

Currency

Why it's easier to spell than understand



AMP Capital's Anthony Edmonds explains why currency hedging for NZ investors is not as simple as it should be

remember once being in a meeting talking about performance attribution. When I asked those at the meeting if they understood the concept of performance attribution analysis, the response from one person was: "Before we go there – how do you spell attribution?"

Currency is a little easier to spell, but is potentially the least understood aspect of investment management within the industry. And now, with the new Fair Dividend Rate (FDR) tax regime for overseas investments, currency hedging for managed funds has become an even more 'taxing' issue.

New tax rules don't work for the currency hedging of global assets

When investing in other countries, currency risk arises which affects the value of the portfolio when considered in New Zealand dollar terms. Currency hedging is used to guard against these foreign exchange fluctuations.



By Anthony Edmonds

However, with the FDR regime, many advisers and their clients may not actually be achieving the degree of hedging they desire. That's why it is vital that advisers who have clients investing in global assets understand how the tax rules work, or don't work, when currency hedging is involved.

Two different tax methodologies for assets and currency hedging

So, let's look at why the tax rules don't work for hedged global assets, using the specific example of global shares in a PIE fund.

Under the FDR regime, these shares are taxed on an assumed return of 5% per annum, regardless of what the underlying shares actually return. Whereas, if the PIE holds any currency contracts (many global share funds are 50% hedged to New Zealand dollars), then the currency contracts get taxed as financial arrangements using an accruals basis.

This concoction of methodologies (the FDR method and

of tax basis which results in different net returns, depending on the movement of the New Zealand dollar.

A working example: Why 100% currency hedging is not really 100% hedged

Let's get into an example. Assume a return of 10% from the underlying global shares, and a 3% movement in the New Zealand dollar. My example also uses an investor with a 30% PIR tax rate. Logically, you would think that by hedging the fund 100% the impact of the currency movement would be removed.

Hedging a global share portfolio 100% broadly implies that the return on the underlying global shares in local currency terms will be unaffected by any movement in the New Zealand dollar relative to foreign currency. (I said broadly as I have ignored forward points resulting from differences in interest rates.) So a 10% gross return from the underlying global share portfolio, would translate into a 10% gross return in New Zealand dollar terms. Assuming a tax rate of 30%, the 10% return should become a net return of 8.5% (as FDR = 5% assumed return, multiplied by 30%, equals 1.5% in tax).

If only life was so simple. The following table shows what happens in reality. I have shown this for a 3% rise or fall in the New Zealand dollar. This example shows that the 8.5% net return in New Zealand dollar terms that the investor would expect to get from hedging 100%, actually varies depending on whether the currency rises or falls. In this case, the total net return is

of tax basis which results in different net returns, depending on the movement of the New Zealand dollar.

An unintended outcome

Global share return in local currency	10%	10%
NZ dollar movement	Up 3%	Down 3%
Global share return in NZ dollars	7%	13%
FDR tax assuming 30% tax rate	-1.5%	-1.5%
Net \$NZ global share return	5.5%	11.5%
Hedging return: 100% hedging	3%	-3%
Tax on hedging assuming 30% tax rate	-0.9%	0.9%
Net hedging return	2.1%	-2.1%
Total net return	7.6%	9.4%

Remember, the expected net return was meant to be 8.5%. Our actual outcome was different (and a function of whether the currency rose or fell). Note that the greater the movement in the currency, the further the actual net return will be from the expected net return.

In reality, we can fix this problem so the returns will be unaffected by the movement of the dollar – at least for 30% taxpayers. All you do is increase the hedging ratio to 142%,

which then takes into account the different tax treatments of the impact of currency movements on the value of the shares, and the return from the currency hedging contracts. In the following example, using this hedging ratio, the total net return when the currency is up 3% or down 3% is the expected net return of 8.5%.

