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FRIDAY NIGHT 'LIGHTS

Currency Hedged Share Classes… Are they really?

28th October 2016

Whether it be European, US, Japanese, EM Equities or any international bond funds, for Sterling investors into those underlying assets, they are also undertaking currency exposure in similar magnitude, IF the investment in question does not undertake some sort of hedging mechanism to mitigate the currency risk. Of course, some of you may be comfortable with the currency risk as you may run your asset allocation more holistically with regards to FX and therefore apply an FX overlay at a portfolio level or indeed run currency positions given your market 'view'. However, for those investors who wish to hedge their currency exposure within each international fund or asset and therefore use currency hedged share classes, there are some notable considerations to make.

The first obvious question to ask oneself is; when buying a GBP share class, does the fund simply take my GBP convert into the base currency of the fund to buy the underlying assets (which leaves me the investor with the currency exposure), or do they operate a hedging mechanism? Once you've answered that question and indeed, believe you're investing in a hedged share class, what else should you be looking at?

In very simple terms, funds who operate currency hedged share classes do so in very similar ways. They will look at the underlying value of the assets in each currency and effectively enter into an FX forward contract whereby they sell the foreign currency and buy GBP. The frequency of that hedge is the critical element that we will discuss and indeed illustrate below.

With regards to the frequency and the impact that can have, let's take a very simple example. Today you invest £100 into a foreign company, which you believe you are going to hold for 6 months. To hedge your immediate currency exposure, you will be required to forward sell the foreign currency and buy GBP for settlement in six months' time. Simples I hear you say, we're hedged. Well the next question is, what happens if that company appreciates in value over that time period and the currency weakens versus the GBP. Well your original £100 is hedged but anything in excess of this (i.e. the appreciation of the underlying asset itself) is not and whilst the asset itself has appreciated in the foreign currency, that appreciated amount once converted back into GBP will of course be less.

And therein lies the crux of the issue when considering currency hedged share classes. How often does the fund hedge; is it daily, weekly, monthly or by some other means? Other means being an automated algorithm that looks at asset moves versus FX moves, or interest rate differentials between the two currencies, since the last FX hedged was implemented. There are also other factors such as major subscriptions and redemptions into the fund, which may remain unhedged during a month and of course the unrealised profit or loss in the FX forward itself that may create a cash drag or indeed benefit to the share class.

It therefore goes without saying that the more volatile the underlying assets and FX are, and (*another boringly technical point here*) how uncorrelated the FX and asset moves are, whilst the less frequently you hedge, the more likely that a tracking error (both positive and negative of course) is likely to occur. Indeed, the most optimal hedge would be to adjust your FX hedge every time the underlying asset changes in value. This dynamic hedging mechanism is effectively what our old friends at the investment banks do, when they sell you a Quanto option. Reminder, a Quanto option pays the % performance of a foreign

Product	Participation
Topix Supertracker, 6yr, GBP daily hedge, 70% EKIP, final year averaging	200%
Topix Supertracker, 6yr, GBP Quanto, 70% EKIP, final year averaging	130%

Rates (bps)	Current	Week Chge
GBP 1yr	58.20	+2.50
GBP 3yr	70.60	+8.10
GBP 5yr	85.50	+12.30

Equity Indices (%)		
FTSE 100	6967.69	-0.75%
S&P 500	2151.13	+0.47%
Nikkei 225	17446.41	+1.52%
Eurostoxx 50	3066.90	-0.35%

Currencies (%)		
GBPUSD	1.2144	-0.74%

5yr Credit Spreads (bps)		
Citigroup	78.83	+1.81
Credit Suisse	133.00	+ 0.73
Deutsche	219.48	+ 10.71
GS	92.22	+1.39
HSBC	71.22	-3.75
JPM	63.08	+1.43
MS	88.82	+1.69

Commodities (%)		
Gold	1266.70	0.02%
Oil	49.54	-2.58%

3m Implied (vol pts)		
FTSE 100	13.95%	0.64%
S&P 500	13.65%	0.43%
Nikkei 225	17.51%	n/c
Eurostoxx 50	18.87%	-0.21%

