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EXPOSED IN CANADA

With no 30% cap, investors should hedge their currency exposure.

The abolition of the 30% Foreign Content Rule has important consequences for optimal investing. Unconstrained mean variance efficiency now requires that Canadians invest most of their assets outside of Canada. Those that do should also hedge a significant fraction of their currency exposure. To understand the rationale supporting this assertion it is helpful to review the determinants of the risk minimizing currency hedge ratio.

Exposure to currencies influences a portfolio's risk in two ways: it introduces volatility to a portfolio and it diversifies the returns of the portfolio's assets. Before the abolition of the 30% rule, the risk minimizing hedging policy for Canadians was to hedge little if any of their currency exposure. The opposite is true for European investors who minimize risk by hedging all of their portfolio's exposure to currencies. By comparison, U.S. and Japanese investors minimize risk by hedging about half of their portfolio's currency exposure. This assumes that a substantial portion of the total portfolio is invested domestically.

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What is it about country of origin that causes these hedging policies to vary so much? It is the correlation of domestic assets with currencies. Canadian stocks, for example, are negatively correlated with currencies; hence, currency exposure diversifies their returns. European stocks are positively correlated with currencies and, therefore, do not benefit from currency exposure. But why do these correlations differ? The Canadian economy is significantly driven by natural resources such as mining and agriculture. These commodity-based resources perform well when inflation rises unexpectedly. The opposite is true of currencies. When there is an unanticipated rise in a country's inflation rate, its currency usually performs poorly. Australia, which aside from sharing a queen, has little connection to Canada. Yet currency exposure benefits Australian investors as well, because its economy is also driven by natural resources. Furthermore, it is easy to extend this argument to European investors. They are net consumers of commodities, so currency exposure exacerbates their sensitivity to inflation.

Because mean variance efficiency requires Canadians to diversify away from domestic assets in the absence of artificial constraints such as the 30% Foreign Property Rule, the beneficial impact of diversification attendant to currency exposure no longer justifies substantial currency exposure.

TO HEDGE OR NOT TO HEDGE?

Some Canadian investors may still choose not to hedge their currency exposure, taking comfort in the notion that currency returns wash out over the long run. This comfort is misplaced, however, especially given that the USD/GBP exchange rate was 7.39 in the mid-19th century. But even if currency returns did wash out in the long run, investors are held accountable for performance throughout their investment horizon, not just at its conclusion.

MEAN VARIANCE EFFICIENCY REQUIRES CANADIANS TO DIVERSIFY AWAY FROM DOMESTIC ASSETS IN THE ABSENCE OF THE FPR.

The conventional approach to risk measurement focuses on end-of-horizon probability distributions, which drastically understate a portfolio's exposure to loss and therefore the beneficial impact of hedging. In many circumstances the probability of a significant within-horizon loss is 10 times as great as the end-of-horizon probability loss. John Maynard Keynes said it best when he followed his famous aphorism, "In the long run we are all dead," with the eloquent observation, "Investors set themselves too easy, too useless a task if during tempestuous seasons they can only tell us that when the storm is long past the ocean will be flat." ■