

Dispelling the myths

Opportunity costs of a passive currency hedge...

Local authority pension funds have up to 40% invested outside the UK. Unlike the rest of their portfolios, the associated currency risk is not diversified. Typically, 80% of the currency exposure is in dollars, euro and yen, and their exchange rate movements significantly impact portfolio returns.

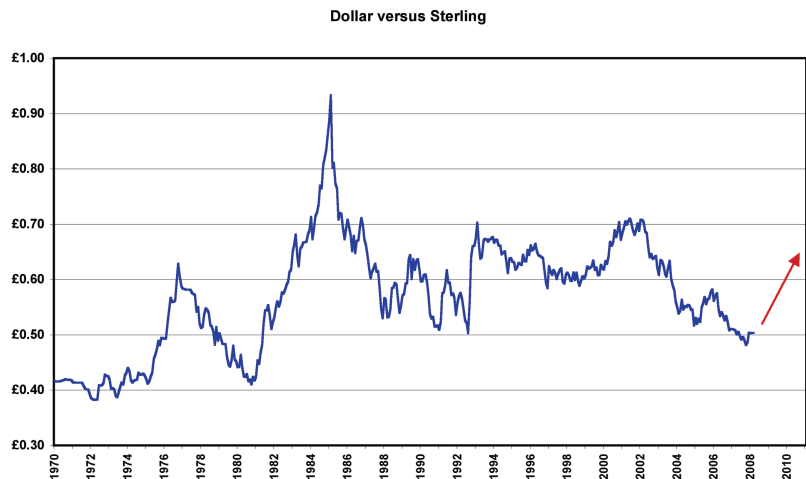
Managing the currency risk with a passive hedge is often seen as risk-free since it eliminates currency returns. However, it is not. Passive hedging has real and significant opportunity costs, and it creates delicate cash management issues.

Many currency managers and consultants see currency as unrewarded risk: there is no expected long-term return since currency returns average near 0%. It is assumed that what is lost on a passive hedge in one period is recouped in another. However, this ignores that currencies move in cycles. For example, the dollar has dropped 30% since 2002.

The illusion that passive hedging is risk-free was enhanced in recent years when currencies fell against sterling and passive hedges had a positive cash-flow. However, the currency cycle has now likely turned up. The yen has risen since August and the dollar has trended up against sterling from \$2.10 in November. The risk of a passive hedge is now how much it will cost if currencies continue up.

To see the cost of a 100% passive hedge when currencies rise, assume a pension fund has £100m in US equities. Since the dollar has gained 40%, or more, many times in the past, assume sterling drops from \$2 to \$1.50 over the next three years, ie. the dollar gains 35% (see chart).

That 35% rise will cause a £35m loss on a £100m passive hedge if US equities move sideways, and more if they rise.



Because UK interest rates are above US rates (6% vs. 3%), the passive hedge will earn 3% (£3m/year), resulting in a net loss on the hedge of £26m (approximately £9m/year). That loss must be paid; it is not a valuation issue.

Where will the cash come from? Although the investment's value has increased 35% due to the dollar's rise, cash must be found in Treasury or raised by selling equities. If cash reserves are used and hedges are settled periodically, the lost cash will no longer earn interest and £1.4m in interest is foregone.

If the £100m is invested in 100 S&P 500 Index shares (to simplify the example) and shares are sold to pay the hedging loss, then nine S&P 500 shares must be sold in the first year, followed by nine more in each of the next two years, leaving a fund with 73 shares. Fewer shares now participate in market gains and dividends received have shrunk.

In addition, after the passive hedging loss has been paid, the dollar may not return to \$2 in future years to permit a passive hedge to recover the lost cash.

Is there a better solution? Consultants agree that currency managers can add value placing and removing hedges as

currencies decline and rise. An 'active' hedging program can protect against currency losses and permit participation in gains when currencies rise, minimising cash losses when currencies rise cyclically. The superior cash-flow profile of an active hedge eliminates much of the very real opportunity costs that passive hedging creates when currencies rise. An active hedge can also generate a higher long-term return by not forfeiting gains and cash when currencies rise – an important benefit for LGPSs seeking all the return they can get and with competing claims the cash managed in their Treasuries.

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