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Currency management for Australian investors

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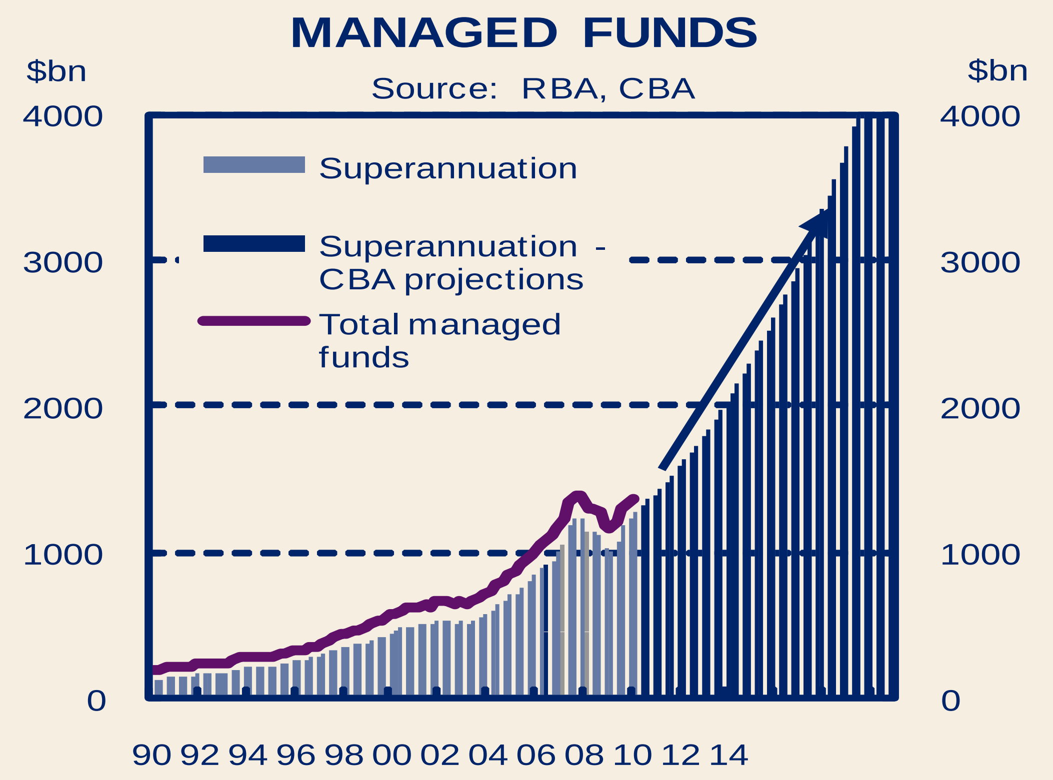
Agenda

- The growing savings pool = growing currency risk
- Hedged vs un-hedged global equity returns
- Is there an optimal hedge ratio?
- Understanding what drives the AUD
    - Thoughts about when to hedge
- Options - how to manage risk in your client's portfolio

Key issues when it comes to currency

- Investments into un-hedged assets results in significant exposure to foreign exchange volatility
- Currency may be a zero sum game over the long-term (20 years +) and may help to diversify total portfolio risk, however, short to medium term volatility (over 3 to 5 years) can be substantial and arguably should be actively managed rather than ignored
- Arbitrary 50/50 hedge ratios are not necessarily the best option. And indeed over rolling 5 year periods, analysis suggests optimal ratios of between 20% and 95% over the past 20 years
- It is in the best interests of the Australian industry to identify and develop FX skills to manage these risks in the future

