investment
portfolio construction

Foreign reserves:
Currency lessons from St Tropez

We could all do with a bit of foreign money in our portfolios (or pockets). AMP Capital's Anthony Edmonds explains why

By Anthony Edmonds

I often wish I had lots more money. Not just a little bit, but the type of wealth that lets you live half the year in a villa in the south of France. While all that sun, food and good wine might become a little tiresome, I would box on.

If I was this wealthy and divided my time between continents, I would also join a small group of people who seem to best understand the vital role of holding foreign currency in an investment portfolio.

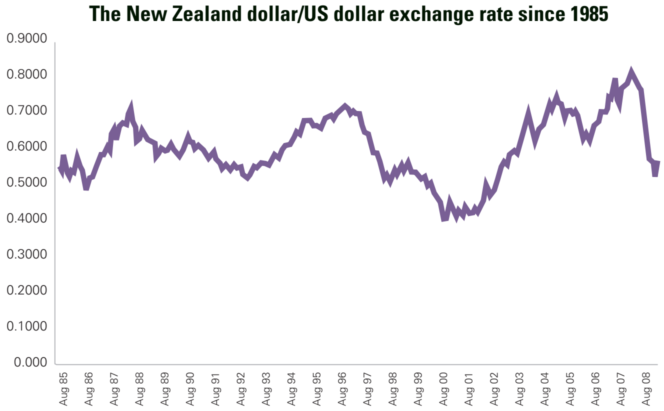
It is these people who can best see the true spending power of their wealth in global terms. In contrast, the investment management industry has struggled with what is the best approach to currency. There seems to be four main camps of how to best manage foreign currency in an investment portfolio.

Camp one:
Hedge out all currency risk

In one camp there are those who recommend that investors should hedge out all of their currency risk. That is, where a portfolio includes foreign assets, they hedge these back 100% to New Zealand dollars.

Chart one below shows the value of the New Zealand dollar versus the US dollar since 1985. In it, the New Zealand dollar rises and falls in a wave-like pattern. If you were to look purely at this chart as a basis for determining whether to hedge or not, you would not see the value of hedging, because the return over time appears to be zero.

The New Zealand dollar/US dollar exchange rate since 1985



However, an important benefit of hedging that chart one ignores is 'forward points'.

The attraction of forward points

In practice, when you hedge you borrow money from a US bank (effectively paying interest on this money) and place this money on deposit in New Zealand, which then earns you interest.

The forward points are the premium you earn as a result of the higher short-term interest rates in New Zealand than the US. Those who support hedging 100% point to the fact that in the past hedging to New Zealand dollars has produced a positive return as a result of this premium to support their approach.

Indicatively, the interest rate differential from hedging a global share portfolio has provided a gain of approximately 4% per year, or 400 basis points worth of forward points, since the mid 1980s.

This suggests that 100% hedging all global assets is entirely rational, which is also supported by the fact that it would have produced better returns over the last 25 years. So now you can see the appeal of hedging 100%.

But what about the risk?

I believe there are some short-comings with this approach.

Firstly, you have to stop and ask: what is this premium for?

This interest rate premium that you get from holding New Zealand dollars is great, so long as the New Zealand dollar does not experience a catastrophic event. The premium you earn is actually the reward you get for taking the risk of putting all your money in just one small country, New Zealand.

Now let's look at the risks. Take, for example, if foot-and-mouth disease struck New Zealand. Our dollar would probably experience a sharp depreciation, which would more than offset the positive effect of the forward points. And just because this has not happened in the past, does not mean that it won't happen. You only need to look at the 25% fall in the dollar between September and November last year to see that the New Zealand dollar can quietly implode. And, if this happened over an extended period, the decline in your wealth would be significant.

Additionally, while the forward points provide a positive return to investors, these are likely to be less in the future.

Camp two:
Hedge out all currency risk in global bonds and 50% of global shares

There is a second camp of investors who believe they should simply hedge all of their global bonds and 50% of their global shares portfolio, which they then call 'the path of least regrets'.

