

Who ate your returns?

Turn on the morning news and you hear about stock markets around the world hitting record levels. Great stories about how China, and that said the rest of Asia, are going gang busters. Everyone, from investment advisers to (tellingly) taxi drivers, is informing you that we have never had such a good investment-return environment. So why is it that you look at your annual global share returns at the end of March and you received a paltry two percent? The question is 'Who ate your returns?'

The answer, and most will not be surprised to hear this, is the Australian Dollar ate your returns. Things looked fine; in so much as global share markets were positive. Certainly there was a wide dispersion in returns (between the best and worst performing countries), but overall they were good. The problem is they looked fine right up to the point where you converted them back into Australian dollars – the money you and I spend every day in the shops – and then you got very little return.

None of the above is rocket science, but the implications of this are interesting. It is at times like this when the temptation to do something different is most attractive.

What you do today depends on the type of risks you are prepared to expose yourself to. There are, with a touch of generalisation, four basic strategies to potentially adopt; stay fully unhedged, switch to fully hedged, adopt a strategic ratio including both hedged and unhedged, or try to time when to be hedged and unhedged to win both ways.

Remaining unhedged

You know where you stand remaining unhedged, being 'hurt' if the Australian dollar continues to rise. But on the other hand, when the Australian dollar falls – something that is highly likely, we just don't know when – being unhedged will bolster your return. For many this effect saved us from the worst of the global equity market returns in the early years of this century. However, the problem remains that we do not know when this will happen, or how much stronger the Australian dollar may get before it happens.

Fully hedge

The second option is to fully hedge the currency position of your portfolio back into Australian dollars. While this will protect you from any future rises in the Australian dollar, it will also hurt you on the downside. So if this is the top of the Australian dollar cycle, you will have worn the pain in both directions. While that sounds unpalatable, given the recent disparity in returns it will not be surprising to see a lot of investors switching to a hedged strategy. The reactionary nature of investors (and the desire to chase returns) is both strong and commonly observed but frequently wealth destroying.

Both of these strategies involve being wrong or right for a period of time, followed by a period of the opposite. The reality is that depending on your starting point and the period of time you are invested; your experience could be good, bad or neutral. Many suggest that over the

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long term, all things should be equal - it is after all a zero sum game - and while markets fluctuate, these even out through time. If this is the case then the risk, or threat, is that investors cannot tolerate being on the wrong side for too long, and start switching in a reactionary nature because they think they are on the wrong side of the equation. For both of these strategies, discipline, and to some extent timeframe (the longer the better as you are more likely to come out with a 'more equitable' experience), is vital.

A strategic allocation to both

Strategy three is to have a strategic allocation to both. This is effectively taking a bet each way, and has the quality we frequently term 'minimising regret'. Minimising regret helps stop people jumping from one strategy to the other while chasing last year's returns and delivers a smoother pattern of returns through time. This could lead to some regret; 'we moved too soon' if the dollar falls, or, 'we should have hedged it all' if the Australian dollar continues to rise. However, for the longer term, if we experience periods of the dollar both rising and falling, investors are likely to be comfortable with the overall outcome. Again, discipline is a hallmark requirement, but for those with a shorter timeframe, not suffering from being totally on the 'wrong' side makes this strategy more appealing.

Market-timing

The final strategy – timing when to be in and when to be out -- is an interesting one. While appealing to many, it is wealth destroying to most. The examples of those who have been successful are limited (George Soros' bet against the sterling in 1992 is one that springs to mind), but examples of those who have been consistent in this ability is almost non-existent or at least not easily discovered (George Soros' losing bet against the Yen in 1993 is a good demonstration of this). The message here is that this is a risky strategy with very uncertain outcomes and assumes a high tolerance for risk and pain.

So given that this all seems so difficult, why have any foreign currency exposure at all? The reality is currency exposure gives some diversification as hedged and unhedged returns will tend to differ, plus it helps match future liabilities. Even those who do not think they want to travel overseas will still be exposed to currency movements effecting the cost of things they buy here in Australia (fuel, foreign-built cars, airline tickets to name a few). It only makes sense that when saving in order to preserve (and indeed grow) our future spending power, we also help match some of these liabilities with an exposure to offshore currencies.

That said what you do now depends on the types of risk you are prepared to take, and the discipline with which you are prepared to invest. However, while recent experience for those unhedged investors has not been great, not all is lost. The upside of this recent Australian dollar strength is that plasma screen televisions and imported cars are cheaper (well, er-hmmm, should be cheaper). So while your global share component may not have made you richer this year, you might look better in your flash new car!