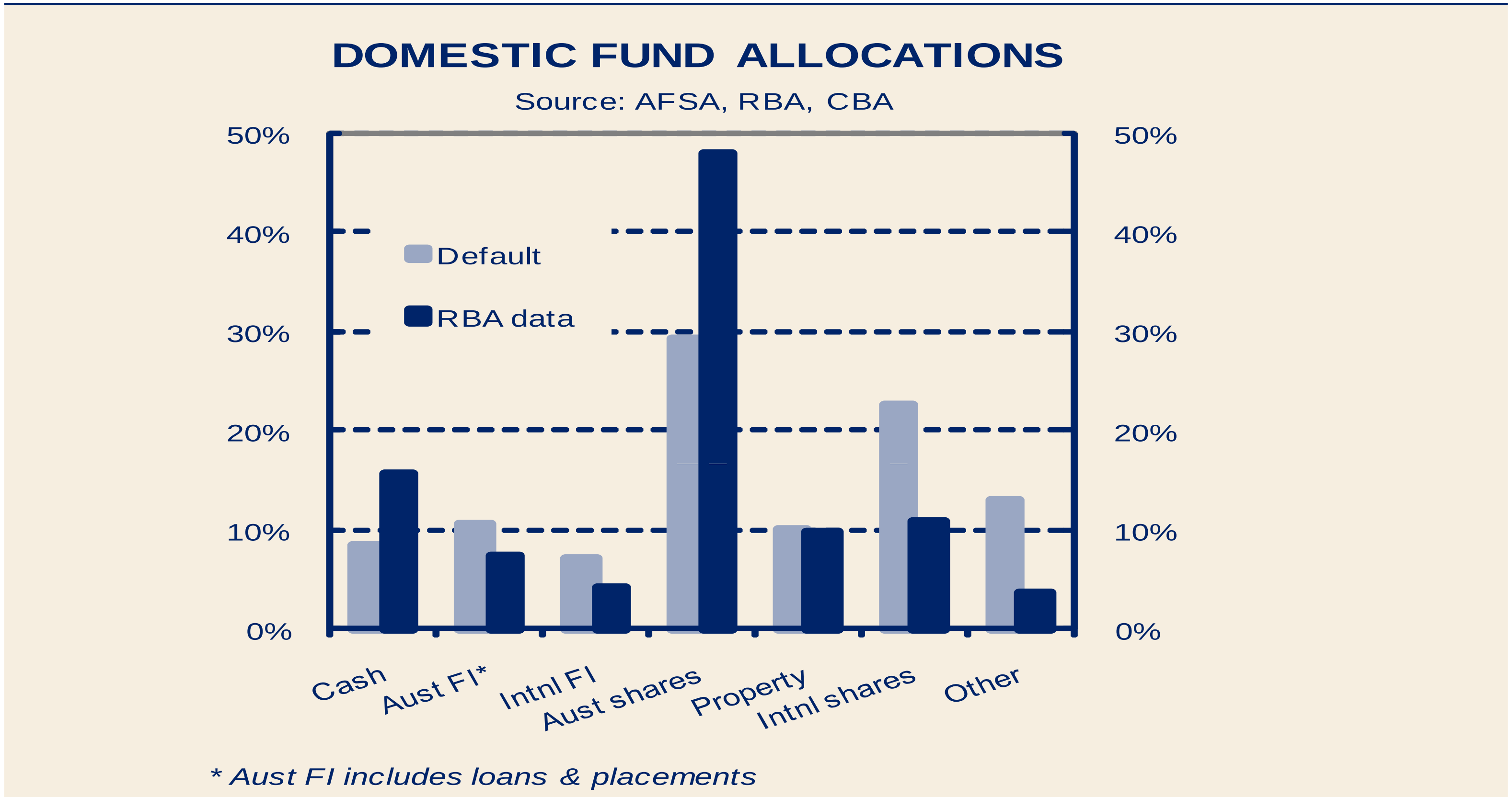
Growth in Australian managed funds



- Future growth of the Australian savings pool is expected to substantially increase the proportional allocation to offshore markets
- Compulsory superannuation underpins growth in the local funds

Source: CBA Managed Funds Report March 2010

Asset Allocation of Australian superannuation funds

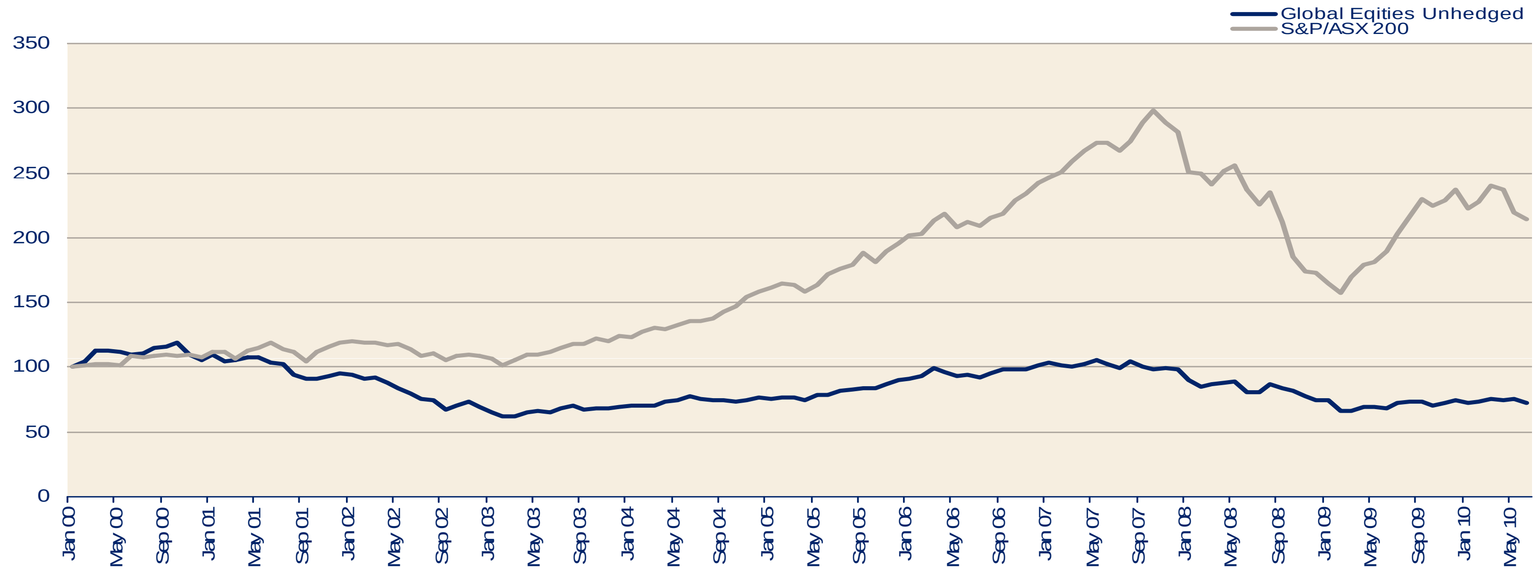


- Average/Default balanced portfolio has 22% in international equities and another 18-20% in other offshore assets
- Recent allocations to international assets has significantly declined, especially to international equities

Source: CBA Managed Funds Report March 2010

AUD the reason for recent asset allocation?

	Year to Feb 09 (%)	Year to Feb 10 (%)	Year to Jun 10 (%)
Australian shares			
S&P / ASX 200 Accum Index	-37	45	13
Global Equities			
MSCI Unhedged in AUD	-22	10	6
MSCI in local currency	-45	43	9
AUD	-31	40	4
MSCI Hedged in AUD	-45	45	12



Source: Bloomberg, S&P/ASX 200 Accum Index and MSCI World Index ex Australia, end Jun 10

Global Equities: the experience depends on where you live

MSCI World unhedged	1 Year %	3 Years % pa	5 Years % pa	7 Years % pa	10 Years % pa
AUD	9.7	-10.4	-0.9	2.5	-3.5
USD	30.8	-5.1	2.6	8.3	0.2
Euro	26.7	-7.7	1.5	3.6	-3.3
Sterling*	19.6	2.3	7.3	9.2	1.1
CAD	11.1	-8.3	-0.1	2.2	-3.0

- For Australian investors an unhedged investment into global equities has 100% currency risk
- Whereas a US investor has only 50% currency risk

Source: Aberdeen and Mercer Global Database as at Feb 2010. Sterling returns are represented by FTSE World Index

