How much hedging do I need?

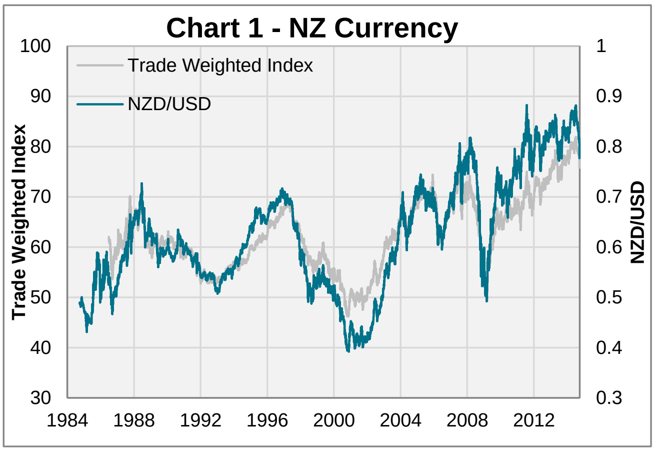
The return of the currency exposure question

October 2014

Introduction The NZ dollar appears to be in a downward phase against other currencies, the US dollar in particular. Given the recent highs this is not unexpected and commentators have been talking of this fall for some time now – for example BNZ recently spoke of the NZ dollar reaching 73 cents by the end of 2015.

The NZ dollar peaked at 88.23 cents against the US dollar on 9 July and by 30 September had fallen to 77.94 cents, a drop of 11.7%. It has since recovered but is still trading at less than 80 cents (as at 24 October).

Tracking the movement in the NZ dollar Chart 1 shows the movement in the NZ dollar since the currency was floated in 1984. It shows how volatile the NZ dollar has been against the USD with major falls in 2000 (when it fell below 39.46 cents) and again in 2009 (when in February it reached 50.07 cents).



At the same time the chart also shows a clear upward movement in the dollar reflecting the overall strength of the NZ economy. This has largely been due to the geographical country location and the increasing value of the primary goods sector.

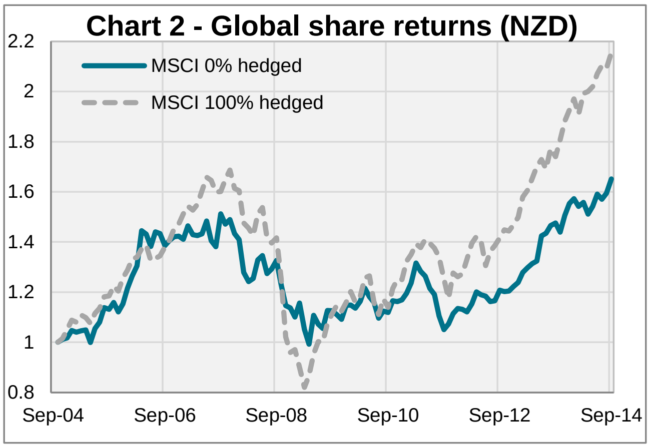
The chart also includes the Trade Weighted Index (TWI) which is a measure of the value of the NZ dollar relative to the currencies of our major trading partners.

Hedging The fall in the NZ dollar begs the questions: what constitutes the right level of hedging to put in place and should pursue an active or passive approach to managing the currency? This applies only to global shares since global bonds (as consistent with their capital preservation role) will be 100% hedged. The main strategies pursued by investors are either:

- A passive 50% or 100% hedge, or
- An active currency policy.

Passive strategy Any hedging brings with it the value of the forward points which reflect the interest differential between NZ and the major overseas economies. This currently is worth 3% per annum and over the last 10 years has been on average worth 1.3% per annum. A strategy which picks up all the value (i.e. a 100% hedge position) clearly delivers a lot of additional value for an investor with a long-term horizon. The downside is a more volatile return and no diversification benefits from exposure to foreign currency. A 50% strategy to a large extent has evolved from the position of least regret: being right half of the time and wrong the other half of the time. While this has its attractions, it does involve giving up 50% of the value of the forward points. However, when the NZ dollar falls it delivers a one-off benefit.

