LEITH WHEELER INVESTMENT OUTLOOK

Leith Wheeler
INVESTMENT COUNSEL LTD.

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" To Hedge or Not to Hedge"

Farmers lead a hard life. They get up early and work late. They incur many costs throughout the year but tend to have only one payday – when their crops are brought to market. Hundreds of years ago, farmers began selling their crops forward into the market while the corn or wheat still grew in the fields. Unsure what the results of their efforts would yield in the future due to the unknown effects of weather, disease, etc., they derived this method to ease the unpredictability of their profession. Even if they knew they created the concept of hedging, they certainly had no idea how prevalent it would become in modern society.

Someone living in Canada expecting to live off their portfolio in retirement or earlier spends Canadian dollars. However, foreign assets in their portfolio are denominated in foreign currencies, thus causing a mismatch. In the last decade, we have seen the Canadian dollar go from 63 cents per U.S. dollar to par. If you held American stocks over this time period, you are quite justified in raising concerns about the "unhedged" exposure to foreign assets in your portfolio.

The concept of currency hedging is simple but in reality is a pretty pesky topic. The trouble is that when looking at historical data, one can find many periods when hedging helps, hurts or does very little. An investor looking for hard evidence to hedge has trouble finding it. One may enter into hedging at the wrong time, incurring outright losses (or best case, incurring unwanted costs) relative to an unhedged position. The move from 63 cents to par does not happen very often, while the move the other way (from par to 90 cents, for example) would provide currency gains for the unhedged investor. So given that these things move both ways and are very unpredictable, hedging currency is a topic that usually polarizes, and often paralyzes sophisticated investors such as Trustees of pension plans. Mercer, an international pension consulting group, surveyed the pension market in 2007 and found almost 80% of small and mid-sized pension plans were not hedging currency on foreign investments, even though they were large enough to do it cheaply. And among those that did hedge, a common approach was to hedge half the currency exposure - clearly a compromise position.

So what's an investor to do?

Let's start by reviewing the facts. Currency values fluctuate widely around the concept of "fair value" and can take many years to revert back to the average. When our dollar was trading below 70 cents U.S., it was deeply undervalued on some economic measures but stayed that way for more than five years. It is now about 15% overvalued on these same measures but that again may persist for some time.

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Does it matter for a long-term investor? Consider the example of Coke. The company earns revenues all over the world and so by owning the stock, you actually own a portion of their global revenues. A weak U.S. dollar might be good for the company over the next few years, as it will help them to sell their products to the emerging markets. This, in turn, may offset some of the possible short term U.S. dollar declines faced by Canadians owning the stock.

Here's another interesting observation: currency moves are often opposite to the moves in equity markets, and can help domestic returns when the equity markets are down. So by not hedging you may actually reduce your equity risk. When looking at the last 20 years, we found quarterly returns for the Canadian equity market that were deeply negative (more than 5% for this analysis – which tends to happen approximately once every two years). We found these instances often coincided with a weak domestic economy and currency which produced gains from investments denominated in foreign currencies. On these "poor quarter" occasions, the equity markets declined by about 10% on average but the currency gains provided a 3% offset to this loss. Therefore, a "flight to safety" towards the U.S. dollar helped Canadian investors. In this respect, an unhedged position was less risky than a hedged one.

Another benefit to having foreign currency exposure would be in a time of rising inflation. While we do not believe this is a risk in the near term, rising inflation (relative to other parts of the world) would usually coincide with a weak Canadian dollar. Having exposure to foreign currencies would be exactly what is needed in this situation. Your cash flow needs for lifestyle expenses to be met by your portfolio would be rising due to inflation, yet you would be benefiting from holdings of strengthening foreign currencies.

Let's face it, equity returns are volatile whether or not the currency of your foreign equity component is hedged. In fact, the hedged returns look quite similar to the unhedged ones. Hedging does not suddenly produce a smooth outcome and sometimes the effects of hedging actually increase volatility. When mixing in the domestic equities and bonds in your portfolio and looking at the results at the total portfolio level, the effects of hedging on "total risk" become marginal over a longer period of time.

Given that the Canadian dollar will likely not rise by 40% from current levels, the decision to hedge or not is simply not a big decision relative to the other risk/reward decisions made in your portfolio. Asset mix completely outweighs the hedging decision in terms of its importance.

It is true that currency hedging could work extremely well if one could time it properly so as to put the hedge on when our dollar is weak, and then take it off later. However, as Alan Greenspan put it, "forecasting exchange rates has a success rate no better than that of forecasting the outcome of a coin toss". Our dollar looks a little overvalued on some economic measures but we also recognize that this can persist for an extended period of time. Until such time as the Canadian dollar looks severely undervalued, hedging away foreign currency exposure may do more harm than good.

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