



Philanthropy New Zealand

Tōpūtanga Tuku Aroha o Aotearoa

Demystifying Currency Hedging

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Why all the fuss about currency hedging?

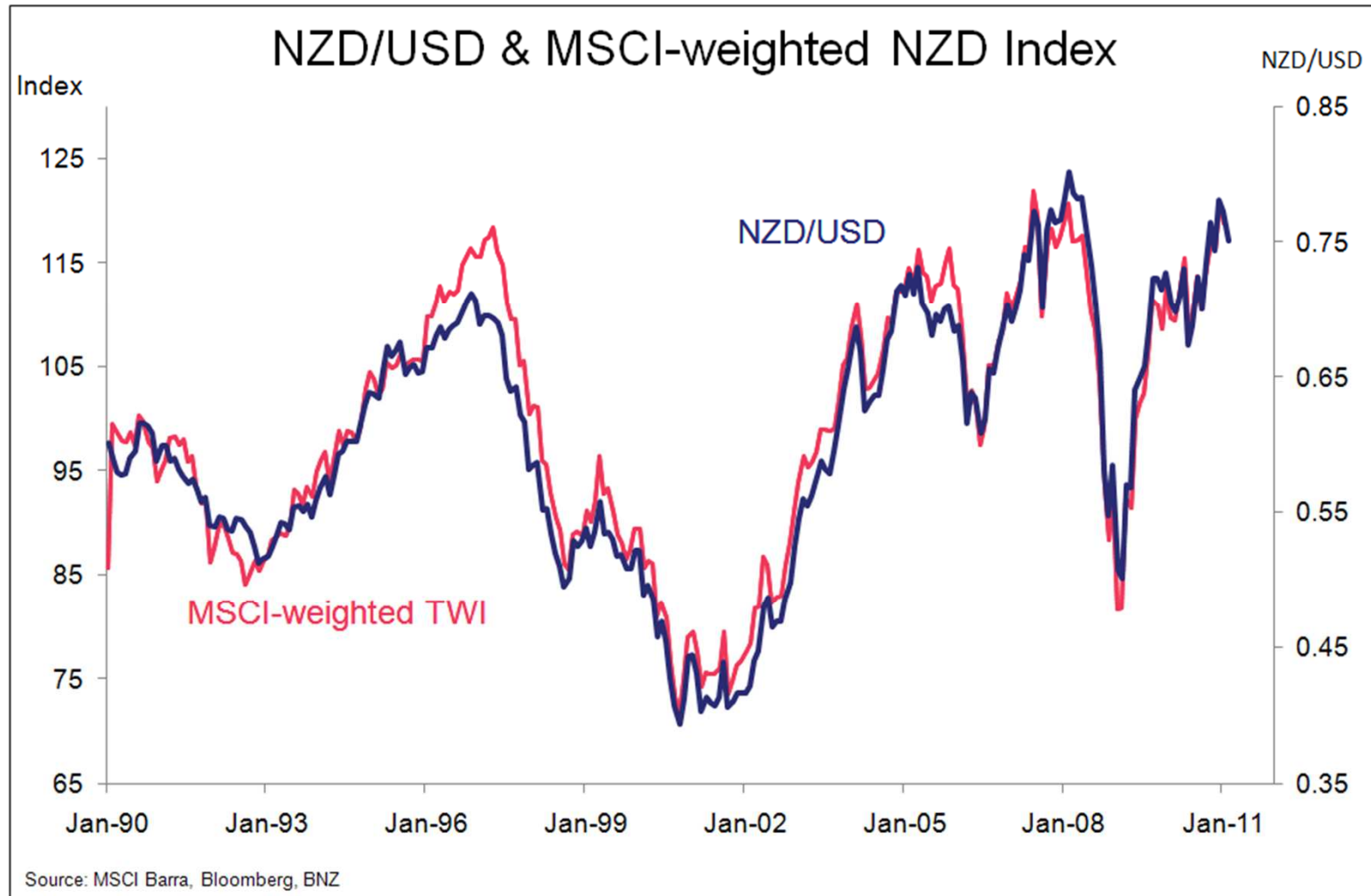
- Investors who own foreign assets are exposed to currency risk.

