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Why it's time to consider currency hedging your portfolio

By Perpetual Asset Management
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With the Australian dollar trading below long-term averages and expected to rise as the US dollar peaks, it's time to think about protecting overseas investments with hedging. JAMES HOLT explains

- Hedging can offset currency movements
- Rising AUD could crimp returns on overseas assets
- Find out about Barrow Hanley Global Share Fund- Class A (Hedged)

THE Aussie dollar is below its long-term average against the US dollar, indicating it might be time for investors to consider adding currency hedging to global equities portfolios.

That's the view of James Holt, head investment specialist with Perpetual Equities.

Hedging can protect a portfolio against foreign-exchange fluctuations by offsetting currency movement effects on the Australian-dollar value of an overseas investment.

The Australian dollar's floating exchange rate means its value is determined by the market through supply and demand.

This allows the currency to adjust naturally to economic situations, helping protect Australia from economic shocks.

But the currency's movements can add an extra layer of uncertainty to global investments. This can add to returns from overseas assets when the Aussie falls or crimp returns as the Aussie rises.

"One of the conundrums of investing globally is what to do about currency, as foreign currency exposure presents an additional risk for global equity investors," says Holt.

"An investor needs to consider not only whether the global asset they are invested in will generate a return, but whether exchange rates will move in their favour – or against them.

"This is why some investors opt for currency hedging, to reduce the impact of currency fluctuations on their portfolio."

What is hedging?

Simply put, a currency hedge is an instrument that offsets any currency movement effect on the returns of an overseas investment, says Holt.

As a result, investment returns should reflect the actual returns in the overseas country in which they were made, without any additional impact from foreign exchange movements.

"This gives investors the option of being able to invest offshore without having to worry about currency movements impacting on their investment choice."

Barrow Hanley Global Share Fund - Class A (Hedged) is an example of a hedged fund distributed in Australia by Perpetual Group.

The fund uses hedging strategies with the aim of providing protection from adverse currency exchange rate movements.

What does hedging mean for investing?

Consider an Australian investor who buys a US stock and finds that it doubles in value.

If the Australian dollar did not move relative to the US dollar during the period of investment, then the gain would be 100 per cent.

But if the Australian dollar halved in value, the value of the investment in Australian-dollar terms would rise by a further 100 per cent – reflecting both the original return on the shares, as well as the exchange rate effect.

The same process could happen in reverse.

If the Australian dollar doubled in value, then this would completely offset the USD rise in the value of investment, leaving the investment value in Australian dollars unchanged.

"These examples are extreme, but they highlight the degree to which currency movements can significantly boost, or significantly negate, the value of overseas investments when they are made," says Holt

Is now the right time to hedge?

Foreign exchange movements can often be supportive for Australian investors and augment global returns.

"Most global equity funds in Australia are 'unhedged' – meaning returns reflect both the stock and exchange rate movements," says Holt.

But with the Australian dollar trading below its average exchange rate since floating in 1983, it may be time to consider taking a hedged position.

“Since the float in 1983, the Australian dollar has risen as high as $1.10 relative to the US dollar in July 2011 and as low 48c in April 2001.

“These large swings in currency exchange rates can have significant impacts on investors returns.

“No one can be certain about the future value of the Australian dollar, but it now trades below the average exchange rate it’s enjoyed against the US since 1983.

“The dollar has sold down to current levels partly because the RBA’s cash rate is lower than that of many offshore central banks, including the US Federal Reserve.

“Australia’s battle against inflation has been a few months behind America’s.

“The RBA is under pressure to keep interest rates a bit higher for a bit longer to contain inflation, just as the Fed appears poised to reduce interest rates.

“That could well be a catalyst for a strengthening in the Australian dollar.”

Impact of commodity prices

Stronger commodity prices could also be supportive of a higher Australian dollar.

“All investing involves risk, no matter the asset,” says Holt. “That’s why some active portfolio managers use different hedging tools to help balance risks and opportunities within portfolios.

“For those who do not want exposure to currency movements, a fully hedged global equity fund would serve that purpose.

“Investors could also choose to have a mixture of fully hedged and unhedged funds if they do not have a firm view regarding currency movement.”

About Barrow Hanley

Barrow Hanley is a global leader in value investing, managing assets for clients for more than 40 years.

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Barrow Hanley is distributed by Perpetual Group in Australia.

Contact a Perpetual Group account manager