: THE KEY TO PERFORMANCE

*Actively managing your cash assets can pay off in the short term.*

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Canadian plan sponsors cannot contemplate adopting a global portfolio without tackling the thorny issue of currency exposure. Before adopting a solution, it is important to understand the benchmark implications of currency exposure as well as to dispel a number of myths about active currency management.

### Measuring the impact

We adopt a practical approach to measuring and understanding the impact of currencies on a global portfolio. We use the example of a portfolio with 70% Canadian dollar exposure and 30% foreign currency exposure, the latter split along the following lines: 17% U.S. dollar, 5% euros and the remaining 8% split among the other currencies of developed markets. We then proceed to compare fully hedged versus unhedged portfolios. We find that over the long run, systematic hedging has little material impact on portfolio returns: losses against one currency are often offset by gains versus another. Over a 15-year horizon, returns from currencies account for less than 2% of total portfolio returns.

In the short run, currencies have a significant impact on portfolio returns. In an average year, currencies can be expected to explain almost one-fifth of total portfolio returns.

Finally, unhedged currency exposure serves to reduce overall portfolio volatility. The currency impacts in both the short and the long run tend to be negatively correlated with overall portfolio returns—although that relationship can swing a lot—and as a result an unhedged portfolio proves to be significantly less volatile than a hedged one.

We conclude from these findings that currency exposure is desirable over the long run, because it helps reduce volatility without undermining returns while still constituting a sizeable tactical challenge for Canadian plan sponsors.

### Dispelling the myths

Active currency management has met a number of

objections over the years. However, the facts support the use of active management in this field. As a result, objections are little more than 'myths' stemming from poor understanding of currencies in general:

**Myth #1 – Currency exposure creates an asset-liability mismatch.** This is only true in an accounting sense. Except in the case of a deflationary shock (e.g. Japan's experience in the 1990s), currency exposure serves to either increase or stabilize Canadian pension plan net surpluses.

**Myth #2 – Managing currencies is too expensive.** As a hyper-liquid asset, foreign exchange exhibits transaction costs as low as government bonds and about 40% lower than equities.

**Myth #3 – Underlying stock and bond managers already take care of currencies.** Over the past 10 years, currency returns have been completely uncorrelated with the relative performance of different stock or bond markets. Even if stock and bond managers are good at gaining exposure to the best markets, there is no guarantee that this will create desirable currency exposure.

**Myth #4 – Currency markets are too efficient to make money.** Most agents trade currencies because of underlying factors (commercial or financial exchanges), not because they seek returns from currencies. This creates an arbitrage opportunity for the few that do.

**Myth #5 – It is impossible to forecast currencies.** Currency managers have been able to add value—net of fees—in 14 of the past 18 years. Their forecasts may not be perfect, but they appear to be right three times out of four.

### Benefits of active currency management

Active currency management is no more arcane than stock or bond management, and presents many benefits for Canadian plan sponsors. Not only do the additional returns generated tend to be uncorrelated with both the benchmark and the returns of other managers, currency management constitutes a cheap and remarkably effective way to manage the risks of a global portfolio. ■