

Unhedged International Equity: Don't judge a book by its cover

Overview

Unlike assets such as equities, real estate or bonds, unhedged foreign currencies do not provide an expected return. Although “hidden” within international investments, currency movements can have a considerable impact on a pension fund’s performance, including risk to meeting future liability payments in the base currency.

After a stellar 2013, calendar year 2014 was a poor year for unhedged international equity investments from a US dollar base. Specifically, the MSCI EAFE total return index delivered 23.3% in 2013, but lost 4.5% in the year that has just ended. These returns, however, mask the impact that US dollar (USD) strength has had on an EAFE equity portfolio. As we will show below, the return attributable to foreign equity risk has been positive in both 2013 and 2014. Conversely, the currency impact has been negative for both years. In 2013, the exceptional performance of international equities was hardly affected by the limited strength of the USD (there was an approximately 3% rise for DXY trade-weighted dollar index). In 2014, the excess return to foreign equities in local terms was a more modest 6.1%. However, the broad and sustained USD rally in the second half of the year more than offset this gain. The Table and Figure 1 below highlight the “hidden” risk of currency exposure by attributing total return to the separate components of international equity investments using the MSCI EAFE index in US dollar terms (unhedged), total return, price index, dividend yield and hedged (into USD) price index.

| | US dollar cash | Spot currency translation | Foreign cash on deposit | Foreign equity excess return (over local cash rate) | Unhedged EAFE return | Hedged EAFE return | Net Currency Impact ¹ |
|------|----------------|---------------------------|-------------------------|---|----------------------|--------------------|----------------------------------|
| | A | B | C | D | | | |
| 2013 | 0.28% | -3.27% | 0.55% | 26.76% | 23.29% | 27.12% | -3.01% |
| 2014 | 0.25% | -10.21% | 0.48% | 5.87% | -4.48% | 6.14% | -10.01% |

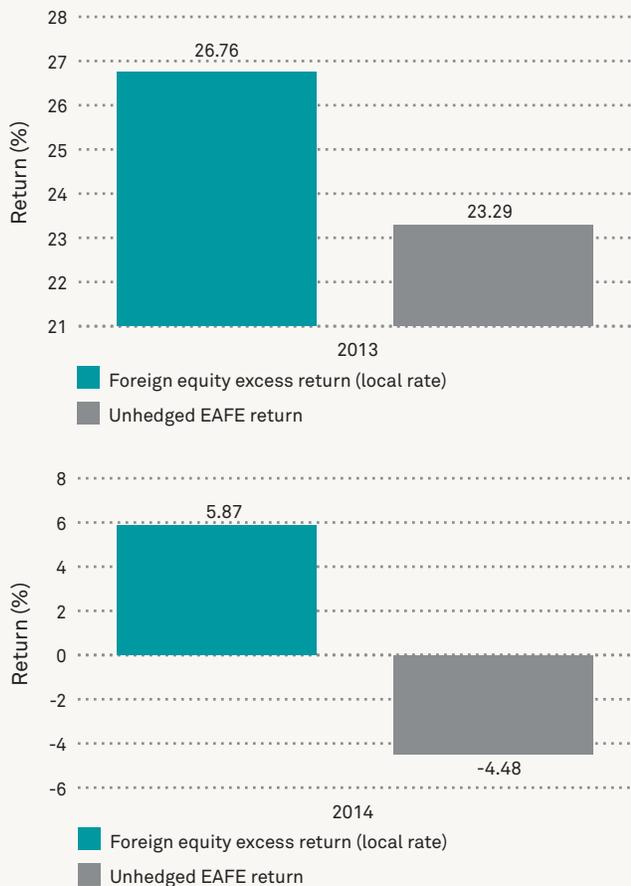
Source: Insight Pareto, December 31, 2012-December 31, 2014, Europe, Asia, Far East unhedged MSCI EAFE, Euro dollar 3 month mid-rate. US dollar terms (unhedged), total return, price index, dividend yield and hedged (into USD) price index.

¹ Figures net of compounding effect: Column C (1 + foreign cash on deposit) multiplied by Column B (1 + spot currency translation) divided by Column A (1 + US dollar cash) minus 1 = Currency impact.



Please note the value of investments and any income from them will fluctuate and is not guaranteed (this may be partly due to exchange rate fluctuations). Investors may not get back the full amount invested.

FIGURE 1: FOREIGN (LOCAL) AND UNHEDGED EQUITY RETURNS



Source: Insight Pareto, December 31, 2012-December 31, 2014, Europe, Asia, Far East unhedged MSCI EAFE, Euro dollar 3 month mid-rate. US dollar terms (unhedged), total return, price index, dividend yield and hedged (into USD) price index.

