

BWMG LONG VIEW - The Currency Effect

The dramatic currency movements that occurred in 2003 have re-appeared in 2004. For over 10 years, we witnessed a decline in the Canadian dollar relative to the U.S. dollar which has resulted in a significant “win” for US-denominated holdings. But in 2003, Canadian investors will recall that the U.S dollar decline of 20% nearly eliminated the large gains that occurred in the US stock market. Could this have been avoided?

Solutions to the Problem?

Investing internationally is absolutely essential as the Canadian stock market represents only 2.5% of the world equity market. As is the case with stock diversification, diversifying across a basket of currencies will limit risk. The movement of the US dollar will create the most significant currency effect for Canadian investors but that effect can be diminished by allocating a portion of a portfolio to non-US (Global) currencies. This is the role of a Global Equity manager. Not only do they consider the fundamentals of the stocks that they include in their portfolio, but also the potential effect of currencies on the companies they buy. Money managers can select stocks that benefit from currency strength/weakness – this process is embedded in their valuation exercise. With respect to fixed income, currency risk can be and should be wholly avoided by investing in only Canadian bonds. The currency risk that is involved in international bonds is usually greater than the potential incremental gain that may be achieved.

Currency Hedging

One option to reduce currency exposure is currency hedging. The purpose is to protect against unfavourable movements in exchange rates that would have a negative impact on the measurement of domestic currency returns. The return on an unhedged foreign portfolio is made up of the gain/loss on the US dollar relative to the Canadian dollar plus the gain/loss on the US security. If the portfolio is hedged, it will simply earn the return on the US holdings (less the cost of implementing the hedge). In 2003, a hedged portfolio would have drastically outperformed an unhedged portfolio while in 1998 the opposite would have occurred. So given the near impossibility of predicting exchange rates, is hedging a worthwhile exercise?

Problems with Hedging

In theory, the long-term expected return from currency exposure should be zero. Many experts agree that currencies tend to be mean-reverting and though they will deviate from the long-term average over shorter time periods, the net result will be relatively neutral. Over these shorter time periods currency can have a significant impact. A currency hedge is difficult and expensive to implement. In order to do this, you must buy a currency futures contract for a time period and decide the currency direction. Finally, in the case where a negative correlation exists between two asset classes, implementing the hedge will actually have the inverse effect and will increase the risk to the portfolio! In discussions with various money managers over many years we have found that currency hedging is rarely implemented by the professionals. Investors with a long time horizon are less likely to benefit from hedging as are investors with professionally managed diversified holdings.



What does History Show?

A recent study by Frank Russell Canada Ltd. showed that over 23 years from 1981-2003 the annualized return of a hedged and an unhedged (US dollar) portfolio were nearly identical. The results are the same when looking at international markets. Surprising to many Canadian investors, much more volatility exists in Canadian and Global currencies than in Canada versus the US. In theory one would expect that hedging would reduce currency exposure and thereby reduce volatility. In practice the opposite was true in both the US and Globally where using a 10-year standard deviation of returns showed that hedged portfolios exhibit greater volatility than those which remained unhedged.

Conclusion

In conclusion, Canadian equity investors have no choice if they want to diversify equity market risk. Canadians must invest outside of Canada, hence they are subject to short-term currency fluctuations in the measurement of their portfolios and it is impractical for most investors to hedge.

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