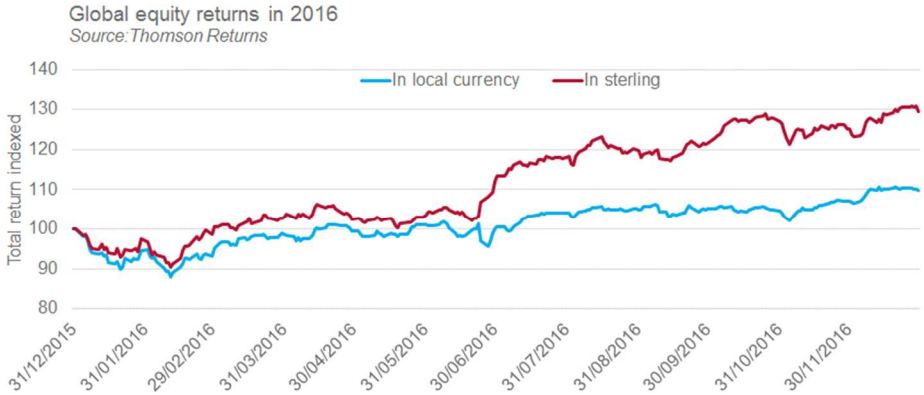
Quarterly investment briefing
Quarter 4 2016

First Actuarial LLP

Equities – to hedge or not to hedge currencies

As well reported, sterling has depreciated since the Brexit vote. The impact on performance of equity markets has been substantial.



During 2016, the biggest driver of the returns achieved from global equities (for a UK-based investor) was whether or not currency exposure was hedged. Investors that hedged would have experienced a return broadly in line with the local currency return – i.e. 20% lower than the "In sterling" returns delivered to those that did not hedge.

Indeed, the impact of currency movements has been so significant that four of our clients, who all had unhedged equity exposure, recently breached their funding based de-risking triggers. As a consequence, these schemes have switched part of their equity holdings into lower risk assets to lock in gains.

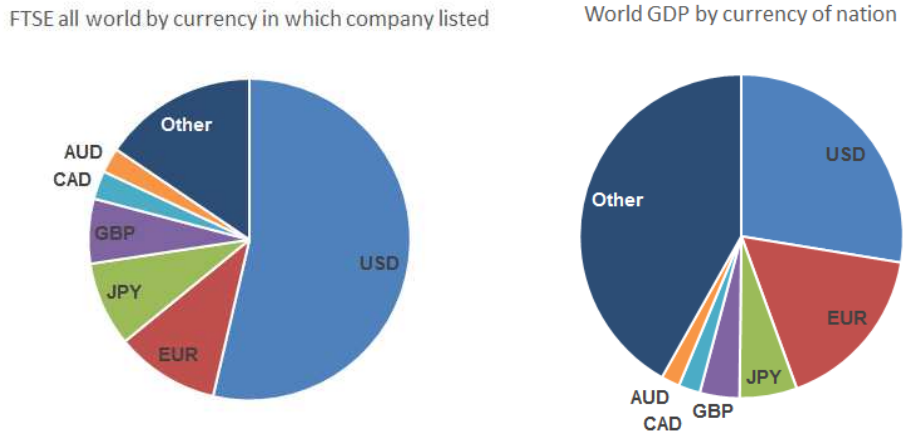
In contrast, many Diversified Growth Funds (DGFs) operate a default position of being largely currency hedged and suffered from relatively weak performance during the year.

The decision to hedge, or not hedge, currency exposure is therefore important and, following the significant change in the value of sterling, now appears to be a good time to consider it.

Full hedging might be a step too far

A company's share price is usually driven by the valuation of the organisation's future profits. If those profits will be earned overseas, then currency fluctuations are likely to influence the share price.

As can be seen below, the global equity market is dominated by US dollar (USD) listed stocks. In contrast a breakdown of the GDP of the world is much less concentrated in USD.



Source: FTSE and World Bank

One of the reasons for the substantial differences in USD weightings in these charts is that USD listed companies earn a substantial proportion of their earnings outside the US. Intuitively this makes sense given the proliferation of products made by the likes of Apple, Microsoft, Johnson & Johnson and Coca-Cola across the world.

A fully hedged global equity fund will remove USD exposure for a company listed in the US (with the hedge being set equal to the value of the investment). Such an approach is likely to over-hedge the USD since the company will also be exposed to a global basket of currencies depending on where its profits are earned.

Unfortunately, assessing the level of currency exposure within the companies held in a fund (and therefore the amount of hedging to implement) is not straightforward. This is demonstrated by the example opposite.

No hedging represents a large 'bet' on sterling

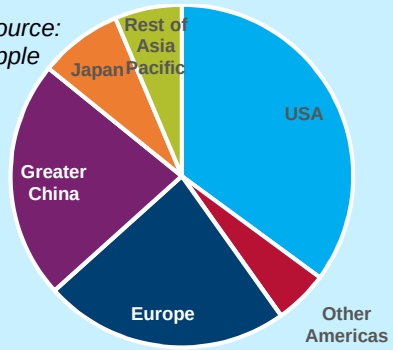
Currencies are measured relative to one another which means that, as one depreciates, others must be getting stronger. This could be an argument for leaving overseas exposures unhedged. The USD might weaken, which would be detrimental for a UK investor's holdings in the US. However this may, at least partially, be offset by gains on holdings in Japan and Europe if their currencies were strengthening.

