STRATEGIC EXCHANGE

SEVEN MYTHS OF CURRENCY

Relative to the US dollar, the Canadian dollar has recently declined to levels not seen in over eleven years, resurrecting investor discussions around the weakness of the dollar and the question to hedge or not to hedge. Bundled with the decision to invest in non-domestic investments, currency exposure tends to be a secondary consideration when deciding between different types of opportunities. This has led to the rise of a number of currency myths.

Myth 1 – Companies are equally affected by currency fluctuations

While most companies in the global equity market have multi-currency costs and revenues, the impact is not experienced equally. The global equity market can be divided into four broad company classifications.

Multinational	Natural Resource	Exporters	Domestic Focus

Multinational companies represent the largest component and have revenues and costs in multiple currencies. The returns and volatility of individual companies will therefore respond to foreign exchange fluctuations relative to each company's domestic currency.

For natural resources companies, such as those in the energy and mining sectors, changes in the price of the associated commodity are the biggest driver of returns and volatility.

Exporters earn the vast majority of their income outside of their home country. Therefore, a weak domestic currency can be beneficial as products will be more competitively priced, while a strong local currency can have the opposite effect.

Domestically-focused companies conduct the majority of business in their home market, so currency fluctuations have a low impact on returns and volatility.

Myth 2 – Investment managers take care of currency risk management.

The approach to currency management varies depending on the style and process of individual investment managers.

As noted in Myth 1, a manager's first consideration is usually stock specific. By breaking companies into broad classifications to evaluate how each is managing the currency impact to the business, the investment manager is able to identify the "true" currency exposure of individual companies.

Fundamental (qualitative) investment managers review currency overweight positions resulting from the stock and sector selection process to determine whether to hedge closer to the benchmark allocation. Such analysis does not always result in hedging.

In contrast, a quantitative manager will often perceive currency exposure different to the benchmark as an uncompensated risk. Therefore, currency differences coming from the stock selection process are hedged to be broadly neutral to the benchmark, after taking into account the costs associated with hedging.

Myth 3 – Global equities are more volatile than Canadian equities

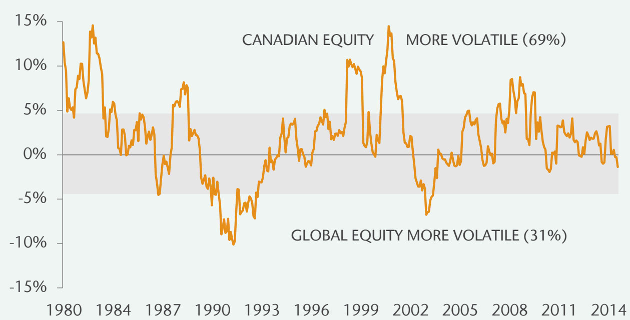
Whether we consider returns over the short term (e.g., one year) or longer term (e.g., 10 years), global equities are generally less volatile than Canadian equities despite the currency exposure.

Chart 1 displays the relative volatility of returns over rolling one-year periods for Canadian equities (the S&P/TSX Index) versus global equities (the MSCI World Index on an unhedged basis).

Despite the currency exposure associated with global equities, historically the Canadian equity market has been more volatile than the global equity market.

Chart 1 – Canadian vs. Global Equity Volatility

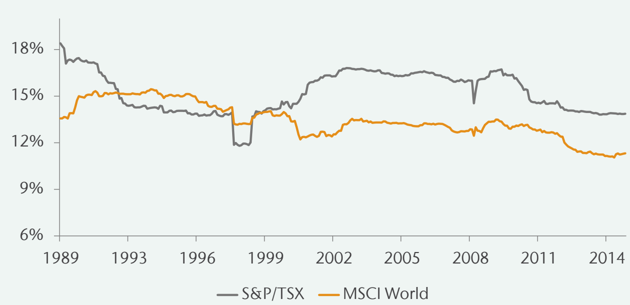
Rolling 1-Year Periods



Source: CC&L Financial Group and secondary sources

Longer-term analysis (10-year rolling periods) shows similar evidence, further supporting that global equity returns are less volatile than Canadian equity (Chart 2).

Chart 2 – Rolling 10-Year Equity Absolute Volatility



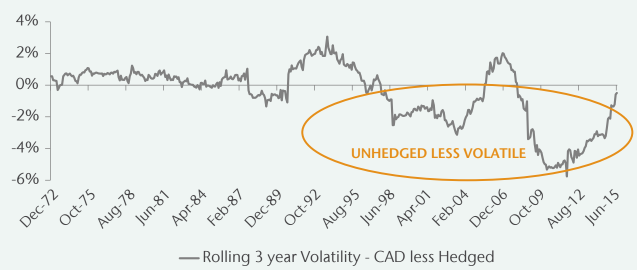
Source: CC&L Financial Group and secondary sources

Global equities offer a much broader opportunity set for investors compared to Canadian equities, which is a contributing factor to their lower return volatility.

Myth 4 – Hedging reduces global equity volatility

Investing in global equities introduces currency exposure. Despite a belief that unhedged returns are more volatile, based on rolling three-year return volatility (Chart 3) the opposite has generally been true, particularly most recently.

Chart 3 – Rolling 3-Year Relative Volatility



Source: CC&L Financial Group and secondary sources

The lower volatility of unhedged global equity is even more compelling from a total portfolio risk and return perspective for a typical multi-asset class portfolio, investing in a range of equities and fixed income. The merits of currency diversification make a strong case for unhedged global equities.

