Currency management

David Wolf | Portfolio Manager

Key Takeaways

- Currency forecasting is hard
- Hedging doesn't necessarily reduce portfolio risk
- We manage currency exposure in the context of our broader active asset allocation process

Why we don't (usually) hedge fx

Volatility in the Canadian dollar (CAD) has increasingly dominated returns for Canadian investors with unhedged exposure to foreign assets. Violent moves in the exchange rate made it hard to lose money in foreign assets in 2015 and hard to make money in foreign assets in 2016. Given this backdrop, it is not surprising that currency management has become one of the most pressing issues for Canadian investors. In this piece, I discuss the approach we take to currency management in our Canadian multi asset class funds, the rationale for that approach, and how that has translated in the positioning of the funds.

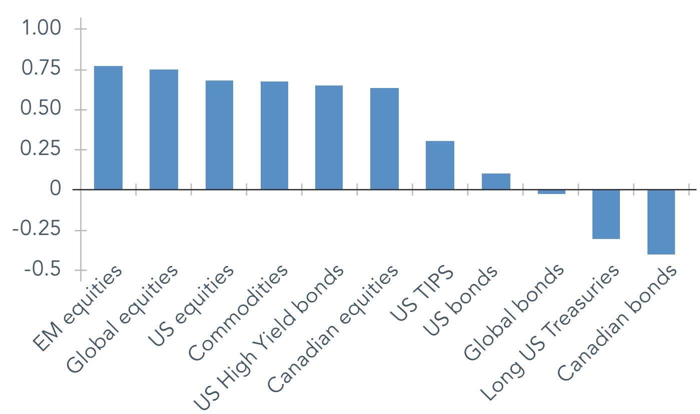
To begin, let me summarize our general approach. While we do manage currency exposures as an integral part of our active asset allocation process in the relevant funds, we normally do so in relatively limited fashion. We tend not to hedge foreign exchange exposures on a large scale, either opportunistically or as a rule. Here's why.

First, while hedging foreign exchange exposure obviously reduces currency risk, it does not necessarily reduce total portfolio risk. For a Canadian investor, currency hedging can actually increase total portfolio risk. Since it's total portfolio risk that we care about in our multi asset class funds, foreign exchange exposure can play a useful role in helping us manage overall volatility in the funds.

This may seem counterintuitive, but it makes sense given that the Canadian dollar is a particularly 'cyclical' currency, heavily influenced by things like global growth and commodity prices. That means that the value of the CAD will tend to move along with the value of (other) assets linked to the cycle, notably risky assets like equities (see Exhibit 1). So when equities go down, the CAD will also tend to go down, which means of course that foreign currencies (notably the U.S. dollar) will tend to go up against the CAD. That rise in the value of foreign currency holdings will tend to offset the decline in the value

EXHIBIT 1: The Canadian dollar moves with risky assets

Correlation of monthly returns between selected asset classes (local currency terms) and CAD/USD, last ten years



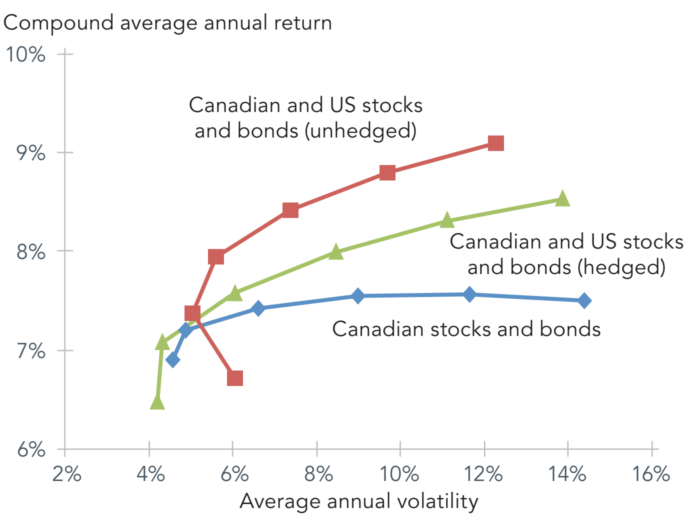
Sources: Bloomberg, FMR Co.

of equity holdings in a given portfolio, thus providing downside protection by dampening the portfolio's overall volatility – for example, as seen in the aftermath of the Brexit vote in 2016.