AUD: one of the western world's most volatile currencies

AUD/USD

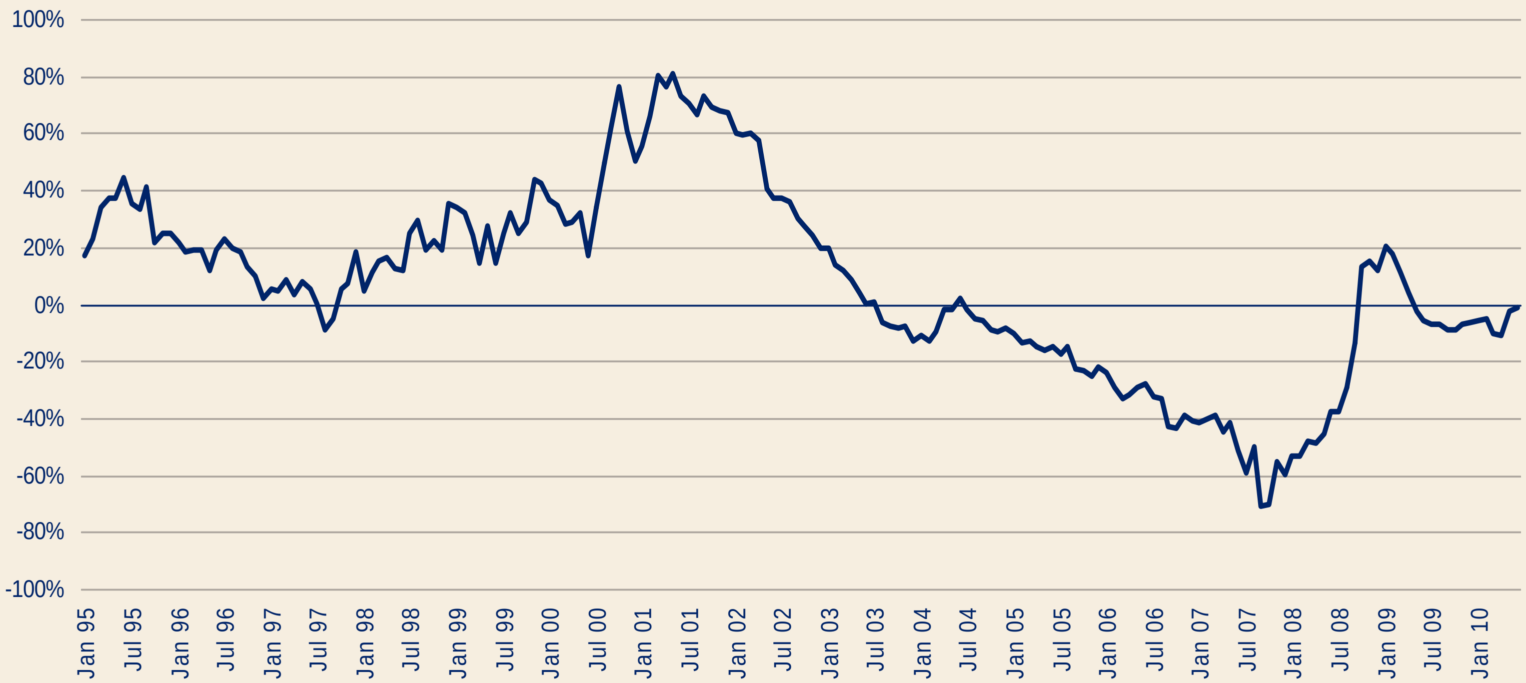
AUD volatility

Currencies	Standard Deviation	Exposure as % of portfolio
CAD	9.28	5.36
CHF	13.65	3.78
EUR	11.64	14.41
GBP	12.11	9.87
JPY	16.53	10.93
NOK	11.98	0.34
NZD	7.39	0.05
SEK	11.7	1.38
USD	11.6	53.87
Weighted Total	**12.14**	**100**

Source: Chart of LHS Bloomberg, Chart on RHS State St Global Markets Portfolio Solutions. Annualised standard deviation vs AUD July 1990 - June 2010. Percentage of portfolio is based on MSCI World (Ex-Australia) **Index as at June 2010.**

Relative global equity returns: un-hedged vs hedged

Relative Rolling 5 Year Returns un-hedged vs hedged index



- Very few periods of time when AUD was a zero sum game

Source: Bloomberg and Aberdeen, MSCI World Index ex Australia hedged and un-hedged, end June 10.
Returns are over rolling 5 years, not annualised.

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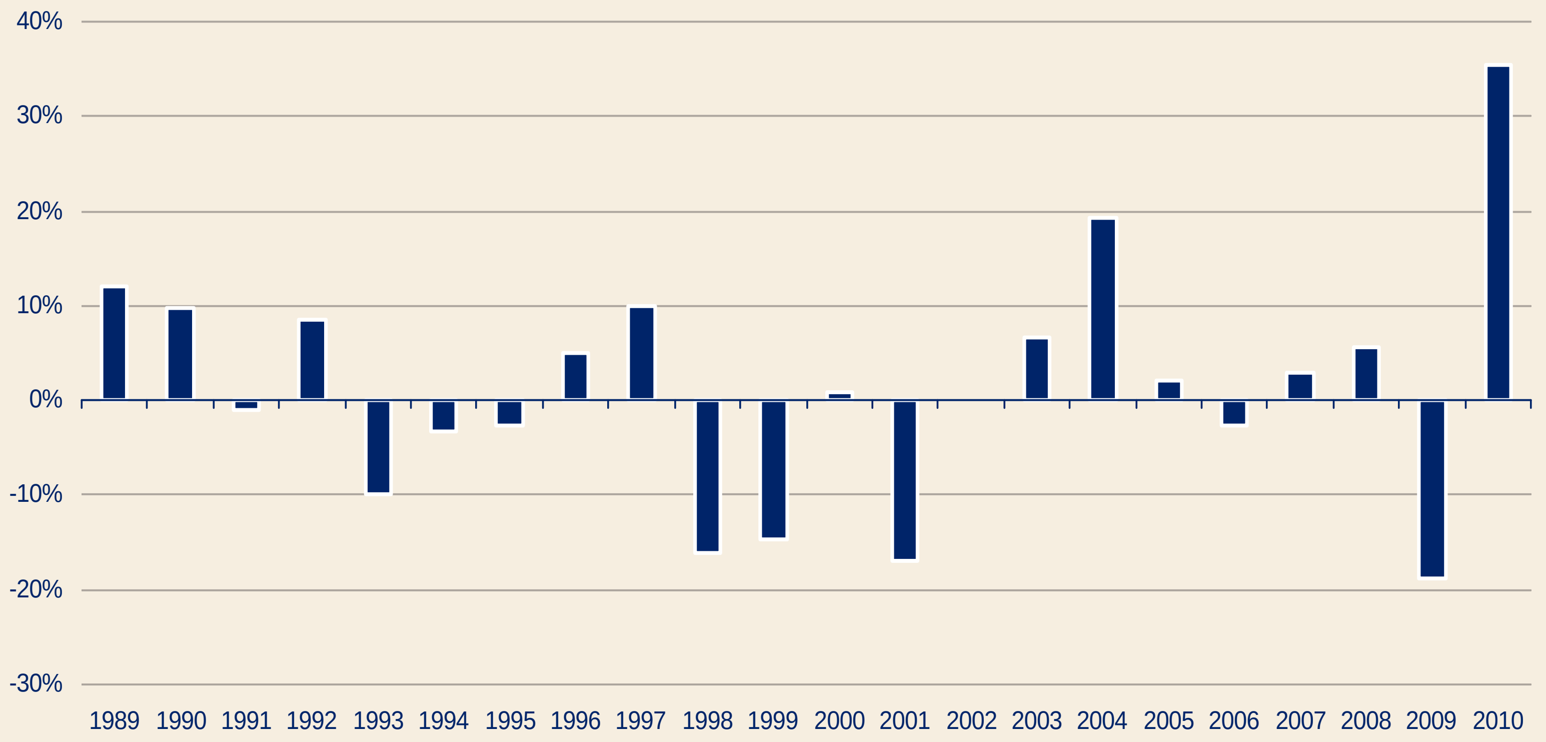
Hedged vs un-hedged returns in global equities