The diversification argument breaks down though if sterling is volatile. If sterling is getting weaker against all currencies, then it does not matter particularly which overseas currency is held – they will all become more valuable in sterling terms. This is exactly what happened in 2016.

If, at some point in the future, sterling undergoes a period of appreciation relative to a basket of overseas currencies, unhedged funds will lag behind their hedged equivalents.

Apple, the world's largest company by market capitalisation, provides a breakdown of its net sales by region (charted below). As can be seen, only around one-third of the sales are made in the USA suggesting that earnings are predominantly denominated in overseas currencies.

Source: Apple



As a US-based company, much of Apple's operating costs (Head Office, design, R&D etc.) is USD denominated. Apple's accounts show that their debt is also USD denominated or hedged to USD.

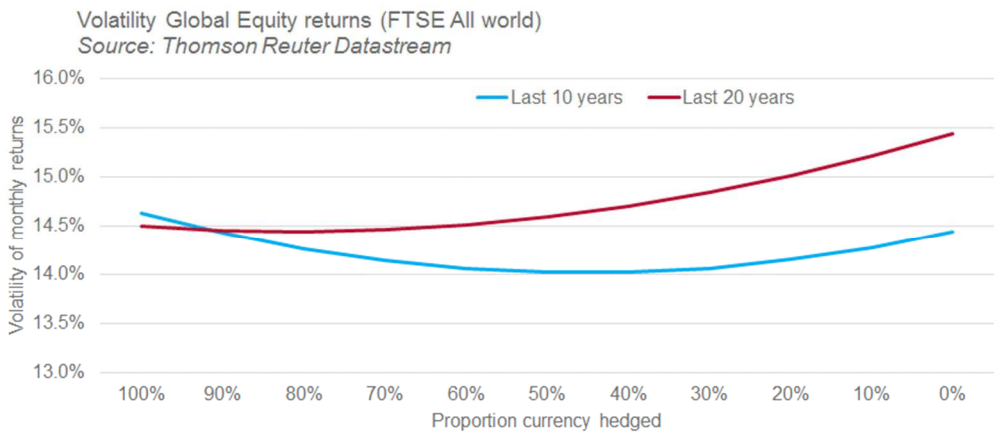
It would appear that the company's costs are strongly linked to the USD whereas its sales are predominantly made outside the US. If that were the case it would therefore be expected that profits (net sales less operating costs and cost of service debt) will have a higher exposure to overseas currencies than the sales figures.

However, Apple's products are currently seen as being premium products and, compared to its competitors, Apple is better able to adjust prices for overseas customers to mitigate currency fluctuations. In addition it carries out much of its manufacturing outside the US and so operating costs are not entirely USD denominated.

Assessing the currency exposure embedded within Apple's share price therefore requires a great deal of analysis and judgement.

Does hedging reduce risk?

On average over the last 20 years removing the currency exposure (as measured by currency of listing) of a global equity portfolio has reduced volatility of monthly returns materially; from 15.4% pa to 14.5% pa. However a partial hedge has been more effective at reducing volatility over the last 10 years as seen in the chart below:



Partial hedging has been more effective at reducing volatility over the last 10 years largely because being unhedged was beneficial during the stock market falls of 2008. During this time, sterling depreciated as investors fled to perceived safer haven currencies. As such, unhedged UK investors made gains that partially offset the stock markets falls.

In a future market shock, unhedged exposure to currencies deemed safer than sterling may well be beneficial again.

So should we currency hedge overseas equities?

Considering global equities in isolation, partial hedging of overseas currency exposure appears to offer the optimal solution. It reduces volatility caused by currency fluctuations whilst avoiding over hedging USD exposure. It also retains the potential to benefit from a flight to safe haven currencies during a market shock.

However, in line with an Integrated Risk Management approach (as encouraged by the Pension Regulator), the level of currency exposure should also be considered at a total assets level and within the context of the sponsor's wider currency exposure.

It might be, for instance, that the currency exposure is very low at the total assets level due to currency exposures being hedged within a DGF. It might then be appropriate to adopt a lower level of currency hedging within a global equity portfolio held alongside it.

Equally the level of embedded currency exposure in a UK Equity portfolio might be a concern (UK listed companies also earn large proportions of their profits overseas) in which case a higher level of currency hedging within an overseas equity portfolio might be appropriate.

The desire for currency exposure can also be influenced by a pension scheme's sponsor. For instance, a UK based retailer may suffer if sterling weakens and it cannot fully pass on increased costs of the goods it imports to its customers. It may then be appropriate to position the pension scheme to gain from sterling weakening by leaving currency exposure unhedged.

Small print

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