Myth 5 – An optimal hedge ratio is 50%.

Once the decision is made to hedge currency exposure, the task then becomes identifying an optimal hedge ratio; in other words the ideal percentage of currency exposure to hedge in order to manage currency risk.

Research papers often point to a 50% hedge ratio as being “optimal” but currency hedging should be based on the actual percentage of foreign currency exposure.

For example, if an investor has a hedge ratio of 0% (i.e., no currency hedging) and another investor has a 50% hedge ratio your natural reaction would be that both can’t be correct. However, if the investor with no currency hedging has 20% currency exposure at the total fund level, while the 50% hedge ratio investor has 40% currency exposure, their net currency exposure will be the same.

This example highlights the importance of assessing risk in the context of the total portfolio and not just at an individual investment level.

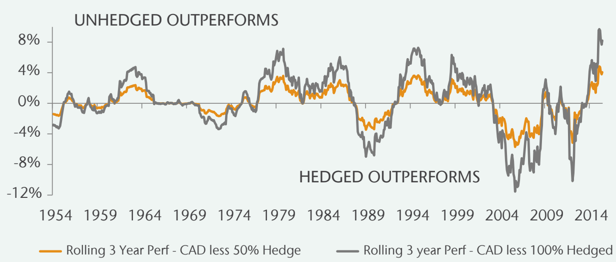
Myth 6 – Regret risk currency hedging has no benefit

Currency fluctuations impact returns over both the short and longer term. Therefore, for some investors hedging a fixed percentage of their currency exposure can be beneficial by reducing the regret of adopting a particular approach and being wrong.

Often referred to as managing "regret risk", the belief is that hedging a fixed currency component leads to a better outcome compared to choosing not to hedge, or choosing to hedge all the currency exposure and having the opposite scenario occur.

Chart 4 displays the relative performance of unhedged US equity returns less hedged returns under two scenarios: unhedged versus fully hedged (grey line) and unhedged less a fixed (50%) hedged return series (orange line).

Chart 4 – US Equity Rolling 3-Year Relative Performance



Source: CC&L Financial Group and secondary sources

The fixed "regret" risk hedging approach takes out the relative return highs and lows, resulting in less extreme outperformance or underperformance, which for some investors is a genuine benefit.

Myth 7 – Dynamic hedging provides short-term benefits

The relative strength or weakness of a currency pair can trend over time. Such trending begs the question of whether a more dynamic approach to currency hedging provides a better solution than a fixed hedge approach.

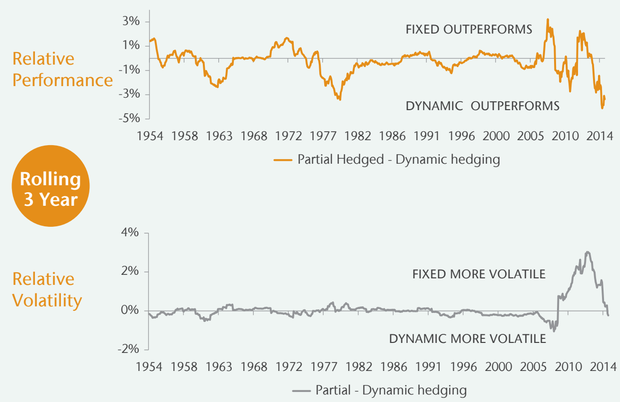
A dynamic hedging approach is based on a set of thresholds acting as triggers to determine the timing and the amount of currency to hedge depending on the currency's relative strength or weakness. To illustrate the dynamic approach, Table 1 below shows a set of thresholds used for a U.S. equity index portfolio.

Table 1 - Dynamic Thresholds

Exchange Rate (US per 1 CAD)	% of US Equities to be hedged
Greater than $0.90	0%
$0.85 to $0.90	20%
$0.75 to $0.85	40%
Less than $0.75	60%

The rolling 3-year fixed (50%) hedge returns less the dynamic hedge returns show dynamic hedging provided a performance benefit in the most recent periods relative to fixed hedging (Chart 5). This was because there was less hedged currency for the dynamic approach when the Canadian dollar weakened.

Chart 5 – Fixed vs. Dynamic Hedging



Source (both graphs): CC&L Financial Group and secondary sources

In the most recent periods, dynamic hedging also maintained more of the lower volatility merits associated with an unhedged approach, but it took decades before any material benefit was realized.

Dynamic hedging provides episodic benefits that can take a long time to surface. The infrequency of the benefit raises the question of whether it is enough to warrant the extra time and governance oversight required, or would time and effort be better rewarded elsewhere?

For more information on currency management, contact:

Peter Muldowney
Senior Vice President, Connor, Clark & Lunn Financial Group
pmuldowney@cclgroup.com | 1- 416-304-6810

Connor, Clark & Lunn Financial Group's Strategic Exchange is an initiative to promote dialogue, understanding and the development of solutions to the often complex investment challenges faced by plan sponsors.

Under the direction of Peter Muldowney, SVP Institutional Strategy, we bring together plan sponsors and consultants in a variety of interactive, educational forums. We also produce thought pieces addressing issues that are top of mind to those involved in managing and overseeing retirement plans.

CONNOR, CLARK & LUNN
FINANCIAL GROUP