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Currency management - to hedge or not to hedge?

Angela Ashton | PortfolioConstruction Forum | 05 March 2015

"Currency management for Australian investors" by Aberdeen Asset Management, PortfolioConstruction Forum, 2010.

Currency risk is a significant issue for Australian investors. Although it is generally believed that currency is a "zero sum game" in the long term, its volatility can overshadow good returns from underlying asset classes and wreck havoc on investors' goals in the meantime.

Leaving a portfolio of international assets unhedged can potentially impact both income and capital values of those assets, particularly over the short term. But hedging, which must be enacted through derivatives, can be costly and exposes a portfolio to other risks such as counterparty risk. Of course, there are other approaches to hedging that can be undertaken – there can be active approaches, designed either to protect or add value to portfolios.

This paper, written in 2010, explores Australian investors' currency management options, the risks of hedging or not, which asset classes should be hedged, and summarises the research on optimal hedge ratios for Australian investors' international equities exposures.

Over the long term, say 20 years, the risk and return of hedged and unhedged portfolios are usually fairly comparable. However, the volatility of the Australian dollar (AUD) is somewhat akin to that of equities at around 11.5% per annum – meaning that managing currency exposure can potentially lower volatility. Indeed, Australian investors' portfolios that are partially hedged usually do display lower levels of volatility over the long term.

So is there an optimal hedge ratio for a portfolio? Unfortunately, the optimal ratio changes with time. Research shows that it has been anything from 15% to 80%, with many studies suggesting 40% or 50% being most optimal. However, this will also be dependent on the asset allocation of the portfolio itself, due to the correlation effect of the AUD with the other assets in the portfolio.

What drives the AUD? It's a "pro-cyclical" currency, so many of those factors that point to a buoyant global economy can be expected to boost the AUD. This research paper suggests that the AUD rises when
- global industrial production or commodity prices are rising:
- Asian growth is good;
- interest rate differentials favour Australia;
- the US dollar is falling; and,
- risk appetite is good.

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Although this paper does not present any definitive answers to the vexing question of the "right" approach to currency management (partly because there are no right answers!), it does provide a good overview of the issues associated with this asset class – and should be required reading for anyone managing investors' portfolios.

Read "Currency management for Australian investors"