Relative annual returns of hedged vs unhedged index

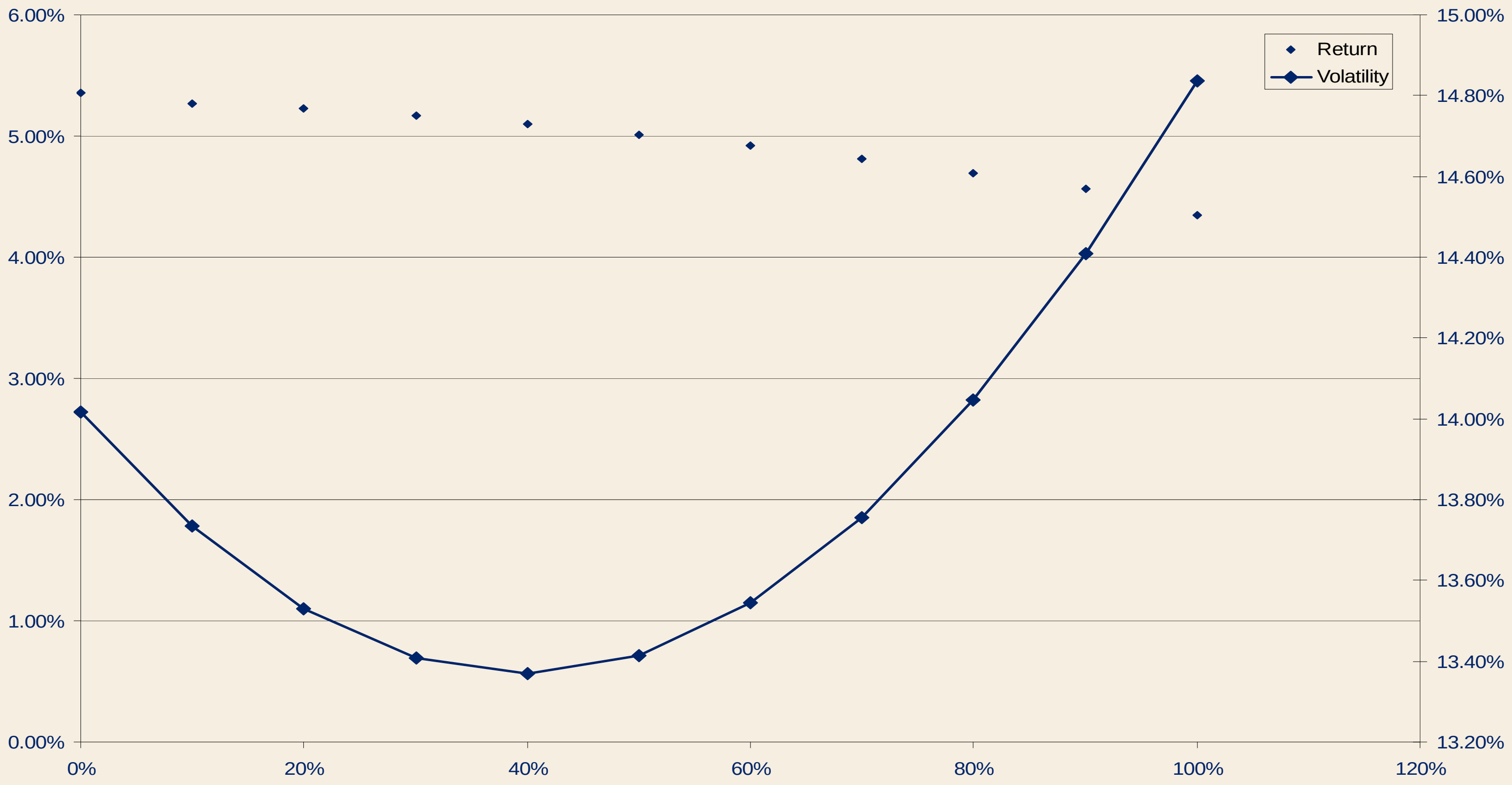


- Year to 2010 was the worst period in the last 20 years to be un-hedged

Source: Bloomberg and Aberdeen, MSCI World (Ex-Australia) Index, year to Feb 89 to Feb 10

The optimal hedge ratio?

