

CURRENCY HEDGING: AN OPTIMAL SOLUTION FOR ALL INVESTORS?

Foreign markets offer many investment opportunities, which in turn may offer good potential returns. The performance of foreign funds, however, may be impacted by adverse fluctuations in exchange rates between foreign currencies and the Canadian dollar. This is what is known as the “foreign exchange risk” or “currency risk”.

Since the Canadian dollar has been highly volatile in relation to leading currencies in recent years, currency-hedged funds could offer some real advantages. In addition to allowing access to actively managed products, they reduce the impact of foreign exchange risk in certain circumstances.



WHO SHOULD HEDGE THEIR INVESTMENTS AGAINST EXCHANGE RISK?

It may be wise to invest in a currency-hedged fund if exchange rate fluctuations are driving down the returns of assets invested in foreign countries. However, **the decision whether to hedge the foreign exchange risk depends mainly on the investor's goals and risk tolerance.** If you're investing in foreign funds, you'd do well to consider the following questions:

- How long is the investment horizon? Since exchange rate fluctuations tend to balance out over time, currency variations have less impact when the investment holding period is oriented towards the long term.
- Are the investor's decisions easily influenced by short-term variations in the value of their portfolio? The impact of exchange rate fluctuations on short-term returns may be positive or negative. If the investor's decisions tend to be influenced by short-term performance, a currency-hedged solution may be used to help maintain a sense of discipline.

Nevertheless, some people believe that these fluctuations cancel each other out over the long term. Since hedged returns may be positive or negative, the long-term effect could be nil and the hedge would be useless. On the other hand, others believe that most investors don't hold their investments long enough to see the effects of fluctuations in exchange rates disappear.



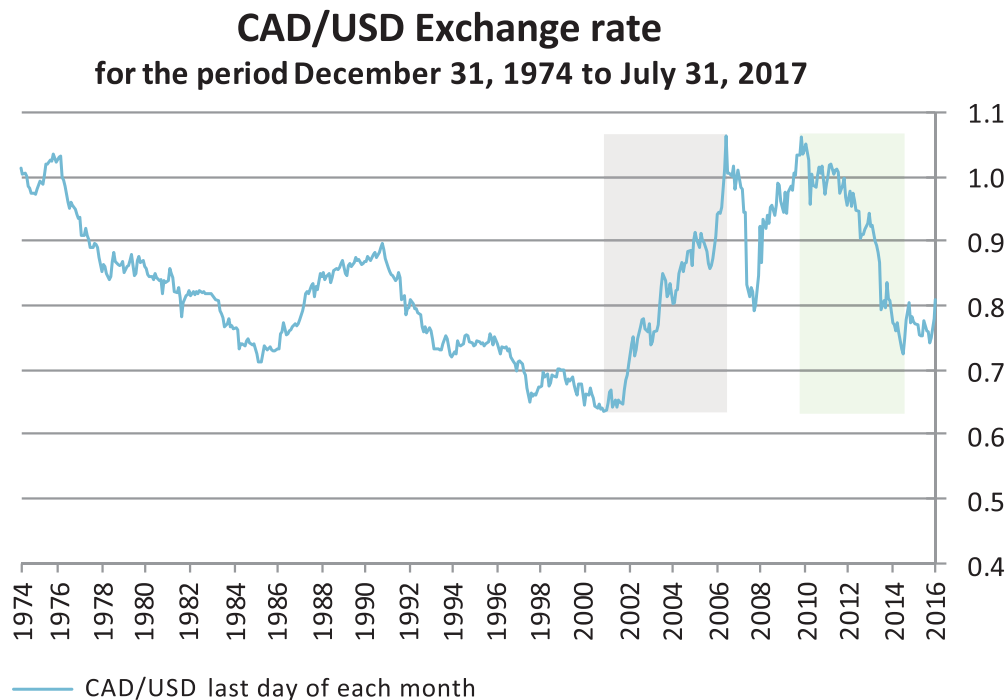
Type of fund	Investor's total return
Non-currency-hedged foreign fund	Return of the fund's securities + currency gains or losses
Currency-hedged foreign fund	Return of the fund's securities

WHAT PROPORTION OF FOREIGN INVESTMENTS SHOULD BE HEDGED: 0%, 50% or 100%?

Investors may wish to avoid a non-currency-hedged situation if the Canadian dollar is gaining in value; they may also wish to avoid being hedged if the value is falling. The decision to opt for a 0% or 100% hedge may end up reducing portfolio diversification; that's why partial exposure may contribute to diversification.

For instance, from 2011 to the present day, an investment in a non-currency-hedged U.S. fund (0%) would have generated a return of over 30% simply due to the depreciation of the Canadian dollar. However, the opposite situation occurred from 2002 to 2007: the value of the Canadian dollar went up considerably, so a non-hedged fund would have generated no benefits.

Given the unpredictable nature of exchange rates, investors might opt for the wrong strategy and come to regret a 0% or 100% hedging decision. In order to minimize the "risk of regret", **one solution might be to opt for a partial currency hedge, i.e. investing in currency-hedged funds in a proportion of around 50%.** That could end up giving investors a sense of protection against losses if the Canadian dollar is on the upswing; it could also mean gains if the Canadian dollar is losing value.



HOW DO MANAGERS HEDGE A FUND?



Generally speaking, in order to put a currency hedging strategy in place, fund managers enter into agreements enabling them to sell a forward or futures contract for each currency they wish to hedge the portfolio against. If one of these currencies depreciates vis-à-vis the Canadian dollar, the fund would then record a gain on the value of the forward or futures contract, which at the same time would offset the exchange loss on the investment. On the other hand, if this same currency appreciated against the loonie, the fund would record a loss on the value of the forward or futures contract, which would end up offsetting the currency gain on the investment.

In both situations, the impact of the exchange rate fluctuations would be balanced out. The U.S. equity, international equity, global equity and all country world index (ACWI) strategies are among the investment solutions for which a hedging strategy is most likely to be in place. Hedging an emerging market strategy is usually more complicated as some currencies may be harder to trade.

WHAT HEDGING STRATEGIES ARE AVAILABLE?

Systematic hedging of foreign exchange risk means automatically seeking protection as soon as a commitment appears. The advantage of this approach is that it completely eliminates currency risk at the onset. In contrast, **tactical hedging** gives fund managers the latitude to decide on a methodology that will determine when the foreign exchange risk will be covered (or not). This approach has the advantage of allowing fund managers to find the best timing for hedging and determine exchange rates trends. This becomes a source of value added for the fund.

The fund managers we selected use either of these approaches or a combination thereof:

Available options for currency-hedged SSQ GIFs		
Asset class	Name of SSQ GIF	Type of hedging
Bond funds	PIMCO Global Bond	1/3: tactical hedging (10%) 2/3: systematic hedging on assets invested in developed countries (70%)
	CI Signature Corporate Bond	Tactical hedging (80% target)
Balanced funds	CI Signature Global Income and Growth	Foreign fixed income: systematic hedging (100%) Equities: tactical hedging (100%)
Foreign equity funds	Fiera Capital Hedged U.S. Equity	Systematic hedging (100%)
	Hexavest Hedged Global Equity	Systematic hedging (100%)
Specialty funds	Lazard Global Infrastructure	Systematic hedging (100%)

Exchange rate fluctuations have a big influence on the total returns of funds with foreign investments: adopt the right strategy with SSQ’s currency-hedged GIFs!



RENOWNED MANAGERS



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