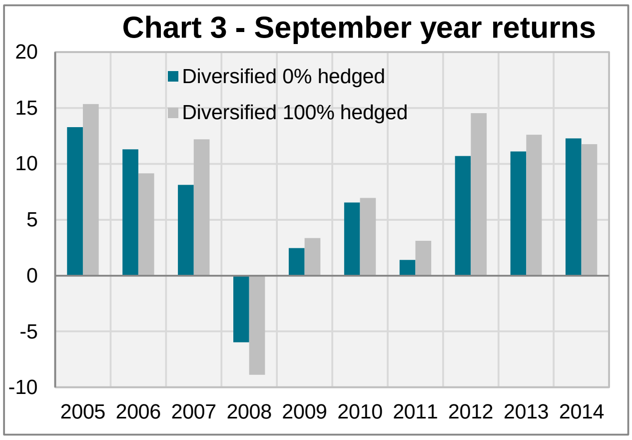
Active policy This is the strategy for those investors who take the view that they are able to make some predictions on the direction and level of the NZ dollar. However those investors who have followed currency moves for some time will know how difficult an active policy is to follow. It is looking to gain the benefit of a falling dollar while putting in place a hedge when the NZ dollar rises and is not at all easy! The NZ dollar at times has a propensity to stay higher for periods longer than expected meaning that the investor is losing the value of the forward points while maintaining a lower hedging position.



Impact on performance: The value of the forward points by definition delivers an additional return on global shares; but the movement in the currency itself also has an impact. Chart 2 shows the performance of hedged and unhedged global shares over the last 10 years. A dollar in September 2004 is now worth

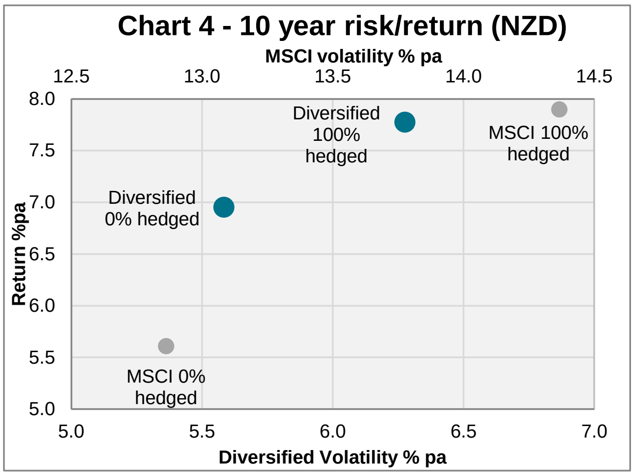
$1.72 if it was invested unhedged, while it has risen to $2.1 if the investment was hedged. Some of the increase in the outperformance of the hedged investment is due to the upward movement in the NZ dollar from 67.59 to 77.9. The chart shows that the only meaningful period when the 100% hedged strategy was behind was during the GFC when the gains from a falling NZ dollar offset the otherwise major fall in global markets. The difference in the returns over the whole period amounted to 2.0% pa or 41.3% in total. This goes a long way to explaining the average results from those KiwiSaver funds with a 100% hedge position for their global share exposure.

Diversification benefits: While a 100% hedge delivers an apparent "free" lunch outcome there is a downside - a more volatile annual return as illustrated in Chart 2. The impact of this can be best seen considering the position of a diversified fund with 50% allocation to growth assets. Chart 3 looks at this and shows the annual returns over a 10 year period. In 7 of the 10 years the fund with a 100% hedge position had the higher return. The years with the greatest variance in the results are 2007, 2008 and 2012, all years which saw major movements in the NZ dollar. So in summary the unhedged results were lower annual returns.



Another way to look at these results is on a risk return chart, see Chart 4. This shows the results for both the return for global shares using the MSCI index and for the diversified fund. While for the diversified fund there is a higher risk level it is hard to argue that this is significant and of course it comes with a higher return at a reasonable trade off.

Time to rethink the 100% hedge option? Our assessment is that the 100% option has been gaining some traction with investors. While at one stage there were a number of parties arguing against it, over time the arguments have waned as investors have come to realise more the value of the regular additional return from the forward points. However the relatively high historic value of the NZ dollar has led many investors to delay a decision to increase their hedge, wanting to benefit from any decrease in value of the NZ dollar. Now that we have seen some fall in the NZ dollar value, a decision may become easier. At the same time we have commentators still talking of the NZ dollar falling as principally the US dollar continues to rise on the back of its strong economic recovery. Other commentators believe that the easing monetary policy seems set to stay for a while both in the US and Europe, and an outcome of this will be continued strength in the NZ dollar. So where to now? Here is a two-step decision making process to achieve a way forward:



1. Take a long-term approach, forgetting the current level of the NZ dollar. What hedging level does one want, balancing the gains from the forward points against the higher volatility and lower diversification?

2. Think about the current level of the NZ dollar and the views of the respected commentators in the market place. And, make a decision on if and when to change.

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries. The firm, established in 1992, has offices in Auckland and Wellington and is an alliance partner of Towers Watson, a leading global professional services company that helps organisations improve performance through effective people, risk and financial management. Its website is at towerswatson.com

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