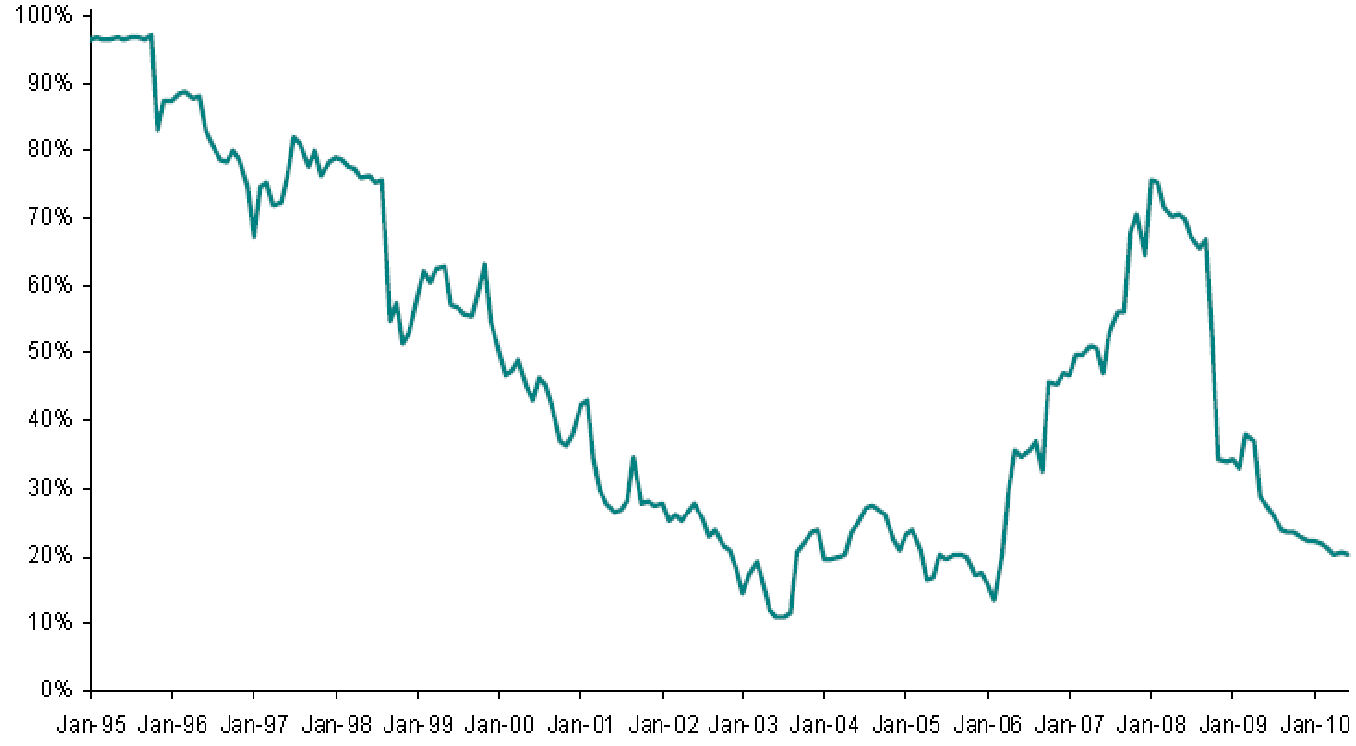
Portfolio Risk vs Hedge Ratio 1990 – June 2010



Source: Aberdeen Asset Management, Bloomberg MSCI World (ex-Australia) in AUD hedged and unhedged

The optimal hedge ratio changes throughout time

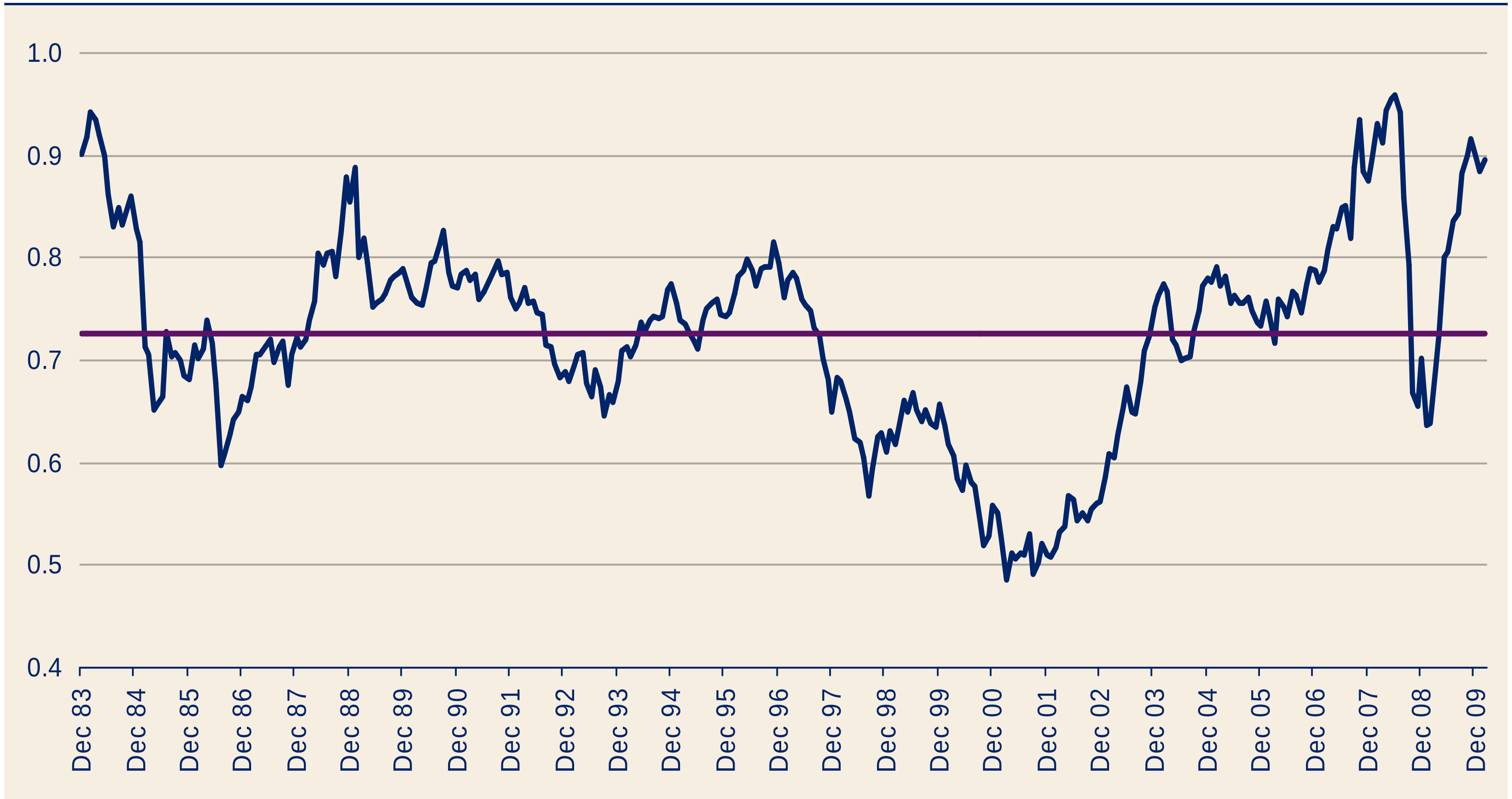
Optimal Hedge Ratios MSCI World Hedged - Rolling 5 yr periods 1995 - 2010



- In the last 5 years the optimal hedge ratio has varied from 10 – 75%.