Currency impact in an historical context

Figure 2 puts the impact of recent US dollar strength into context. It shows the cumulative impact of currency effects on the EAFE equity index since 1988 by tracking the difference between the fully hedged index and an unhedged outcome. The chart illustrates the fact that the current US dollar rally, which began mid-2011, has cost unhedged investors about 20% relative to a fully hedged outcome. The magnitude, of this effect though sizeable, is relatively commonplace.

It is barely half the magnitude of the dollar's appreciation in the 1995-2001 currency market cycle. Having no currency policy or an unhedged policy stance is a decision that has been starting to attract some attention, and could potentially become quite uncomfortable in the near future with the improving US economy and the Federal Reserve's intention to begin normalizing monetary policy, a significant divergence from policy elsewhere in the developed and emerging world where 16 central banks have eased policy so far in 2015.

FIGURE 2: IMPACT OF CURRENCY ON THE EAFE EQUITY INDEX



Source: Insight Pareto, MSCI EAFE price index in US\$, MSCI EAFE price index hedged into US\$, December 31, 1987 to December 31, 2014.

Cumulative impact of currency on EAFE index calculated as follows: MSCI indexes are re-based to 12/31/97. Cumulative currency impact is calculated as:

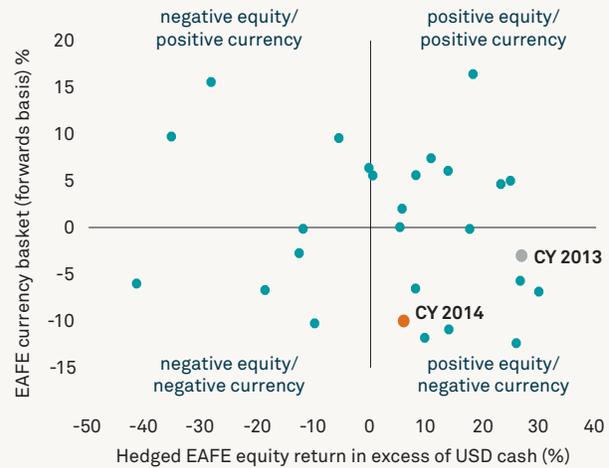
$$\frac{\text{Level of MSCI EAFE price index in US\$}}{\text{Level of MSCI EAFE price index hedged into US\$}} - 1$$

Worse things could happen

As highlighted above, the negative returns from currency slightly detracted from the very favorable equity return in 2013, and more than offset the more modest equity return in 2014. However, as Figure 3 illustrates, this is hardly surprising. In the 27 years since 1988, ignoring the three years when the impact of currency was essentially zero, half the time (12 years) currency returns were beneficial and half the time they were detrimental. The worrying aspect of the chart, however, is the handful of outcomes in the lower left quadrant. Here, both the currency outcome and the return to foreign equity risk are negative. Such outcomes may lead investors to question the whole rationale for international diversification. Given how relatively cheap and efficient it is to manage currency risk, this would be an unfortunate and largely avoidable outcome.

Sometimes exchange rates fluctuate in an investor's favor and other times they do not. Unmanaged (unhedged) currency is a passive decision taken in a somewhat arbitrary basket of currency exposures that add risk to the portfolio, but provide no expected return. This risk becomes increasingly important as allocations to foreign investments rise. Currency hedging is a risk management strategy that provides a way for investors to seek to reduce the inherent uncertainty in the value of international investments caused by exchange rate movements. It can be addressed strategically with a formal currency policy, and implemented tactically according to an investors risk tolerance.

FIGURE 3: CURRENCY IMPACT VS EQUITY IMPACT ON EAFE INDEX (CALENDAR YEAR RETURNS)



Source: Insight Pareto, MSCI EAFE index data, euro dollar 3 month interest rates. in US\$, MSCI EAFE price index hedged into US\$, December 31, 1987 to December 31, 2014.

Currency impact (vertical axis) calculated as calendar year returns on index shown in Figure 2.

Return to equity risk (horizontal axis) calculated as:

$$\frac{(1 + \text{MSCI US\$ EAFE US hedged return}) * (1 + \text{dividend yield})}{(1 + \text{US dollar cash yield})}$$

Find out more

Insight Pareto

200 Park Avenue, 7th Floor

New York, NY 10166

212.527.1800

insightpareto@insightinvestment.com

www.insightpareto.com



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