This means the level of the investors' overall currency exposure is a function of their total global shares exposure. I think the only reason this type of logic exists is that in a balanced portfolio this results in about a 20% exposure to foreign currency, and that this feels about right.

Shaky logic if you are an aggressive investor

The logic behind this approach becomes shaky when you consider a diversified growth type of strategy with a higher exposure to global shares. This more aggressive investor would have a higher foreign currency exposure for no other reason than the fact that they have a higher global shares exposure.

Camp three:
Active currency hedging

There is another group of investors who take a highly active approach to currency hedging. This group significantly changes their currency hedging exposure based on their view on whether the dollar is trending higher or lower.

While I do believe that an investor's currency exposure should be actively managed, care needs to be taken around this. It is a lot harder to predict the movement in the dollar than it first appears. Also, if you take really big currency positions, these will then dominate the overall performance of the portfolio, dwarfing all other active positions taken in the portfolio.

When I talk to people who take a highly active approach to currency hedging, I normally ask them about their understanding of forward points and risk budgeting.

I often find myself surprised that they are only looking at the actual track of the currency (as shown in chart one), and not taking forward points into account. And risk budgeting just leaves them with a confused look on their face.

Camp four:
Hold enough foreign currency to hedge your foreign liabilities

From my perspective there are a number of reasons to hold foreign currency.

Firstly, this helps mitigate the risk of something catastrophic happening to the New Zealand dollar, or our economy. If this happened it would effectively erode our spending power.

Secondly, and as a related point, it recognises that a significant portion of all the money we spend is on things priced in foreign currency.

Holding foreign currency hedges these liabilities. The fact that there is a cost associated with holding foreign currency is fine (the cost being the loss of the forward points associated with currency hedging).

I consider this 'cost' to be like an insurance premium against something really catastrophic happening to our currency. To offset these liabilities, I think most New Zealand investors could be holding around 30% to 40% of their investment portfolio in foreign currency.

Another factor (that I won't go into detail on here) supporting holding foreign currency is that it recognises the strong correlation between the New Zealand dollar and the performance of local assets, especially New Zealand shares.

So, foreign currency acts as a diversifier within a client's portfolio. This can be seen recently with the fall in the New Zealand dollar coinciding with the fall in New Zealand shares.

Increases volatility of returns

While it mitigates these risks, holding a relatively high level of foreign currency does introduce a new problem. It increases the volatility of the returns that you receive, as reported in New Zealand dollars.

However, by only ever thinking about investment performance or wealth in one currency, only tells half the story.

To get what I am driving at, think about the 12 months ending 31 December 2008. The Melville Jessup Weaver Investment Survey (December 2008) shows that the average wholesale balanced fund returned –14.9%.

Given the turmoil in global markets, this return doesn't seem too bad. But to scare yourself, think what this return would look like when expressed in US dollars. By my calculations in 2008 the New Zealand dollar fell by approximately 27% against the US dollar.

Accordingly, when you think of the value of our portfolios in US dollar terms, this has diminished significantly. In practice this means that the foreign-priced goods we frequently purchase cost more, eroding our spending power.

Conclusion

And this is where globe-trotters come back into the equation. If you lived half of the year in the south of France or spent a lot of time travelling, you would stop thinking about your wealth purely in New Zealand dollars and start thinking about it in foreign currency terms.

If you are holding lots of New Zealand dollar assets, and you then switch your reporting base to Euros (or US dollars), you suddenly realise how risky this is.

This reflects that if the New Zealand dollar falls, it becomes immediately apparent that all the goods you are consuming cost more, and that your wealth in global terms has diminished. When you sit back and think about it carefully, their consumption of foreign-priced goods is really no greater proportionately than the rest of us. The only thing that really changes is the location in which they buy these goods and the currency they use to pay for them.

And this is where we could all get a lesson from the wealthy. Holding foreign currency is a good idea, despite the fact that there is potentially a cost to this (being the forward point you miss out on). This is because currency provides a hedge against something disastrous happening to the New Zealand economy and dollar.

That's why I think holding foreign money in an investment portfolio is something that should gain currency with nearly every New Zealand investor at home, not just those with globe-trotting lifestyles. A