Source: State St Global Markets Portfolio Solutions

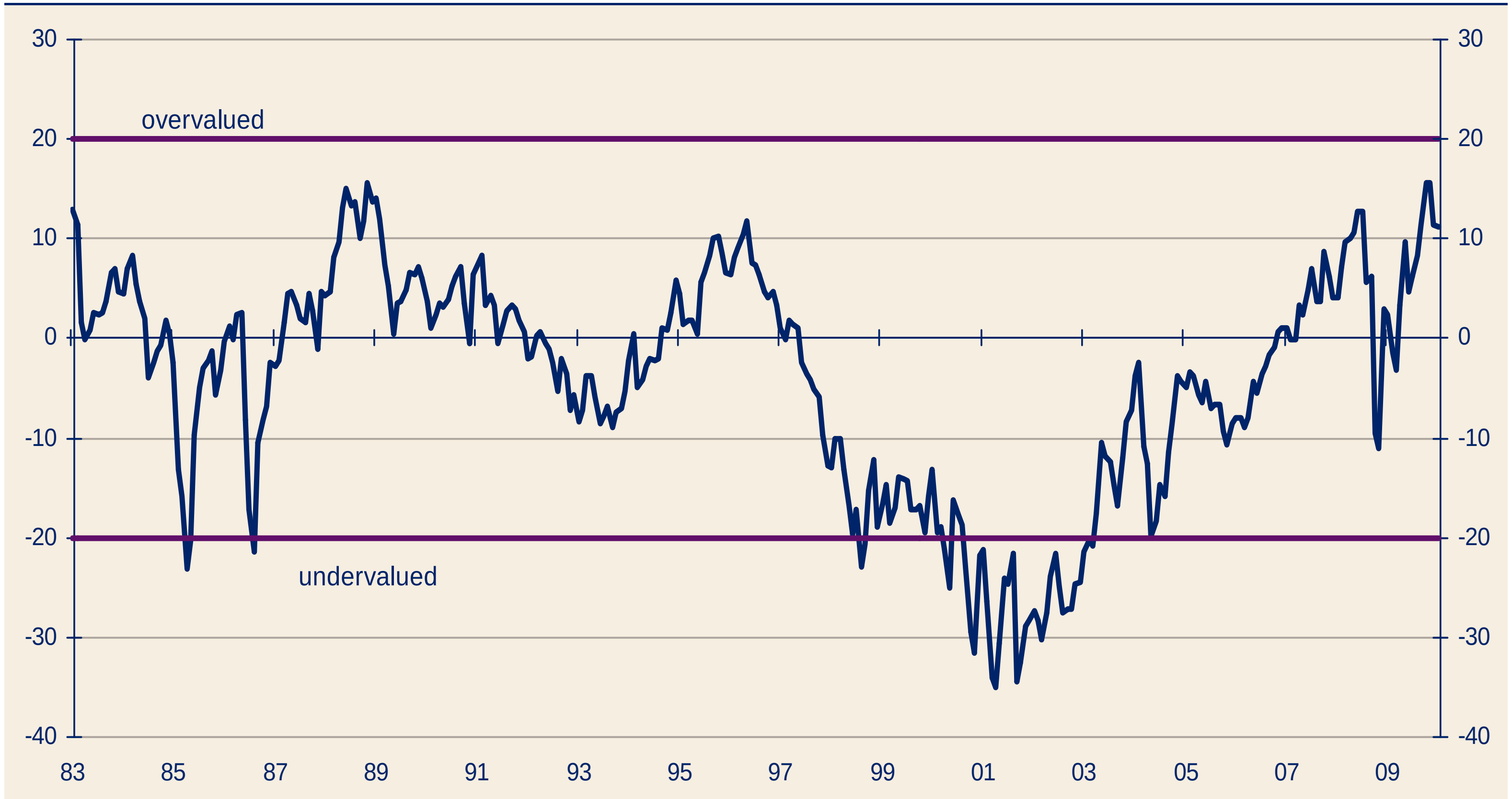
What drives the AUD?



- One year ago the AUD/USD rate was trading around its post-float average of about 72 US cents
- One year on it is back to trading at post-float highs!