Many of you will have seen the example I often present at Fidelity events, showing how a simple combination of Canadian stocks and unhedged U.S. Treasuries would have virtually eliminated annual losses for Canadian investors over the past 25 years. Exhibit 2 shows a more generalized analysis. The blue line gives historical returns and volatilities for all-Canadian portfolios of stocks and bonds (the line shows model portfolios stretching from 0% to 100% equities). The red line diversifies half of the portfolio into (unhedged) U.S. stocks and bonds. This diversification improves performance, both increasing return and reducing risk (the line shifts up and left). The green line then keeps the U.S. assets but hedges out the currency risk. Returns go down – not surprisingly, given that the Canadian dollar has depreciated on net since the early 1990s – but volatility goes up for all but the bond-heaviest of portfolios.

EXHIBIT 2: Hedging doesn't necessarily hedge

Portfolio returns and risk for Canadian investors since 1990



Sources: Bloomberg, FMR Co.

This is the negative correlation between the U.S. dollar and equities in action. By eliminating the favourable effects of that correlation for Canadian investors, hedging foreign exchange risk has increased total portfolio risk.

Of course, just because currency hedging has generally reduced returns and added risk for Canadian investors doesn't mean it's a bad idea for every investor at every point in time. For example, leaving a portfolio made up entirely of global bonds unhedged is going to give a Canadian investor a lot of extra volatility and little else under most circumstances. More generally, the (un) desirability of hedging for Canadian investors is going to depend on the particular structure of a portfolio. That's one reason we offer currency-neutral versions of many of our funds, and hedge by policy in segments of other funds (such as the non-Canadian fixed income component of the Monthly Income Fund).

What about hedging opportunistically? After all, it's clearly going to be advantageous to hedge during periods when the Canadian dollar is going up. The challenge, however, is identifying those periods in advance.

The fact is, currency forecasting is extremely difficult. Numerous academic studies have found that the exchange rate projections of even professional forecasters tend to be no better than flipping a coin. There are two reasons for this. One, currency markets (particularly in the major pairs) are the most liquid of financial markets, which means they tend to be more efficient in discounting all available information. Two, exchange rates tend to both affect and be affected by just about everything else (they are among the most 'endogenous' of variables in any macro model). So accurately forecasting an exchange rate essentially means accurately forecasting everything, and doing so in a way that improves upon the collective wisdom of millions of market participants. Not so easy, to say the least.

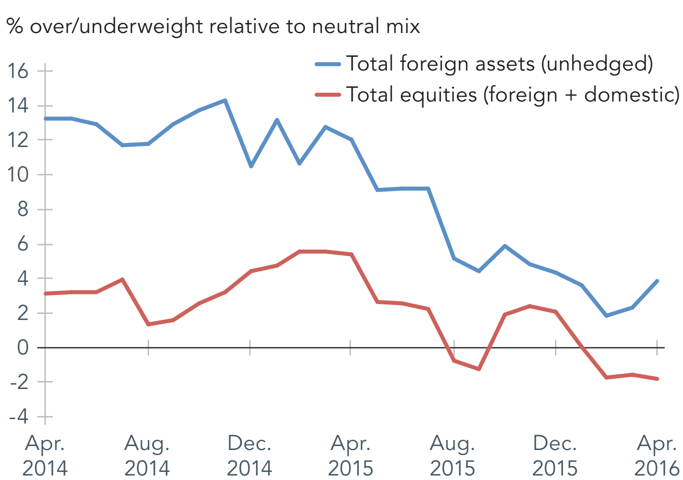
To sum up, then, hedging is not generally advantageous as a rule, and hedging opportunistically is very hard to do well. This argues for a generally unhedged approach to foreign investments. And that is indeed the basic design of our multi asset class funds in Canada.

But we can't and shouldn't ignore currency entirely. As above, Canadian dollar movements will tend to be correlated with movements in just about everything else we hold in the funds, even domestic assets (higher oil prices, for example, will tend to boost both the CAD and the energy-heavy TSX). So we must consider currency as an integral part of our asset allocation process, in terms of both our positioning and the analysis of macro, valuation and sentiment factors that informs our strategy. Moreover, it helps us to do so, because it gives us another dimension along which to calibrate our positioning to enhance return and manage risk for a fund as a whole. As with other aspects of our active asset allocation process, however, we do so in disciplined fashion with reference to a fund's neutral asset mix, mindful in particular that currencies are among the hardest of financial variables to project.

