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Established 1981

A.G. BISSET & CO'S ULF J. LINDAHL looks at the underestimated risks of a passive currency hedge

SKATING ON THIN ICE

Passive hedging has become popular, but is it risk-free?

Passive currency hedging is seen as a risk-free strategy that can reduce or remove currency losses from an internationally invested portfolio. However, passive hedging is not risk free.

Consultants see currency as an unrewarded risk: There is little if any expected return while the return volatility is high from year to year. It is true that the expected return is near zero when monthly and annual returns are averaged.

Since 1970, the average annual return in the dollar against sterling was +1.1% with a standard deviation of 11, while in the past decade it was -2.1% with a standard deviation of 7. Hence, it is assumed that what is lost on a hedge in one year is gained back in another year, and that, therefore, there is little risk associated with a passive hedge.

This "illusion" has been reinforced by the fact that passive hedging produced gains in recent years when the dollar, the euro and the yen, which represent most of the risk in most UK pension portfolios, declined against sterling.

What are the risks of a passive hedge?

The risks of a passive hedge are tied to cash-flows. When declining currencies are hedged, hedging gains will be paid to a portfolio that offset the valuation loss that occurs when currencies decline. It is the opposite when currencies rise.

A hedge will now generate losses that must be paid. Since the average rise in the key currencies (USD, EUR and JPY) averaged 8.4% in the 19 years in which they rose during the past 33 years, it can be expected that every other year a 100% passive hedge will suffer a loss of 10% (a 50% hedge a loss of 5%).

However, because currencies move in cycles of 3-5 years, passive hedging losses accumulate in the upward phase of the cycle. We believe an upward cycle has begun since the dollar, the yen and the euro have risen significantly since last August.

As hedging losses grow in the upward phase of the cycle, underlying securities must be sold. Assume an investment in the S&P 500 Index and that the dollar moves from \$1.95 to \$1.50 over the next two to three years (up 30% – see chart right), then, as shares are sold, an investor will have fewer and fewer of them and will receive less and less in dividends (which historically have made up a large portion of total, long-term returns). If equities move lower, the number of shares that must be sold will increase since they are worth less and less.

Even with a 50% passive hedge, the negative cash-flows will be significant and they will impact underlying investment returns and asset allocations.

But what if I place a highly leveraged pooled vehicle alongside a passive hedge?

Several UK pension funds have implemented programs with a "strategic" passive currency



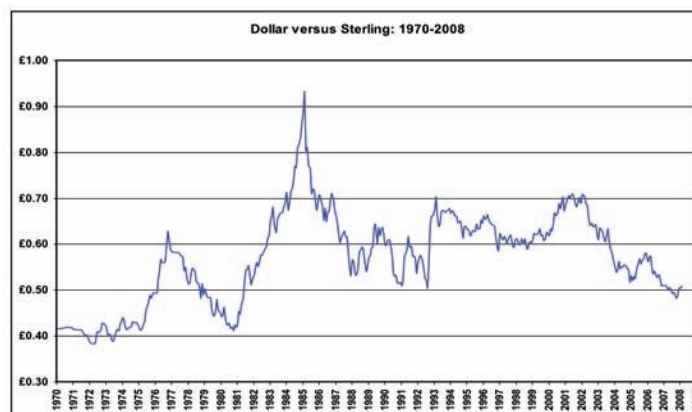
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hedge combined with a leveraged currency fund, or pooled vehicle, expected to generate a return of 1% to 2% when "spread" over a fund's entire foreign investments.

Having made the "strategic" decision at the fund level, the currency manager is no longer responsible for whether the passive hedge generates positive or negative cash-flows and is only measured based on its currency fund performance.

But at the pension fund level, if currencies rise and they are 50% passively hedged, the leveraged currency program, which usually requires an investment, must first have a return that equals that of the assets that were sold to invest in the currency fund, followed by a return that offsets the 50% passive hedging loss before any "new" currency return or currency alpha accrues to a portfolio.



Thus, when the two pieces are combined, there is a high probability that a "passive

+ leveraged fund" strategy will be found unsatisfactory.

Is there a better solution?

At A. G. Bisset & Company, we believe the primary concern of investors with significant international exposures is to manage that underlying currency risk to avoid unnecessary losses.

The management needs to be executed with an aim to actively hedge and unhedge exposures in the short-term while applying a strategy that adapts to the upward and downward phases of the 3-5 year currency cycle to maximize hedging returns while minimizing negative cash-flows and the ugly effects they can have on a portfolio.

Bisset's blended active currency overlay strategy successfully removed its passive hedge element last August and permitted clients to retain their passive hedging gains of the preceding periods. Most recently, Bisset has introduced this blended strategy, (specifically developed for sterling-based investors), in the United States, gaining a mandate from the City of Philadelphia's Board of Pensions and Retirement.

The success of the blended strategy was one of the reasons A. G. Bisset & Company won Global Pensions magazine's "Currency Manager of the Year Award" in February 2008.

The future is always uncertain, but the historical cyclicity and associated large and prolonged trends in currencies suggest that the time for a UK investor to have a passive hedge could be one of the least opportune ones in years. Yet, the currency risk, when 30-40% is invested internationally, is simply too large to be left unmanaged.