June 2009

Impact of the rising NZ dollar

1. Introduction

The rise in the NZ dollar has come as a major surprise to many investors, albeit that it is in response to a weak US dollar.

The NZ dollar had drifted to below 50 cents US with many commentators expecting it to continue lower. Instead since the 9th of March it has risen from 49 cents to 65 cents on the 3rd of June 2009.

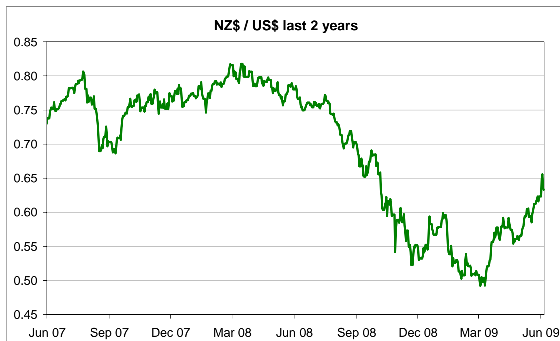
We raise 3 issues:

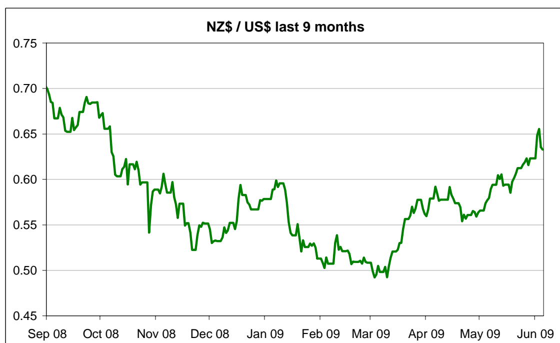
- The question of the need to allow for tax when setting a hedging position
- What to do in the short term with this rise in the currency
- The need to set a long term strategic position.

The results of our review leads us to the view that having a 50% long term passive hedge position has advantages over the other options open to an investor.

2. Recent movements

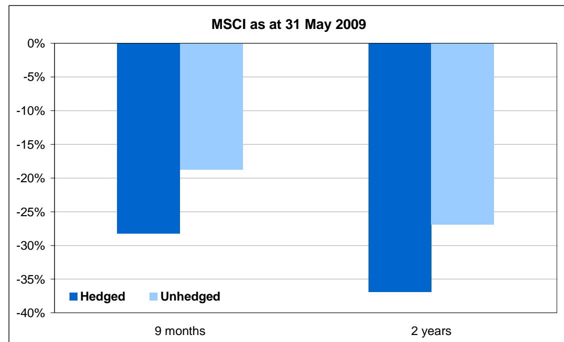
The charts below summarise the movements in the NZ dollar. The steep decline since July 2008 is clear as well as the recent upward surge.





3. Impact on the MSCI

The following chart shows the returns for the 9 month and 2 year periods for the MSCI hedged and unhedged to 31 May 2009.

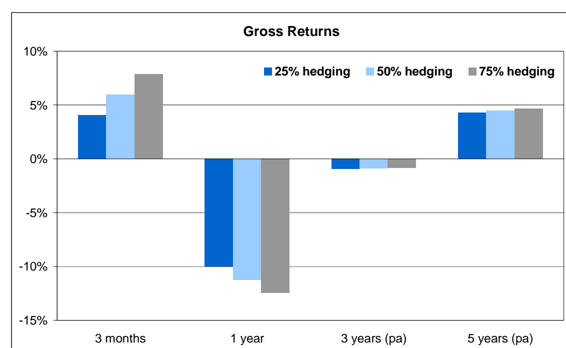


Neither result is particularly good viewing, but the unhedged results show how the decline in the NZ$ has provided some protection against the major fall in global sharemarkets.

4. Impact for an average Balanced Fund

How has the movement impacted on the returns for a Balanced Fund with different hedging positions?

We have shown below the gross return results as at 31 May 2009 for a fund with a 60:40 growth: income asset split and with 25%, 50% and 75% hedged positions on global shares. There is a 35% allocation to global shares. The hedge positions are all gross of tax. Note, that we assume index performance, ie nil value added.



The results show returns over 3 months of 4.1% and 7.9% for the 25% and 75% hedged positions. Over 1 year the results are -10% and -12.4% for the 25% and 75% hedged positions respectively. However over the 5 year period the returns have narrowed to 4.3% and 4.6%.

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5. Need to adjust positions for taxpaying funds

Taxpaying investors in global shares will be liable for FDR tax on the underlying assets and accruals regime tax on any hedging in place. These different tax bases need to be taken into account if an investor is to achieve the after-tax return they intend.

In the two examples below we see how in January and May this year the movement in the NZ dollar had a very different impact on the investor's net return depending on whether they are 50% hedged on a net or gross basis. The numbers are approximations.