Let me illustrate how this approach works using the example of our positioning in the Global Balanced Fidelity Managed Portfolio (FMP) over the past couple of years. As Exhibit 3 shows, through 2014 and early 2015 we maintained a material overweight in unhedged foreign assets, explicitly creating a significant underweight to the Canadian dollar. The core thesis was that markets were very likely underestimating the challenge to Canadian asset prices posed by much lower oil prices and a slowing Chinese economy, particularly against the backdrop of an overvalued exchange rate (see Exhibit 4) and an unbalanced domestic economy. Our preference was for U.S. assets and we were happy to take the currency risk as well, reflecting not only the better prospects for the U.S. dollar but also its role in reducing risk, given our broadly overweight position in equities.

EXHIBIT 3: Active allocation in action

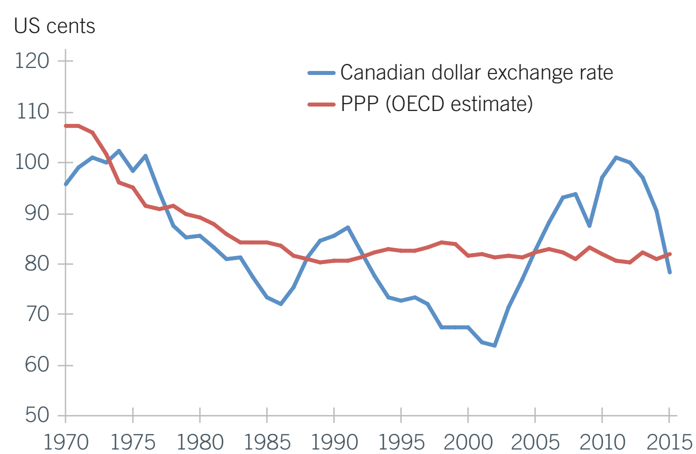
Relative positioning by aggregated asset class in the Fidelity Global Balanced FMP



Source: FMR Co.

EXHIBIT 4: Was overvalued, now fair, probably needs to get cheap

The Canadian dollar-US dollar exchange rate and purchasing power parity (PPP)



Source: Bank of Canada, OECD, Haver Analytics, FMR Co.

As 2015 progressed, the consensus looked to be increasingly adopting the same positioning, pushing Canadian asset prices down to levels which more appropriately discounted the macro outlook. So with sentiment increasingly one-sided and valuations fairer, we bought back into Canada. We did this both by selling foreign assets and by shifting some of our exposure in the Global Bond fund to the Currency Neutral (hedged) version of that fund. In addition, we were generally reducing our total equity risk over this period as the cycle showed increasing signs of age, while also rotating into the better-looking risk/return profile on offer in emerging market equities, whose underlying currency exposure was likely to broadly mimic the Canadian dollar (in other words, we had more CAD-like risk among our foreign asset holdings). The result was the effective elimination of our underweight in the CAD by the early part of 2016.

With the Canadian dollar bouncing back to near 80 cents US – a level that's probably around the upper end of the range that's likely to be tolerable for this economy over the visible horizon – we moved some risk back into the U.S. dollar in the second quarter of 2016. But our underweight to Canada remains considerably smaller than a year or two ago, when our positioning reflected an unusually favourable set of circumstances for taking currency risk with high conviction. Then as now, our active asset allocation process is designed to take advantage of those high conviction opportunities in whatever market they may lie.

David Wolf, June 27, 2016

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Author

David Wolf | Portfolio Manager

David Wolf is a portfolio manager for Fidelity Investments. He is the co-manager of Fidelity Managed Portfolios, Fidelity Canadian Asset Allocation Fund, Fidelity Canadian Balanced Fund, Fidelity Monthly Income Fund, Fidelity U.S. Monthly Income Fund, Fidelity U.S. Monthly Income Currency Neutral Fund, Fidelity Global Monthly Income Fund, Fidelity Dividend Fund, Fidelity Global Dividend Fund, Fidelity Income Allocation Fund, Fidelity Balanced Managed Risk Portfolio and Fidelity Conservative Managed Risk Portfolio.

He is also portfolio co-manager of Fidelity Conservative Income Private Pool, Fidelity Asset Allocation Private Pool, Fidelity Asset Allocation Currency Neutral Private Pool, Fidelity Balanced Private Pool, Fidelity Balanced Currency Neutral Private Pool, Fidelity Balanced Income Private Pool, Fidelity Balanced Income Currency Neutral Private Pool and Fidelity U.S. Growth and Income Private Pool.

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