

# MLC Viewpoint

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## Currency strategies: Managing risk or enhancing returns?



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With the Australian dollar's meteoric rise (at the time of writing it was down to US\$1.02, after reaching an all time high of US\$1.10) the topic of currency and hedging is garnering plenty attention.

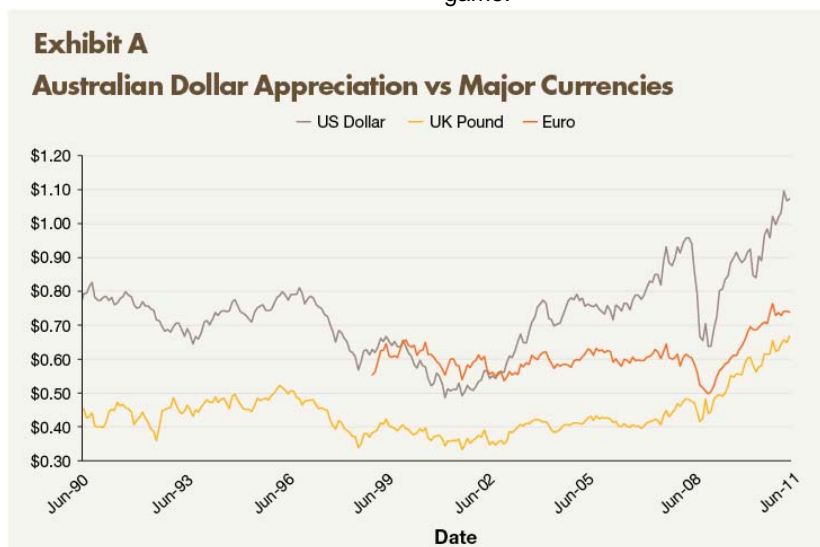
As shown in Exhibit A, the Australian dollar has appreciated by over 50% against the US dollar over the two years to the end of June 2011 and it has also risen strongly against most other major currencies over the same period. At the same time there have been wild swings in the values of various global currencies, which has particular relevance to Australian investors who hold overseas assets.

Depending on the approach to currency management, global asset

returns could be as high as 21.2% pa over the past two years for fully hedged global equity returns versus only 5.3% pa for unhedged returns.

Periods to 30/6/2011	1 Year %	2 Year %	3 Year %	4 Year %
MSCI All Country Index (unhedged)	3.2	5.3	-2.2	-3.6
MSCI All Country Index (Hedged)	26.4	21.2	2.1	3.4

However, whilst currency exposure can materially impact returns over short and medium timeframes, over the long-term we'd expect the return on hedged and unhedged global shares to be similar. This is because currency markets are simply exchange mechanisms that do not produce real wealth; in the long term they are a zero-sum game.





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Given the significant impact currency can have on portfolio returns and volatility, it is sensible to have a well considered approach to currency management. Even if you cannot predict the direction of the Australian dollar, you can structure your portfolio to effectively manage your currency risk.

## 1. Controlling total portfolio risk

With the difficulties in picking currency movements, particularly over short periods, some might throw in the towel and decide to fully hedge. Infact it turns out that hedging all your currency exposure is not necessarily optimal in terms of reducing your total portfolio risk and volatility.

It makes intuitive sense that up to a point, some level of currency exposure should serve to reduce total portfolio risk because of the diversification benefits currency brings to the portfolio. However, as currency exposure is raised, the risk level will also eventually begin to increase. Exhibit B gives a stylised illustration of this point.

A key driver in setting the level of hedging is to find the minimum risk outcome (or volatility as measured by standard deviation) at the total portfolio level. One common method for diversified portfolios (and one which MLC adopts) is to take a strategic long term approach to currency exposure. This approach allows MLC to better identify a level of hedging that mitigates unrewarded risks. The major risk of being fully hedged or unhedged is very simple—it is the risk that the Australian dollar goes against you in a material way for an extended period of time.