January For the month of January the NZ dollar fell by 13.2%, with the MSCI in local currency terms falling 7.1% but in unhedged terms the MSCI rose by 5.2%. Being completely hedged therefore incurred a loss of around -12.3% compared to the unhedged position.

For an investor with a 50% gross hedge, the gross return would have been -0.9%. But the net return would have been 0.8% (at a tax rate of 30%) because some of the loss from the hedge would be offset by a tax credit. An improved position.

May Contrast this with the position in May when the NZ dollar rose by 12.6% and the MSCI also rose by 5.7%. In unhedged terms the MSCI fell 3.0%. For the investor with a 50% gross hedge the gross return would have been 1.4%. However the net return to the investor who is 50% gross hedged has instead been reduced to only -0.1%.

50% net hedged If instead we had put in place a 50% net hedge position, ie one which takes account of the tax position, then the return in January is reduced from 0.8% to -1.1%, ie more in line with the 50% gross position. However in May the return has increased from -0.1% to 1.2%.

A number of superannuation funds have taken account of the net tax position, others have not. While funds could afford to overlook this when the NZ dollar was falling this is not the case with the NZ dollar now haven risen to the current levels.

6. What strategy to adopt going forward

The recent events have proved yet again how hard it is to form a view on the direction of the NZ dollar, leaving a trustee unsure as to what long term currency strategy to adopt.

The options are:

- Pursuing an active currency strategy
- 100% hedged
- 50% hedged
- 100% Unhedged.

The problem with the first approach is illustrated by recent events.

For the other three options the decision could be made to either take a completely passive stance or introduce some active management around the position.

The arguments in favour of a fully 100% hedged position are:

- History shows that over time you will pick up a forward points premium.
- There is no evidence that the NZ dollar is depreciating long term and so by hedging an investor is not losing out on the gain that would arise from this.
- One is really investing in the underlying shares and therefore should question whether they are being adequately rewarded for taking a currency position.

The arguments for a 50% position are:

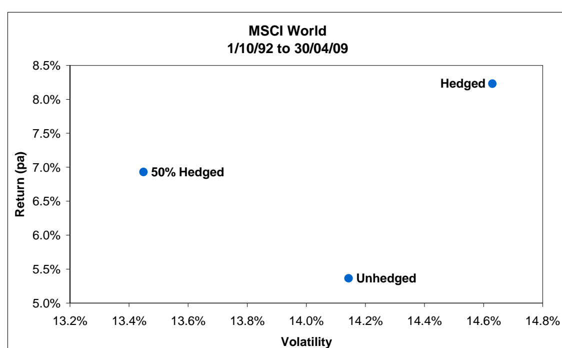
- An investor receives some cover when the NZ dollar falls substantially. There is some evidence this occurs when there is stress in global share markets.
- The volatility of a 50% hedged portfolio has generally been slightly lower than a 100% hedged portfolio.
- A depreciation in the NZ dollar will often coincide with poor performance from domestic asset classes, and so having some exposure to this will be beneficial.
- This is the position of least regret. Given a rise or a fall in the currency, the position is at most 50% wrong.

The arguments for a 100% unhedged position are:

- If the NZ$ is in a long term decline position then this will provide long term protection of the value of a global shares portfolio.
- There is no such thing as a free lunch. Assuming markets are efficient, then over the long term, the additional return from forward points under a hedged position should be equivalent to the currency gains under an unhedged position. So why incur hedging costs.
- This of course relies on the efficiency of markets and, even then, may only eventuate over the very long term.

There is also the major event risk to consider – for example, a major Wellington earthquake or an outbreak of foot and mouth disease. Both these scenarios could result in a substantial and sudden fall in the value of the NZ dollar. Maintaining an unhedged (or partially unhedged) portfolio provides some insurance against such risks.

If we look at the period from October 1992 to April 2009 the risk return outcomes of each of the three defined options supports a 50:50 approach as shown in the chart below.



7. Future movement and setting a long term position

The biggest factor recently driving the NZ dollar has been the US dollar and the flight either to it or away from it. This has been a function of the level of risk aversion in global share markets.

So if share markets continue to rise and the NZ dollar does likewise then investors who have some exposure to currency will give back some of the gains they made when the NZ dollar fell. Those who were 100% hedged will be extremely happy with this.

However a steady rise in markets seems unlikely, while a fall in the NZ dollar given the fundamental imbalances with the NZ economy seems more likely. Given this a level of exposure to currency would seem a reasonable position in the near term.

But while looking to set a shorter term position, the need to resolve and agree a long term strategic currency approach is paramount. Of the options available to an investor the one which may best suit an investor who both has a long term objective but also has to manage the pressures that arise from short term positions may be the 50:50 option.

ABOUT MELVILLE JESSUP WEAVER

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