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Does hedging mean better returns?

Study shows that unhedged portfolios generally performed better

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The stunning appreciation of the Canadian dollar from a low of US62¢ in January 2002 to a 13-decade high of US$1.09 in November 2007 dramatically undercut U.S. equity returns. Many beleaguered advisors facing dismayed clients turned to the torrent of currency-hedged funds served up by the fund industry, only to get whipsawed as the plunging loonie lifted the performance of unhedged equities in 2008.

With many currency hedging studies focused on short time frames, my firm, **Tacita Capital Inc.** of Toronto, analyzed the returns of equity portfolios composed equally of stocks represented in the S&P/TSX composite index, the S&P 500 composite index and the MSCI EAFE index. The study looked at three levels of currency hedging — unhedged, 50% hedged and fully hedged — for the 39-year period from 1970 to 2008.

Although currency investment is a zero-sum game overall, this was not the case for Canadians. The unhedged portfolio outperformed the partially hedged and fully hedged portfolios by 45 basis points and 94 bps a year, respectively. Compounded over 39 years, the unhedged portfolio created 40% more wealth than the hedged portfolio. The long-term depreciation of the C$ relative to the US$ and the Japanese yen in particular bolstered unhedged returns. The probable causes are Canada's poorer productivity growth and higher inflation rate. The unhedged portfolio also had higher returns in 23 out of 35 five-year rolling periods. Notably, its annualized standard deviation of 14.7 was slightly less than that of the hedged portfolio (15.2) and virtually equal to that of the partially hedged portfolio (14.8).

The future may vary from the past but advisors need to consider this historical experience. First, one of the arguments for not hedging foreign equities is that it improves a portfolio's inflation-fighting capability if higher relative domestic inflation contributes to a depreciating currency. This contention seems validated. Second, similar to Japan in the 1970s and 1980s, an unhedged strategy for faster-growing markets such as China appears more promising. Finally, currency hedging does not reduce long-term portfolio volatility — advisors lured into believing this because of the 2002-2007 experience were myopically misguided.

The argument for currency hedging is primarily behavioural. At the end of 2007, the five-year cumulative return of a fully hedged portfolio was 110%, compared with the 67% return of the unhedged portfolio. It is the scale of this differential that drove many investors to jump on the hedging bandwagon at the most inopportune time. Helping clients manage emotionally driven, performance-corroding behaviour is a critical task of advisors. In that vein, a partial hedging strategy can play a role. It is easier to persuade a client to stay on course when your 50%-hedged strategy delivered a five-year 87% return at the end of 2007 while still getting one-half the benefit of the plunging loonie in 2008.

There is another reason to consider a partial hedging strategy. One of our findings is that the C$ is increasingly a petro-currency. From 1970 to 1989, changes in the C$/US$ exchange rate had a minimal correlation of 0.11 with changes in the price of West Texas crude. From 1990-2008, this correlation increased to a material 0.56, indicating that a rising C$ and negative currency effect is increasingly associated with rising oil prices and vice versa. With oil prices currently at a cyclical four-year low, the potential for an upswing in oil prices and the C$, with a consequent hit to foreign equity returns, has probably grown.

There has never been a better time to ensure that your hedging strategy effectively handles both portfolio and investor considerations. **IE**

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