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A 30% taxpayer's net returns in a PIE fund hedged 142%: The desired outcome

Global share return in local currency	10%	10%
NZ dollar movement	Up 3%	Down 3%
Global share return in NZ dollars	7%	13%
FDR tax assuming 30% tax rate	-1.5%	-1.5%
Net \$NZ global share return	5.5%	11.5%
Hedging return: 142% hedging	4.3%	-4.3%
Tax on hedging assuming 30% tax rate	-1.3%	1.3%
Net hedging return	3%	-3%
Total net return	8.5%	8.5%

Now we are cooking. By over-hedging the global shares, we have now got the correct net return – at least for a 30% taxpayer.

Hedging ratio needs to change for different taxpayers

And here lies the problem. Under PIE, tax is calculated at the investor level (not within the fund). Accordingly, the hedging ratio is only right for one group of investors. In our example, investors with a Prescribed Investor Rate (PIR) tax rate of 30%.

To confirm this, let's redo the table with the only change being the tax rate. This time we will look at the impact on a 19.5% PIR tax rate investor. Remember – the investor's tax rate is 19.5%, so the expected net return increases to 9.0% (not 8.5%).

A 19.5% taxpayer's net returns in a PIE fund hedged 142%: An unintended outcome

Global share return in local currency	10%	10%
NZ dollar movement	Up 3%	Down 3%
Global share return in NZ dollars	7%	13%
FDR tax assuming 19.5% tax rate	-1%	-1%
Net \$NZ global share return	6%	12%
Hedging return: 142% hedging	4.3%	-4.3%
Tax on hedging assuming 19.5% tax rate	-0.8%	0.8%
Net hedging return	3.5%	-3.5%
Total net return	9.5%	8.5%

As shown, we now have the problem of the net return not being right for 19.5% taxpayers. This demonstrates a pretty significant flaw in the FDR tax regime, and advisers need to be aware of this – and what to do about it.

Fixing the problem

There are a number of ways this problem can be fixed, so let's look at this quickly.

Firstly, the Government could tweak the tax rules. There are some fundamental flaws in the new tax rules, and this is one of them, that they must fix. Especially when you work through the implications for KiwiSaver diversified funds.

Fund managers could fix this by creating really complex global share fund structures, in which the currency hedging contracts reside within the offshore vehicle in a tax haven such as Luxembourg or the Cayman Islands.

Another way is for the manager to offer two global share funds (as AMP Capital Investors does) – one unhedged and the other 142% hedged. The client, or their adviser, can then combine these funds to achieve the right currency weighting, taking into account the client's PIR tax rate. This is demonstrated in the following table which shows how a 142% hedged fund and an unhedged fund are combined to achieve 100% hedging for investors with different PIR tax rates.

Combining hedged and unhedged funds to achieve the desired hedging level

100% hedging position (net of tax)

	142% hedged fund	Unhedged fund
30% PIR tax rate *	100%	-
19.5% PIR tax rate *	87%	13%
0% PIR tax rate *	70%	30%

We can also adjust weightings for taxpayers who wish to achieve a 50% hedging position.

50% hedging position (net of tax)

	142% hedged fund	Unhedged fund
30% PIR tax rate *	50%	50%
19.5% PIR tax rate *	44%	56%
0% PIR tax rate *	35%	65%

* Weighting to each fund rounded for simplicity

This 'fix' will not work within a diversified PIE fund with a range of investors on different PIRs (like the KiwiSaver funds).

Conclusion

As demonstrated, with the new FDR tax regime for overseas investments, currency hedging is now very complex. The focus of hedging should be about what role currency plays in a client's portfolio, and how much currency hedging each client should have. I think this is one of the most fascinating and least understood aspects of portfolio management within the New Zealand industry.

Instead, we are bamboozled with complex calculations just to give our clients the currency exposure they want on a net of tax basis. Let's hope the Government steps in and fixes this problem. In the meantime, take time to understand the issue. There is a good chance that your currency exposure is different than what you intended it to be. **A**