Source: Bloomberg

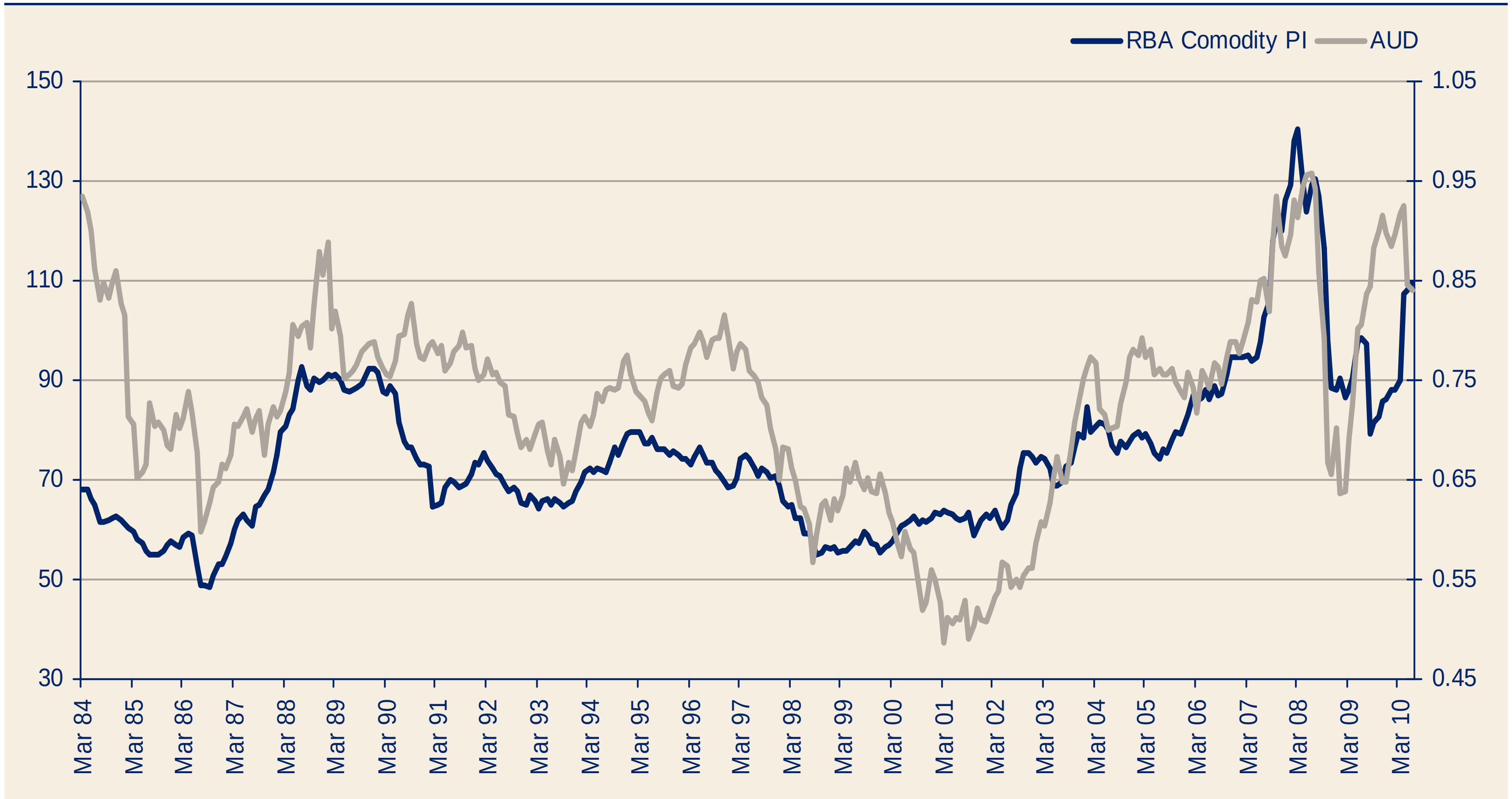
Medium term AUD valuation - PPP



- On a variety of measures the Australian dollar is trading at “expensive” levels

PPP = Purchasing Power Parity
Source: Bloomberg, Mar 10

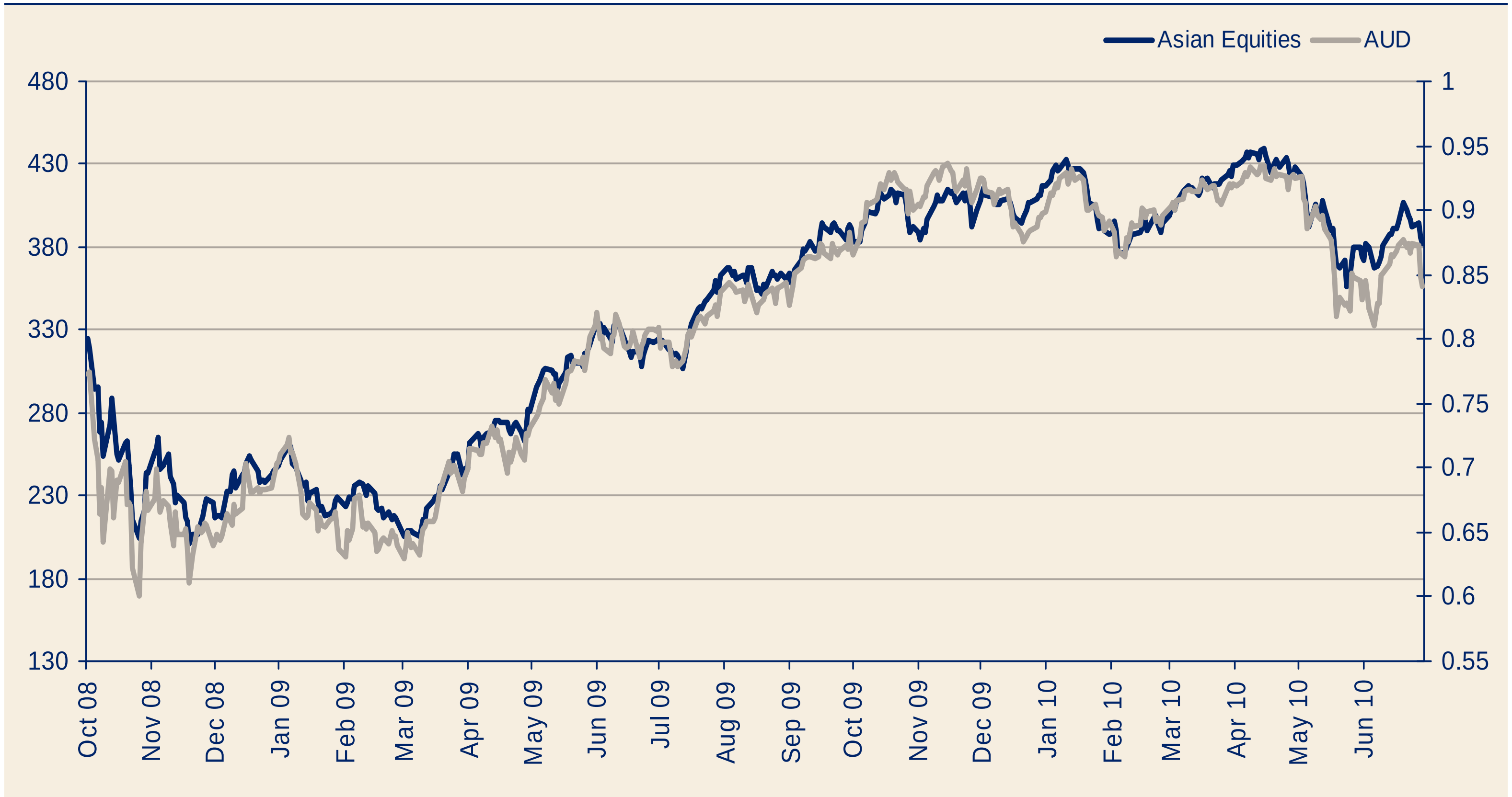
AUD vs commodity prices



- Part, though not all, of the answer lies with Australia's connection to Asia via commodity exports
- More recently, RBA rate hikes are likely to have pushed AUD beyond fair value based upon commodity prices alone

Source: Bloomberg, Reserve Bank of Australia

AUD vs Asian Equity Markets



- The AUD has also been trading like a proxy on global risk / the "Asian Growth Story" and quite closely to Asian equity returns
- What does this mean for future fair value of AUD?