But deciding on the actual level of currency exposure involves as much art as it does science. As you can see from Exhibit B, there isn't necessarily a hedging point that is perfect for all portfolios. Around the lowest point of the curve, there isn't much difference in total risk over a fairly broad range of foreign currency exposure. This point also varies considerably depending on the assumptions made regarding currency behaviour. For example, if we used historical currency

behaviour as a proxy for the future, we may be guided by the results shown in Exhibit C. This chart shows you the experience over the past 20 years for a portfolio of global shares reflecting the MSCI World Index. It shows the annualised risk as well as returns for the portfolio across a variety of hedging levels.

There are a couple of interesting observations from this chart. Firstly, the experience over the last 20 years is that an investor would have received better returns had they hedged more of their global assets. While some in the industry use this kind of chart to justify having more hedged this is misguided. The shape of the above curve is simply an outcome of the time period chosen. Over this period the Australian dollar, on average, appreciated against the basket of currencies in the MSCI Index. Looking forward over the next 20 years, however, the reverse could be true and we could see Exhibit C completely invert, rewarding investors with higher exposure to currency.

The other, more important, observation is that risk was reduced by introducing some currency exposure; in this case the sweet spot was between 30–40 %. The key point when setting the long-term strategic hedging level is not to focus on currency as a way to enhance returns; rather look at it as a way to reduce risk. Having, some level of currency exposure should achieve this aim.

## 2. Factors influencing the strategic hedging level

As we have seen, numerical precision around the long-term strategic hedging level is difficult to determine but it's also not critical; what becomes important when determining a long-term strategic hedging level are more qualitative factors such as those outlined below:

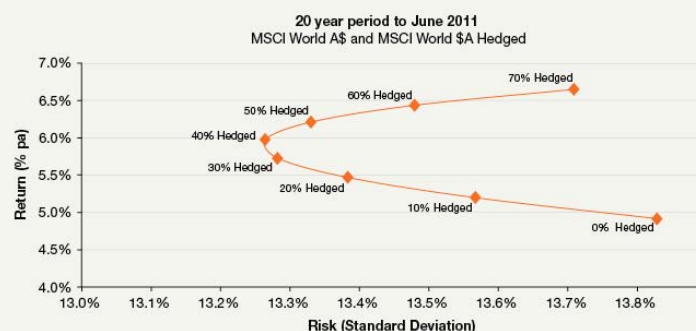
### Regret minimisation:

An important starting point in determining how much to hedge. The idea behind this approach is to minimise regret by having an each-

**Exhibit B**  
**Currency Hedging in a Diversified Portfolio**



**Exhibit C**  
**Ex-Post Risk vs. Return**





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way bet on any foreign currency exposure (for example 50% in both hedged and unhedged global assets). In this strategic approach one can never be more than 'half wrong,' which appeals to many investors. Whilst there is still some potential for regret (eg an Australian investor who held 50% currency exposure over the past two years), over the longer term, through a series of ups and downs, investors are likely to be more comfortable with the overall experience.

### Event risk—a sustained rise in the Australian dollar:

A more important factor in the hedging decision is that foreign currency exposure is an undiversified 'bet'. If the value of the Australian dollar were to appreciate for a sustained period against the basket of currencies in which global share investments are made, the negative impact on total portfolio returns measured in Australian dollars could be substantial. MLC believes it is prudent to limit the overall size of this 'bet'.

Exhibit D shows the annualised returns for the hedged and unhedged MSCI Index for each 3 year period over the last 21 years. It also shows the difference (or hedging impact) between the two indices.

As you can see, currency impacts can vary considerably over relatively extended periods of time so it is worthwhile limiting the extent of the currency 'bet' in order to reduce this event risk.

### Scenarios approach—building in robust diversification:

Because no-one can reliably predict the future, MLC uses a scenarios approach to consider a broad range of potential investment environments or scenarios. This approach allows us to allocate unhedged global assets in each portfolio to optimise diversification benefits across a range of potential investment outcomes. Risk is managed at an entire portfolio level, so that the proportion of unhedged exposure generally increases the higher the level of risk appetite (and the higher the overall proportion of growth assets).

Using a scenarios approach provides us with insight into how currency could be expected to impact hedged and unhedged global share returns across a range of possible future outcomes.