	NZD Value	NZD/USD	USD Value
Initial Portfolio Value	NZ\$100,000	0.7000	US\$70,000
Equities Unchanged, NZD falls	NZ\$127,273	0.5500	US\$70,000
Equities Unchanged, NZD rises	NZ\$82,353	0.8500	US\$70,000

- Hedging reduces the volatility of portfolio values due to movements in the NZD.

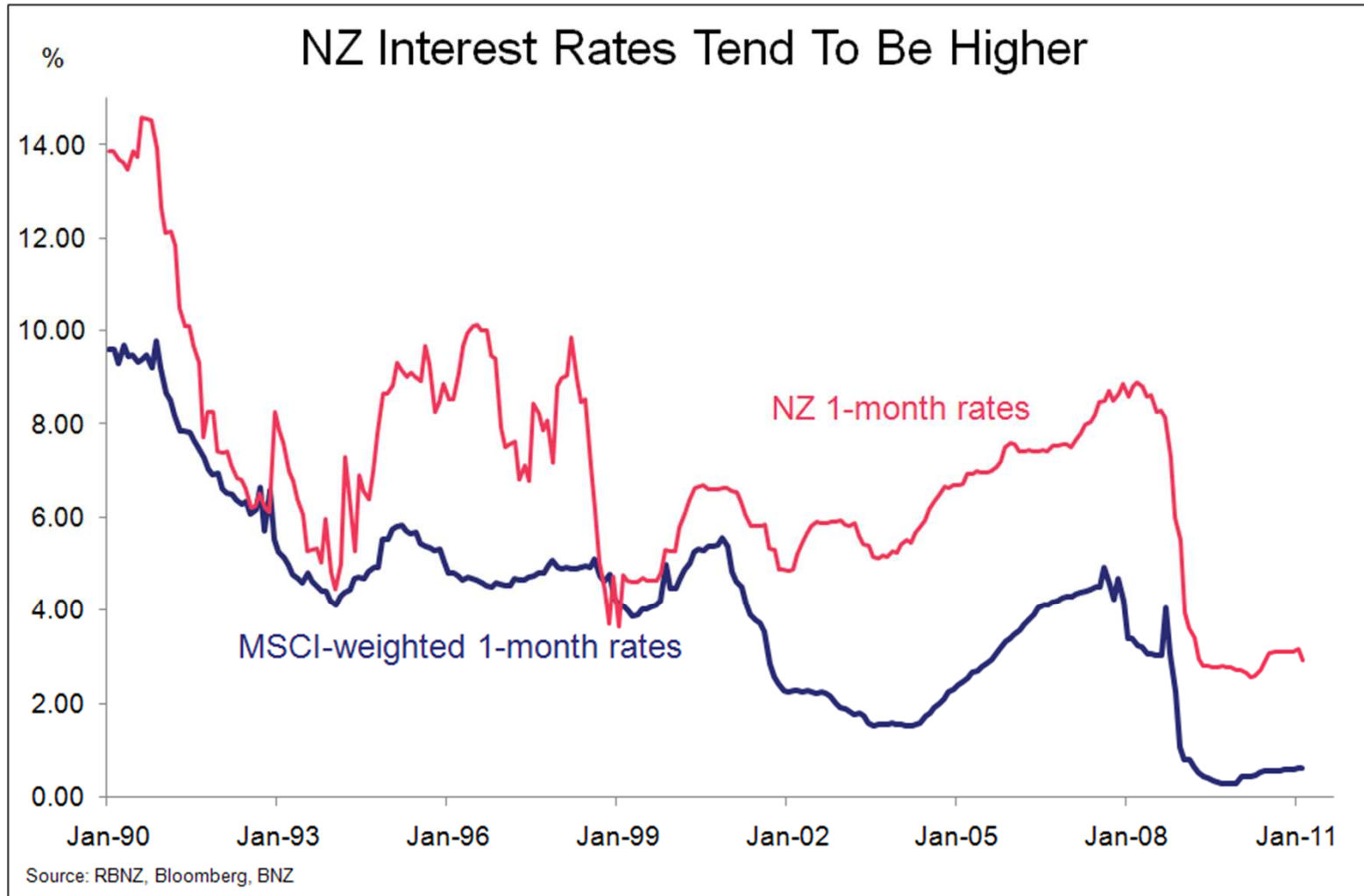
Hedging In Theory

Do the “ups” and “downs” cancel out?



Hedging In Theory

Can hedging enhance portfolio returns?