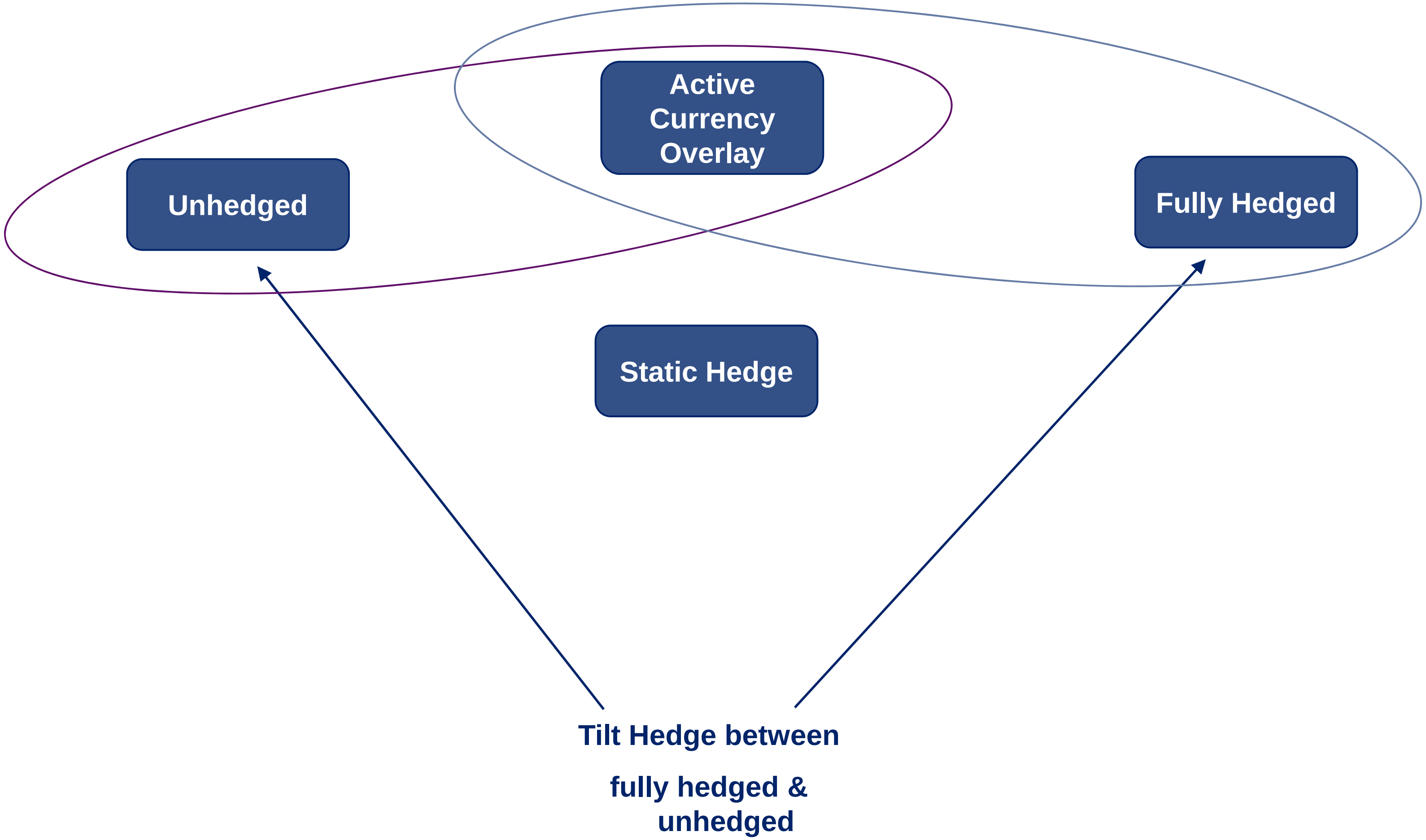
Source: Bloomberg

Simple rules for considering hedging

- Periods when the Australian dollar strengthens / consider hedging:
  - Rising global industrial production / rising commodity prices
  - Asian growth remains sound
  - RBA tightening / interest rate differentials favour Australia
  - Falling US dollar
  - Positive risk sentiment

- Periods to reduce levels of hedging:
  - When most / all of the above is priced-in !
  - Any periods of risk aversion (eg rising levels of market volatility / uncertainty)
  - Peak in regional growth / concerns for potential economic weakness
  - Mature phases of regional / global monetary tightening
  - AUD rates fall below global rates

Approaches to currency management



Benefits of each approach

- Fully hedged will benefit total returns when AUD appreciates
- Unhedged will benefit returns when AUD depreciates
- Switches between hedged and unhedged may incur transaction costs and tax
- Therefore, using an active currency approach with either hedged or unhedged strategies will adjust your exposure accordingly throughout an economic cycle

The case for active currency management

- The global currency markets are the largest and most liquid markets in the world
- However, many participants don’t trade currency to maximise profit
- Passive / transaction related trading by central banks, corporations, investment managers and others creates inefficiencies in foreign exchange markets
- There is a mismatch in the time horizon between foreign exchange participants that creates pricing anomalies over variable time periods.
- An abundance of research into currency strategies that take advantage of pricing anomalies; eg forward rate bias, momentum strategies, value and volatility strategies

tive currency management can reduce risk as part of an overall International Equity portfo

Active currency overlay – key features

- Aim to identify cycles where the Australian dollar is likely to appreciate vs. currencies in the global equity portfolios
- Risk reduction emphasis
- Utilise an overlay approach to manage existing portfolio exposures
- All hedges back into $A
- Focus on a proxy basket of currencies (EUR,JPY,GBP and USD) against the AUD
- Actively manage option and forward positions
- Maximum hedge ratio defined for existing clients / set against an un-hedged global equity benchmark

Main objective is to reduce the risk of $A appreciation impacting returns

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Target hedge ratio and strategy

- Undervalued vs valuation measures
- Positive fundamental data flow
- Positioning short vs. history
- Supportive risk regime
- Positive technical environment

Long AUD

Short GBP,JPY,EUR,USD

- Overvalued vs valuation measures
- Negative fundamental data flow
- Positioning long vs. history
- Negative risk regime
- Negative technical environment

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Summary of Implications

- Any un-hedged investment into offshore markets is an allocation into two asset classes; currency + local asset markets
- While alpha is more significant from underlying equity management, total returns are heavily influenced by currency strategy
- Currency impacts might be minimal over long time periods at select points of time,
  - However high levels of volatility around these points suggest it is imperative to manage client's currency risk
- Active currency overlays aim to smooth returns and volatility, but they will not insulate investors from large swings in the AUD
- Strategically allocations can be managed using a range of currency options
  - Eg: unhedged, actively hedged or hedged
- Given the Australian dollar's relationship with global growth / global risk, an investor must consider their hedging strategy before investing offshore

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Aberdeen's international equity options

- Aberdeen Actively Hedged International Equities Fund
  - Un-hedged benchmark
  - Up to 50% hedged to AUD
  - No allowance to short the AUD
- Aberdeen Fully Hedged International Equities Fund
  - Aims to be fully hedged to the AUD
- Aberdeen International Equities Fund
  - No hedging within Fund

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