As an example, Exhibit E illustrates a sub-set of the 40-plus future scenarios that MLC currently considers in the asset allocation process. Returns above the horizontal axis show the expected annual outperformance of unhedged global shares over a prospective five year period. Those below the axis show the extent of expected unhedged global shares underperformance over five years.

As can be seen, there are a range of outcomes (mostly adverse scenarios) where unhedged global shares could be expected to outperform hedged. Looking at just one scenario, Global Depression for example, the outcome is not surprising. In a depression the demand for commodities collapses, Australian shares perform poorly,

the Australian dollar sells off and therefore unhedged global equities performs comparatively better. Global equities unhedged is a valuable diversifier in this scenario.

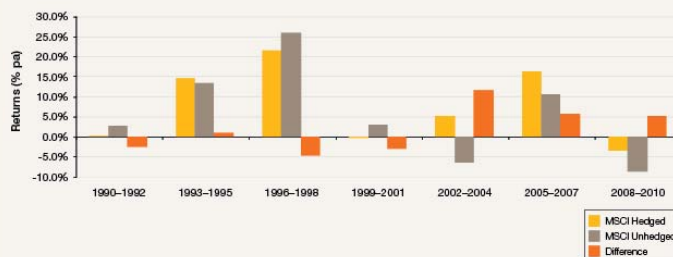
Whilst we do not know what the future holds for currency markets, taking a scenarios approach forces us to consider a range of outcomes (both good and bad), including how currency may impact overall portfolio returns.

### 3. Strategic Overlay: managing currency risk at extreme levels

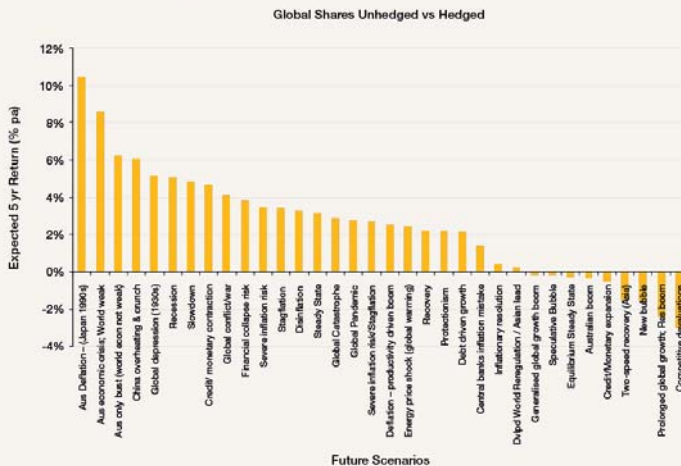
Another advantage of taking a partially hedged approach to currency management is that it provides a lever to strategically manage currency risk. This is particularly important when currencies rise to seemingly overvalued levels (or, conversely, fall to undervalued levels).

When equity markets decline, our

**Exhibit D**  
**MSCI Hedged vs Unhedged Returns**



**Exhibit E**  
**Difference in Expected 5 Year Returns**





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dollar also tends to depreciate. This is because the Australian dollar tends to be correlated with global risk appetite. We saw this during the GFC when share markets around the world plummeted, followed closely by the Australian dollar. Increasing unhedged exposure can help protect returns during downturns (as the Australian dollar falls it increases the value of foreign assets, helping to offset the fall in the asset values themselves) whilst still maintaining exposures to any upside in equity markets. Hence the proportion of hedged versus unhedged assets is an

important lever in MLC's Strategic Overlay Process.

#### 4. Currency implementation: active or passive?

Another key currency decision is whether to adopt a passive or active approach to currency implementation. For the most part, MLC adopts a passive approach to hedging global asset exposures. State Street Associates (SSA) and JP Morgan Asset Management are employed as external managers of currency overlay portfolios within our diversified and sector portfolios. They are required to hedge

currency exposures according to the actual country exposures of MLC's portfolios within a relatively tight tracking error to minimise transaction costs for our clients.

The impact of currency on portfolio returns as well as volatility can clearly be substantial—both on the positive side and the negative. Having a robust and well considered approach to currency hedging is therefore very important, particularly during these volatile times in global currency markets.

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