AGF INSIGHTS

MARKETS

Why currency management is not a zero-sum game

By Tom Nakamura and Mark Stacey

MARCH 2018

Tom Nakamura, CFA
Vice-President and Portfolio Manager
AGF Investments

Mark Stacey*, MBA, CFA
Senior Vice-President, Head of Portfolio Management & Co-Chief Investment Officer
AGFiQ

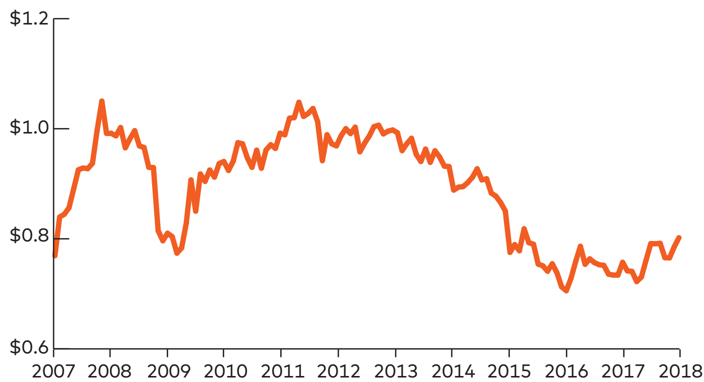
*A registered Advising Representative in Canada with Highstreet Asset Management Inc., a subsidiary of AGF Investments Inc.

Global stock markets have the potential to boost returns and diversify portfolios, but investors need to pay close attention to foreign exchange markets in order to make the most of the opportunity. Currency fluctuations, in particular, can add significant volatility to an investment abroad and left unchecked may detract from its overall performance.

In the past, the value of one's home currency relative to its foreign counterparts would not have been a consideration for many investors, particularly those who were entirely invested in domestic stocks and bonds. At the same time, for those who did invest abroad, FX markets were relatively muted and of less consequence than some of the more acute currency moves that have resulted more recently from global markets becoming more interconnected over the past few years.

Take the Canadian dollar, for example. The loonie currently trades close to US 80 cents, but its relative value to the U.S. dollar has been far from static over the course of the past decade, whipsawing dramatically from a high near US$1.06 in 2011, to a low of roughly US68 cents at the beginning of 2016.

Fluctuations in the loonie (against the U.S. dollar)



Source: Bloomberg LP and AGF Investments - as of February 26, 2018

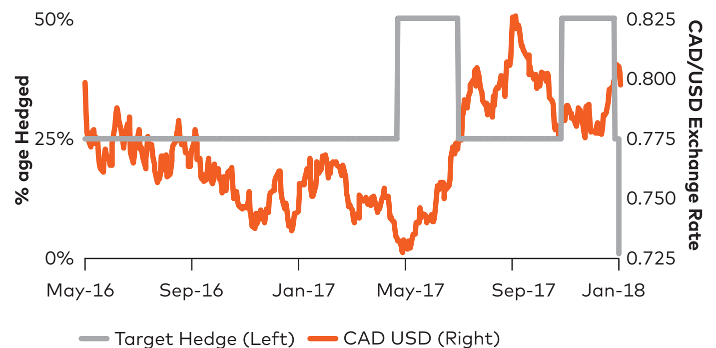
One of the best ways to manage big deviations like this is to employ an active hedging strategy that is focused on reducing volatility, but doesn't lose sight of periodic opportunities to generate alpha.

From a tactical perspective, investors can benefit from a currency hedge when a foreign currency is falling relative to an investor's home currency. This is based on the idea that not doing so would erode some of the potential returns associated with the underlying investment. Vice versa, unhedged investors can benefit when a foreign currency that is strengthening relative to their home currency.

Many investors, however, choose to fully hedge their FX exposure at all times in order to negate the potential volatility associated with currency moves altogether. Other investors, meanwhile, choose to be unhedged always based on a belief that currency fluctuations will balance out over time and represent a zero sum game in the long run.

Our approach to currency management tries to find a balance between risk and reward, by hedging a portfolio's currency exposure to varying degrees based on prevailing market conditions. Hedged positions in most of our U.S. Sector Class strategy, for instance, have typically ranged from zero to 50% of its total currency exposure, but these positions are reassessed on a daily basis and can change quickly if necessary. In the past year alone, the percentage of the fund's hedge position has been adjusted several times.

