

The importance of currency: it can't be ignored

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It is impossible not to take a position on the Australian dollar – not because everyone has a view, but because the decision to invest offshore is actually two decisions: international assets and currencies.

As Macquarie Funds Management's Phil Dolan says: "There's an inherent exposure to foreign exchange risk. Deciding to do nothing is, in fact, making a decision."

Dolan, the head of marketing, research and product development for Macquarie, has recently held a series of investor lunches at which he and van Eyk Research director Rob Prugue spoke about the currency issue.

Foreign exchange trading represents a vast market, far larger than any other, of which only 2 per cent is related to trade in goods and services. The majority of trading is for other investment or Government-related reasons and it is dominated by major global players.

In this market, the Australian dollar gets far more attention than it deserves. The \$A is the sixth most traded currency, partly because of our time zone and partly because of the open liquid nature of the economy.

The interest in the \$A from an Australian investor's viewpoint follows the currency's long slide over the best part of the past 15 years, culminating in a free-fall earlier this year to below US50c.

While the \$A recovered somewhat last month, to hit US53c, there appears little support above the 50c mark.

The fall has added a lot to returns from international share funds in the past year, but the question now is whether a subsequent rise will wipe out those gains.

Van Eyk has been more vocal than most research houses in warning investors that the \$A appeared undervalued and was likely to appreciate significantly over the medium term.

Van Eyk also surveyed a range of managers in March to determine their latest positions with respect to currency exposure. Most managers – 10 out of 14 – had not hedged the \$A in recent months, with the researchers suggesting that because the benchmark MSCI World Index was unhedged, the managers preferred not to take on the additional risk.

But there was an overall lack of transparency for their clients to make a decision. Only two of the managers surveyed – ABN Amro and Rothschild – had 'no intention to hedge' as their stated objective.

Van Eyk pointed out there was a growing number of international funds which provided fully hedged versions, leaving investors to make up their own minds on the currency. These include a hedged option for the Merrill Lynch Global Titans Fund as well as hedged global funds from Barclays Global Investors, Vanguard Investments and Lazard Asset Management.

Van Eyk questions whether the offer of a hedged option by active managers is justified, putting the responsibility of hedging with the investors rather than the managers who are better equipped to make the decision.

The van Eyk report concludes: "Advisors who were considering switching to hedged funds may wish to consider the rationales the professionals have offered not to hedge. Our own view is that the \$A is extremely undervalued. Hence, advisors should direct monies to well-rated managers who are at least partially hedged."

Prugue told the recent investor lunches that picking currency trends, particularly in the short term, was a very risk task.

What they needed to do, he said, was to have a sensible hedging strategy with which they were comfortable and stick to it.

Dolan says that long-term investors do not have much to fear from currencies as the variations "tend to wash out". But for most investors, with a two to three-year horizon, currency does matter.

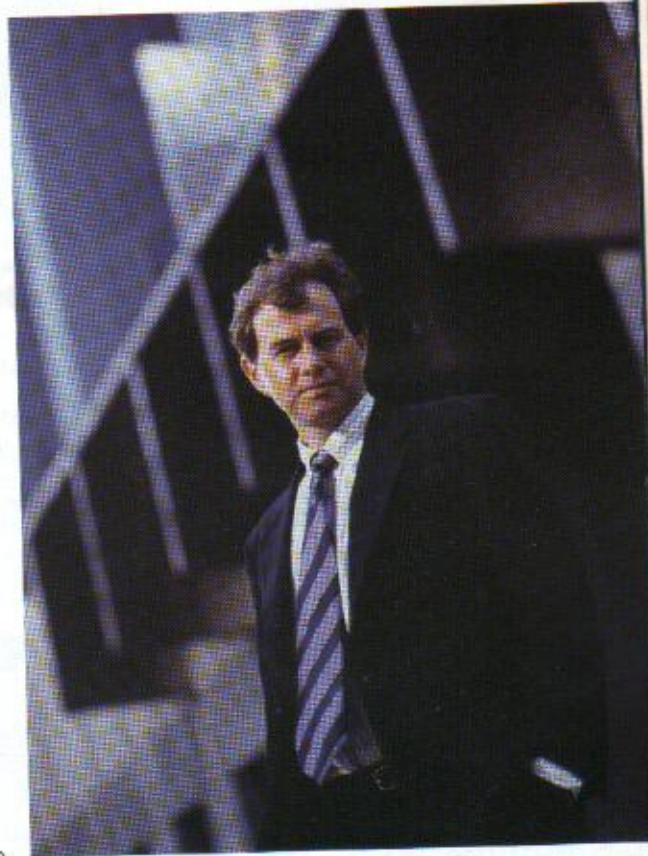
For super fund members, for instance, the average time horizon might be 30 years. But the average trustee, like financial planners, is likely to have a one-year horizon.

"Investors need to appreciate that currency can make a difference," Dolan says. "The key is what you choose as your benchmark."

While the widely used MSCI World Index is unhedged, institutional investors are increasingly adopting a benchmark of 50 per cent hedged and 50 per cent unhedged.

Dolan says the starting point need not be "sacred" but should be a reflection of the investors' risk tolerance and investment time horizon.

Phil Dolan: starting point for benchmark need not be sacred



Since 1987, the result of a generally depreciating \$A has added 2.2 per cent a year to international investment returns. In local currency terms, the MSCI World ex-Australia has returned 10.6 per cent a year average, against a 12.8 per cent return on an unhedged basis.

At the same time, being unhedged has increased volatility from 13.5 per cent to 14.9 per cent.

To demonstrate what currencies can do in the short term, however, Dolan points out that the largest monthly gain due to currency moves in the past 14 years was a 12.5 per cent rise. The largest monthly loss due to currency was minus 6.3 per cent. ■