Investment Insight

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ARIA | CAPITAL

Over the hedge: *Whether or not to hedge currency exposure is a question we are frequently asked, even more so since the extraordinary moves we have seen in the Euro in recent times. In many cases we have constructed portfolios that provide a balanced global currency exposure, without taking strong hedging positions. This is a strategy that has served most clients well because, irrespective of a company's domicile, in today's global economy corporate earnings tend to reflect diverse currency influences and trying to second-guess the net currency exposures can be a fruitless exercise. However, for lower volatility strategies there is a stronger argument for currency hedging as currency moves such as those seen in the last 12 months can substantially erode, or magnify, underlying investment gains.*

If this is a topic that's relevant to you, our Investment Team are happy to discuss it with you. However, there's no monopoly on wisdom on the matter, and in in this week's ***Inside Track*** *we share the considered thoughts of GMO on the subject.*

Sale of the Century: *The bond market continues to sizzle. Some would say it's lost the plot, and the plotters would tend to agree. Switzerland last week became the first to issue 10 year government debt with a negative interest rate. Perhaps more intriguing is Mexico's issuance of 100-year Euro denominated debt, or "century bonds". This follows hot on the heels of their recent US dollar, UK sterling and Japanese yen century bonds as they follow the trail of quantitative easing around the globe. But issuing Euro denominated debt, particularly with a 100 year time frame, opens up lots of potential issues both for Mexico and for the bond purchasers. In* ***Pic of the Week*** *we take a closer look at perhaps the biggest issue....currency.*

The Inside Track

GMO's Catherine LeGraw recently published a White Paper on currency hedging. Founded in 1977, GMO is a global investment management firm managing over $115 billion in client assets. The following are some interesting extracts from Catherine's paper.

Currency "hedging" is not hedging

In the age of global business models, most large cap companies are not exposed purely to the currency that their stock is denominated in. For example, roughly half of U.K. stock market capitalization is comprised of companies whose business has minimal exposure to the United Kingdom; these companies simply decided to list in London. Shorting the British pound against a basket of U.K. stocks does not "hedge" currency exposure; it layers on a directional short currency position.

Does hedging reduce volatility?

Investors frequently cite empirical work that demonstrates that hedging currency for international equities reduces risk (by "risk" they mean "volatility"). In the short term (i.e., less than a five-year investment horizon), hedging currencies may reduce volatility. For us at GMO, a reduction in short term volatility is not a compelling argument for hedging because we are long-horizon investors.

Hedging may increase tail risk

The idea that hedging increases volatility in the long term may seem counter-intuitive. While commonly accepted as a benign form of leverage, currency hedging equities increases the notional exposure, and therefore the magnitude of possible return or loss. In other words, hedging increases tail risk by layering (short) currency exposure to the equity investment.

We don't hedge as a rule, but there are exceptions

Domestically-oriented companies - An investor may want to hedge a concentrated investment in domestically oriented companies (e.g., banks, insurance companies, REITs). Domestically-oriented companies realize the majority of their revenues and costs in the local currency; therefore their cash flows are essentially a nominal return stream in the local currency. An investor who does not want exposure to that currency may choose to hedge these types of equities.

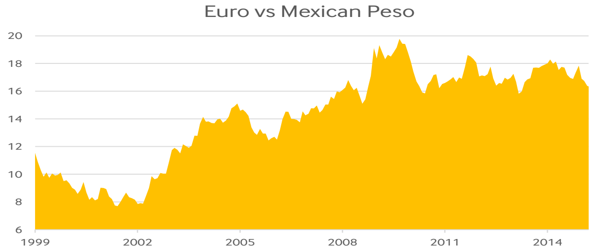
Long/short investments - Our practice of not hedging currency risk for equity investments holds for long-only investments. In long-only investments, volatility is a positive: it provides opportunities for the patient, long-term investor, but it does not impose a requirement that the investor take any action. A fall in the price of the asset gives the long-only investor the opportunity to buy more at a more attractive valuation, but the investor does not have to take any action at all. In a long/short portfolio, volatility is a negative because it can force the investor to take action; for example, an investor may be compelled to cover a short position, thereby locking in a loss. For that reason, anything that can make a long/short position less volatile without impacting expected return improves the trade.

Currency hedged ETFs

Recently, as assets have been flowing into currency hedged equity exchanged traded funds (ETFs), we worry that investors have observed the higher returns from hedged equities as the dollar has risen and concluded that currency hedging is the right thing to do. Systematic currency hedged strategies (such as hedged ETFs) short currencies based on the stock's listing currency....we believe this is not an accurate representation of the currency exposure. In fact, by adding short currency positions, investors may be opening themselves up to new risks. Currency management is a useful tool when done for the right reasons: because of a high-conviction view, or a desire to mitigate an identified risk exposure. We caution that a simple currency hedging strategy may not achieve these objectives.

Pic of the Week

Mexico's Euro denominated "century bond" carries a healthy coupon of 4%. But for Mexico it opens up several important questions about the Euro: Will it exist in 100 years? Who will its members be? How will the Peso perform against the Euro over that timeframe? The last question is possibly the most important. The chart below shows the Peso's decline against the Euro over the past 15 years. One view is that this makes the Peso cheap, and it should strengthen against the Euro. However, if history repeated itself Mexico could find itself in very deep trouble...in about 99 years and 51 weeks' time!



Market View

	Last 7 days	YTD	5Y Ann.
Global equities	+0.6%	+7.3%	+8.5%
US equities	+0.7%	+2.2%	+12.0%
European equities	+0.5%	+19.9%	+8.5%
Emerging market equities	+1.7%	+10.0%	+0.4%
Irish equities	+1.7%	+21.4%	+13.7%
Commodities	+2.6%	-2.1%	-5.5%
Hedge funds	+0.6%	+3.4%	+1.2%

Economic indicators	*Bond yields*	*Inflation*	*GDP YoY*
Ireland	+0.6%	-0.6%	+4.1%
Germany	+0.1%	+0.3%	+1.4%
USA	+1.9%	0.0%	+2.4%
China	+3.6%	+1.4%	+7.0%

Week ahead: Key events

20/04 UK House Prices & EU Construction Output
21/04 EU Government Debt/GDP Ratio
21/04 Germany ZEW Survey
22/04 Japan Trade Balance & EU Consumer Confidence
22/04 US Existing Home Sales
23/04 EU Composite PMI & UK Retail Sales
23/04 US Initial Jobless Claims & New Home Sales
24/04 US Durable Goods

Currencies	*Current*	*YTD Δ*
EUR:USD	1.08	-10.9%
EUR:GBP	0.72	-7.1%
EUR:CNY	6.68	-11.5%
GBP:USD	1.49	-4.1%
Bitcoin	226.59	-28.6%

Commodities	*Current*	*YTD Δ*
Gold	1,200.94	+1.4%
Copper	6,067.50	-4.7%
Oil	63.47	+3.7%
Wheat	487.75	-18.4%

Central Bank rates	*Current*
Eurozone	0.05%
USA	0.25%
UK	0.50%

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