Hedging Currency Risk

Prepared by: Affin Hwang Asset Management

To hedge or not to hedge? That's probably the question on the minds of most investors, as they look outwards for their investments and seek to add to their allocation overseas.

However, this also runs the risk of increasing their exposure to foreign currencies, leaving them potentially vulnerable to movements in exchange rates. Sometimes, the currency swings are so large that it could impact your portfolio's overall returns.

Does that mean you should fully hedge your position? The answer probably lies somewhere in the middle, depending on the investor's own objectives and risk-tolerance.

> How Currency Volatility Impacts your Portfolio

Following the removal of the 30% foreign exposure cap by EPF last year, members can now invest in unit trust funds that are fully invested in foreign markets. Whilst, this provides additional diversification benefits and exposure to foreign assets, investors should also pay attention to how currency movements can impact their portfolio.

A stronger foreign currency vis-à-vis a weaker local currency will yield higher returns, when viewed from the investor's home market. Conversely, if one invest in a foreign asset and the corresponding foreign currency depreciates, this will reduce gains from the investment.

There are a variety of factors that can influence a currency's direction. These include central bank actions, inflation levels, increase/decrease in the country's trade balance, overall attractiveness of the country's goods & services, and investor sentiment surrounding the country's prospects.

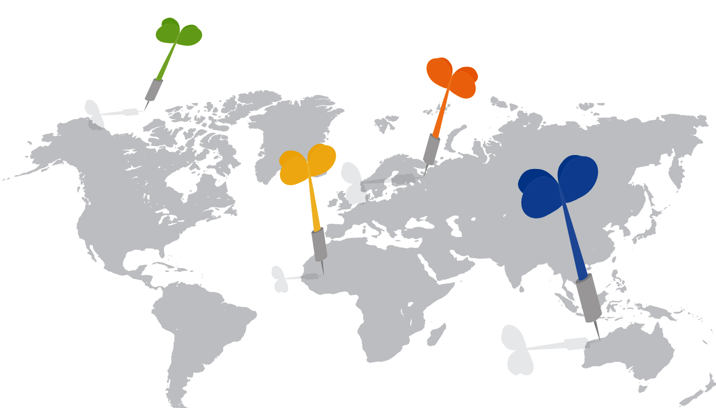
> When to Hedge?

Any decision that an investor has on whether to hedge or not, often springs from the following considerations:-

- ***Investor's Objective*** – A hedging strategy has to be tailored accordingly to an investor's objective. For instance, a more aggressive investor with aims to maximise returns will have a much different hedging strategy, compared to a more conservative investor with capital perseveration needs and wants to reduce risk.
- ***Currency Needs*** – An investor may have specific currency needs, and as such may decide to enter into a particular currency hedged-class. Example, an investor looking for exposure in US high yield bonds, could invest in the AUD hedged-class of the fund, if he is looking for steady income distribution in AUD.
- ***Taking a View*** – Alternatively, an investor may decide to take a view on a currency if it will strengthen or weaken. Essentially, this means that the investor is making a calculated bet on a currency's movement given prevailing economic/market indicators, and then hedge his position accordingly.
- ***Equity or Fixed Income*** – It is more common to hedge a fixed-income portfolio compared to equities, as currency movements are more pronounced in fixed-income assets. Due to their more stable nature and requirement to provide a steady income stream, the benefits of hedging a fixed-income portfolio will be more discernible when reducing volatility. Their fixed durations also allows for easier hedging tactics and planning.

It is less common for equity funds to have hedged classes, as returns generated tend to be able to offset any adverse currency movements.

> Understanding Currency & Asset Correlation



Investors who embark on hedging strategies should also understand how currencies interact with the underlying assets of their portfolios. Do they move in the same direction or opposite of each other?

For instance, commodity-based currencies like the AUD is positively correlated to equity returns, and as such a market downturn can amplify losses on both the underlying asset and currency. An investor would then be dealt a double-blow through negative returns from both the underlying asset and currency depreciation.

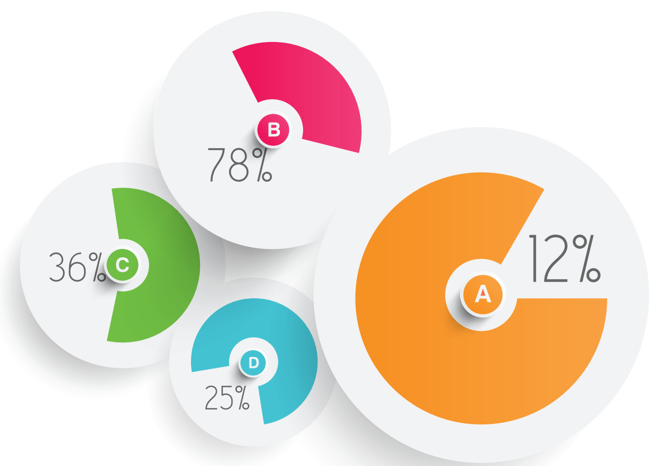
However, currencies like the Japanese yen and safe haven currencies like the Swiss franc are currently negatively correlated to equity market returns (i.e. they move in opposite directions). This negative correlation means, that in the event of a market downturn, the currency acts as a 'natural hedge' against losses and will provide a neutralizing impact on an investor's portfolio.

> Create Your Own Natural Hedge

If picking stocks and investing is hard enough, placing additional factors like currency movements make it doubly so.

Instead, investors should focus on the quality of the underlying asset and base their investment decisions on strong convictions and the fundamentals of the particular asset-class.

It is far more essential to remain invested in the market, than predicting currency movements which places a greater degree of assumptions and in timing the market.



It bears remembering that an ideal portfolio isn't one that does not incur any losses at all. That's next to impossible to achieve.

Instead, investors should endeavour to create a well-balanced portfolio which has diversified exposure across various asset-classes, so that gains from one asset-class can still cushion losses from the other. This include staying diversified across different currencies when constructing your portfolio.

For example, an investor could consider starting with a 50:50 currency mix, where 50% of their portfolio is designed to take in currency translation exposure (eg. USD, AUD-perspective, etc.), whilst the remaining 50% is reserved for currency hedged exposures (i.e. RM exposure). By doing so, an investor can look past immediate currency concerns, and also benefit from currency movements in either directions over the longer term.

Thus, through diversification an investor can also create 'natural hedges' in their investment portfolio.

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