5yr Implied (vol pts)		
FTSE 100	19.76%	0.11%
S&P 500	20.75%	-0.24%
Nikkei 225	18.98%	0.06%
Eurostoxx 50	20.17%	0.16%

Source Bloomberg / Partner Banks
Data as at 28th October, 11.00am

Upcoming events	
1st Nov	BOJ Policy Statement
02nd Nov	BOJ Quarterly Report
02nd Nov	Fed FOMC Meeting and Rate Decision
03rd Nov	BoE MPC Meeting and Rate Decision
03rd Nov	IMF Meeting
04th Nov	US Non-Farm Payrolls

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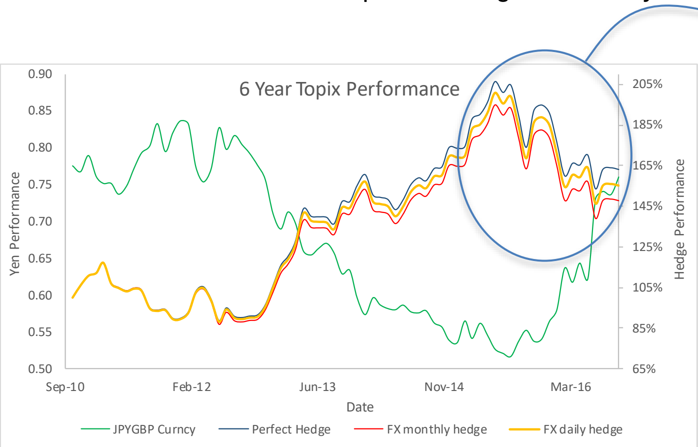
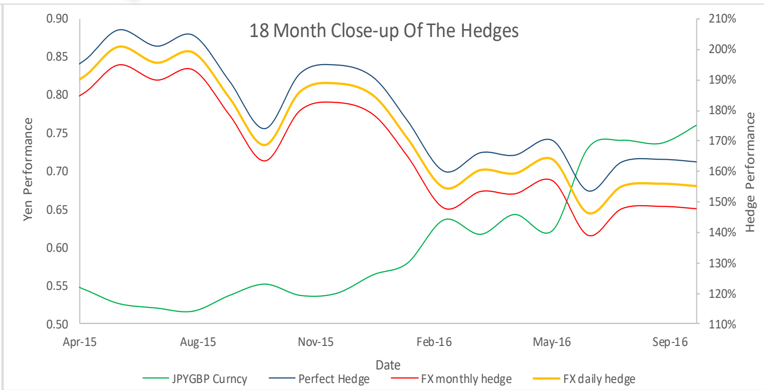
asset, in a chosen currency; for example, GBP. In this case the option holder is perfectly hedged whilst the trader has to run that dynamic hedging risk. And to illustrate the impact on hedging frequency, we chart below the performance of the Topix Index under three scenarios. A perfect hedge, a monthly hedge and a daily hedge.





Having considered the above chart, you may then conclude that obviously the perfect hedge is best, but the daily hedge does a pretty good job, whilst the monthly probably is too infrequent given the underlying asset and FX volatility. That then leads to the next question, which is: How much do the banks charge for providing that perfect currency hedge and is it worth it given the under/over performance of the daily hedge? Well we'll leave you with the below investment terms for a Quanto Supertracker and a Daily Hedged Supertracker, both on the Topix. You may conclude that actually the superior participation terms you gain for taking on that intra-day risk is a price worth paying or indeed looking at it another way, our friends in the investment banks charge too much for what is seemingly much less risk than the implied levels they use to compute that intra-day hedging risk they have to run.

Super-Trackers		
Product Type	6 Year Topix **Quanto GBP** Supertracker (70% EKIP)	6 Year Topix **Daily-Hedge GBP** Supertracker (70% EKIP)
Participation	**130%**	**200%**

Last but by no means least, when considering a currency hedged share class, look at how frequently they hedge and indeed compare the performance of the base currency share class to that of the currency hedged. If the hedge is an effective one, then their performance should be broadly similar.

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