U.S. Sector Class: Historic changes in target hedge level



Source: Bloomberg and AGF Investments – as of Jan 10, 2018

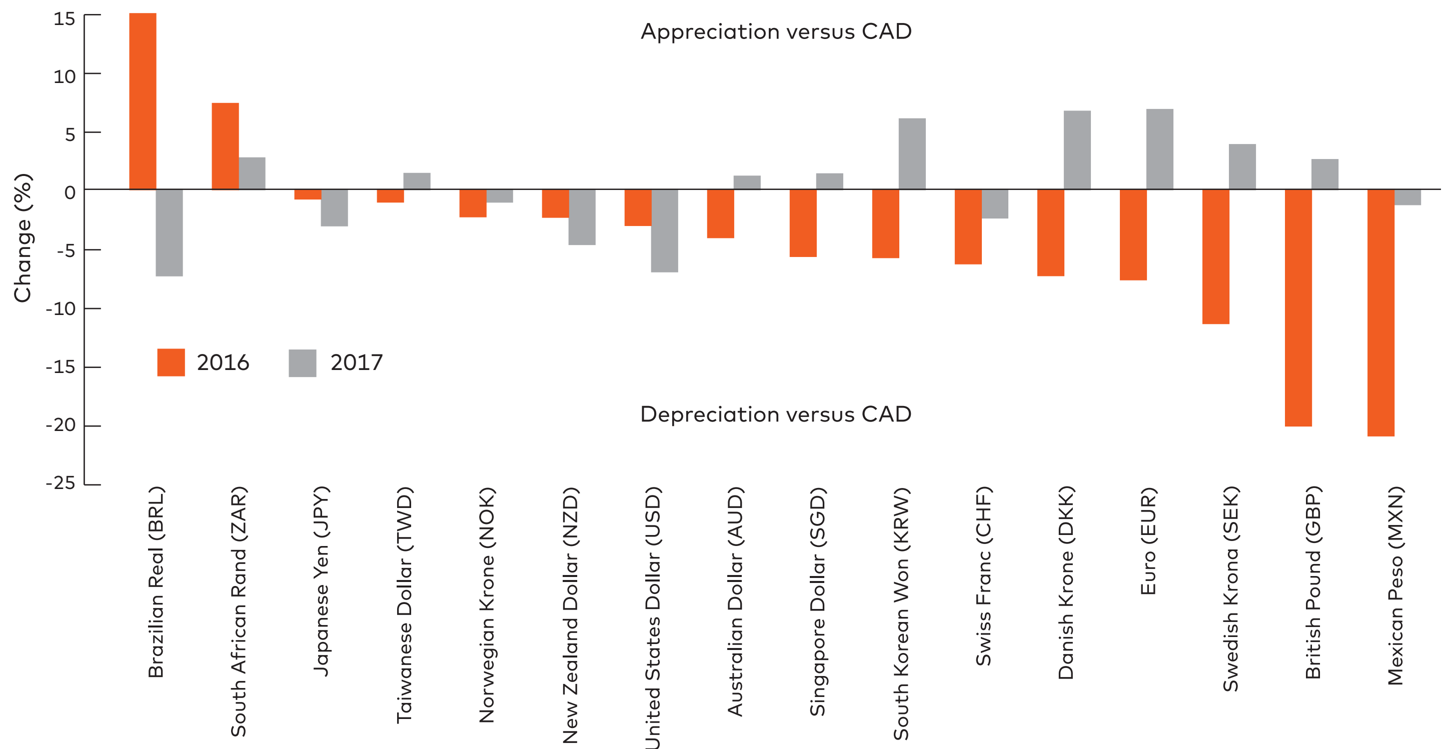
To find the right mix of hedged and unhedged exposure in our global mandates, we analyse a number of factors that have the potential to impact the Canadian dollar's relative value against other currencies. By doing so, we recognize that no one factor will determine the loonie's movements all of the time. Oil prices, for example, have been highly correlated with the loonie in recent years and may continue to influence the direction of the Canadian dollar's value. Interest rate differentials, meanwhile, could have an even bigger impact as central banks like the U.S.

Federal Reserve and Bank of Canada contemplate their own unique timelines for tightening monetary policy.

Beyond these two key drivers, it can also pay to review speculative positions in FX markets (i.e. net longs), and compare recent moves in a currency's relative value with historical moves to assess its momentum. Purchasing power parity, which compares different countries' currencies through a market "basket of goods" approach can be another useful gauge to follow.

Often enough, this type of analysis is done to help determine the Canadian dollar's expected future value against the U.S. dollar, but in a truly global portfolio, relative value to other currencies also needs to be considered. For instance, the loonie could weaken against the greenback, but strengthen against the euro, possibly leading to two very different hedging decisions.

How does the loonie stack up?



Source: Bloomberg and AGF Investments

It's equally important to account for the correlation of certain currencies to different asset classes. The Canadian dollar tends to move in sync with the direction of global equity markets but that's not always the case for the U.S. dollar given its safe haven status. When stocks fall, therefore, the loonie is prone to depreciate against the greenback. In this scenario, a U.S. equity portfolio that is 100% hedged in Canadian dollars runs the risk of having higher volatility than a portfolio with a more active hedging program that benefits from some degree of U.S. dollar exposure.

Taken all together, currency management requires a disciplined approach that takes calculated bets based on sound research. But done right, it is a worthwhile pursuit that can enhance the benefits of investing abroad by reducing volatility and capturing additional gains along the way.

Commentaries contained herein are provided as a general source of information based on information available as of February 6, 2018 and should not be considered as personal investment advice or an offer or solicitation to buy and/or sell securities. Every effort has been made to ensure accuracy in these commentaries at the time of publication; however, accuracy cannot be guaranteed. Market conditions may change and the manager accepts no responsibility for individual investment decisions arising from the use of or reliance on the information contained herein. Investors are expected to obtain professional investment advice.

AGF Investments is a group of wholly owned subsidiaries of AGF Management Limited, a Canadian reporting issuer. The subsidiaries included in AGF Investments are AGF Investments Inc. (AGFI), AGF Investments America Inc. (AGFA), AGF Asset Management (Asia) Limited (AGF AM Asia) and AGF International Advisors Company Limited (AGFIA). AGFA is a registered advisor in the U.S. AGFI is registered as a portfolio manager across Canadian securities commissions. AGFIA is regulated by the Central Bank of Ireland and registered with the Australian Securities & Investments Commission. AGF AM Asia is registered as a portfolio manager in Singapore. The subsidiaries that form AGF Investments manage a variety of mandates comprised of equity, fixed income and balanced assets.

Date of publication: March 14, 2018.