

## **What is currency hedging?**

Currency hedging is a technique used by any entity buying and selling assets in a foreign currency to lessen the risk associated with changes in exchange rates. The intention is to remove the effects of currency changes from the actual value of the asset.

## **Why would an investor consider currency hedging?**

By hedging you are removing the currency volatility and delivering the risk/return characteristics of the asset you are investing in. You could think of hedging like removing the static from a radio signal so you are tuned into your desired station. For example, let's say an Australian investor intends to buy an asset in England, they are required to convert their \$AU into £UK. Once the asset is purchased in £UK, the investor is exposed to the risk that the exchange rate will move by the time the asset is sold. This can either increase the return, if the \$AU weakens (as they will receive more \$AU for their £UK) or detract if the \$AU strengthens.

Currencies are highly volatile and offer no long-term expected return. For every 'winner' there is a counter-balancing 'loser' (note that this is not the case with investing in property or shares, as all investors can receive a positive return).

## **Does hedging help or hinder returns?**

The evidence shows that the effect of hedging on returns is ambiguous. That is, the gross return of a hedged portfolio can be greater or less than the return of an unhedged portfolio. As well, hedging entails additional costs and taxes that can reduce the investor's return. This means that even if hedging produced a higher gross return, the net return might be lower than an unhedged portfolio once costs were taken into account.

Studies of the merits of hedging are often dependent on the period under review. For instance, in the five years from 1997-2002, an Australian investor would have profited from being completely unhedged, yet in the following six-year period the converse held true.

## **What proportion of a portfolio should be hedged?**

There is no right answer. A widely used approach is to hedge 50% of overseas assets. This avoids the potential for large fluctuations that can result from either a totally hedged or unhedged position.

## **How do investment managers hedge currencies?**

The most common approach is to enter into forward foreign exchange contracts. This involves agreeing to exchange Australian dollars for a foreign currency at an agreed rate at an agreed future date. While the financial instruments used can be quite complex, most managers take out 30-day forward contracts which involve selling a foreign currency forward and entering into new contracts at the end of the period.

## **Which currencies are hedged?**

Each investment manager decides which currencies to hedge, with the most common being the US dollar, Euro, Japanese Yen, UK Pound, Swiss Franc, Swedish Krona and Canadian dollar.

## **Does currency hedging cost?**

Yes. Currency hedging costs approx 5-10 basis points (0.05% to 0.1%) pa.

For further detail, download our in depth paper 'Bringing Home the Bacon' or call your adviser.

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