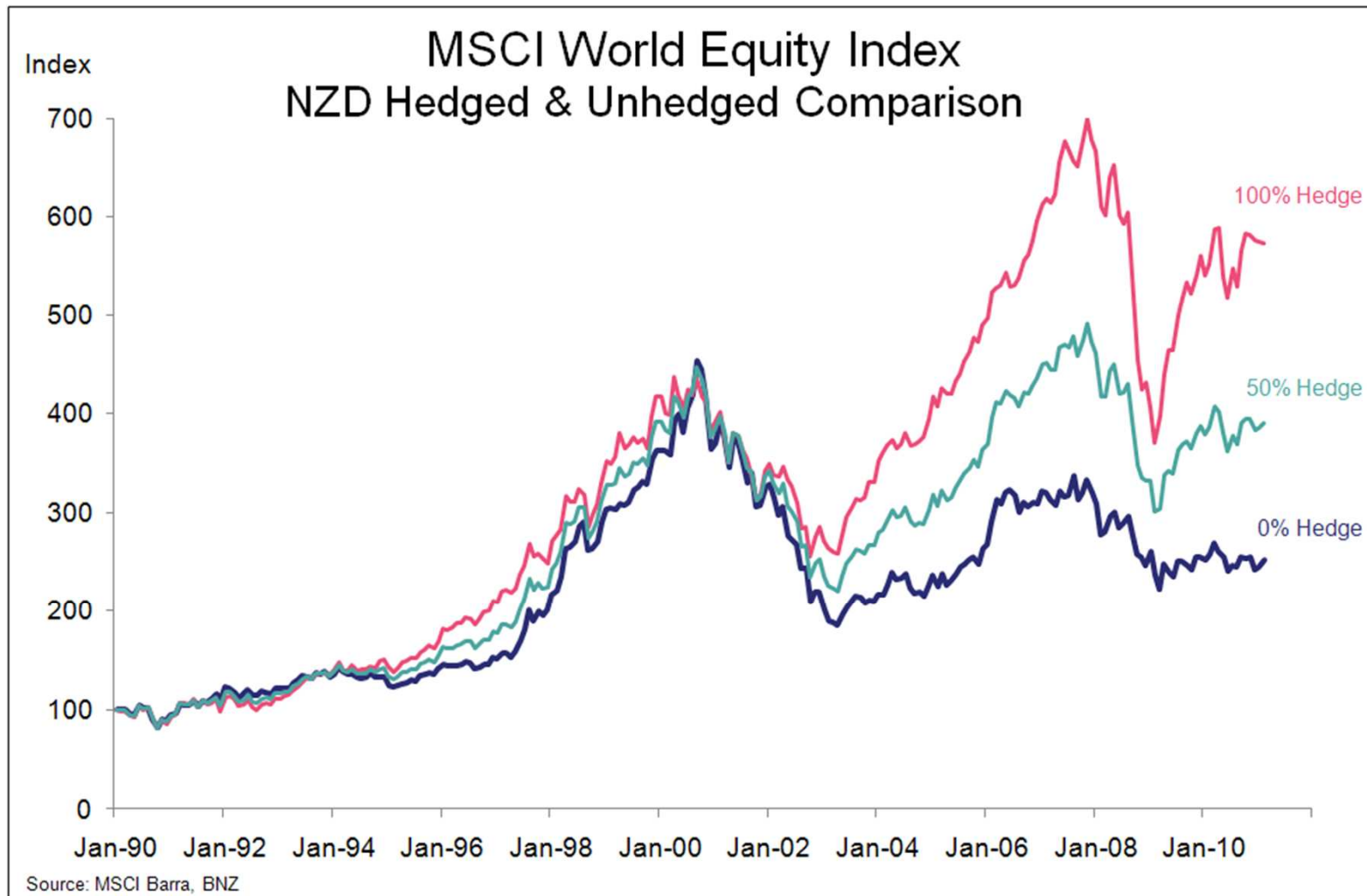
Hedging In Theory

Summarising Hedging Benefits

- Cyclical nature of currencies means the “ups” and “downs” probably cancel out over time.
- Hedging can reduce the volatility of portfolio returns.
- And, because New Zealand interest rates tend to be higher than those offshore, hedging helps enhance returns.
- As a result, a 100% hedged MSCI Equity portfolio outperformed over the past 5, 10 and 20 years.

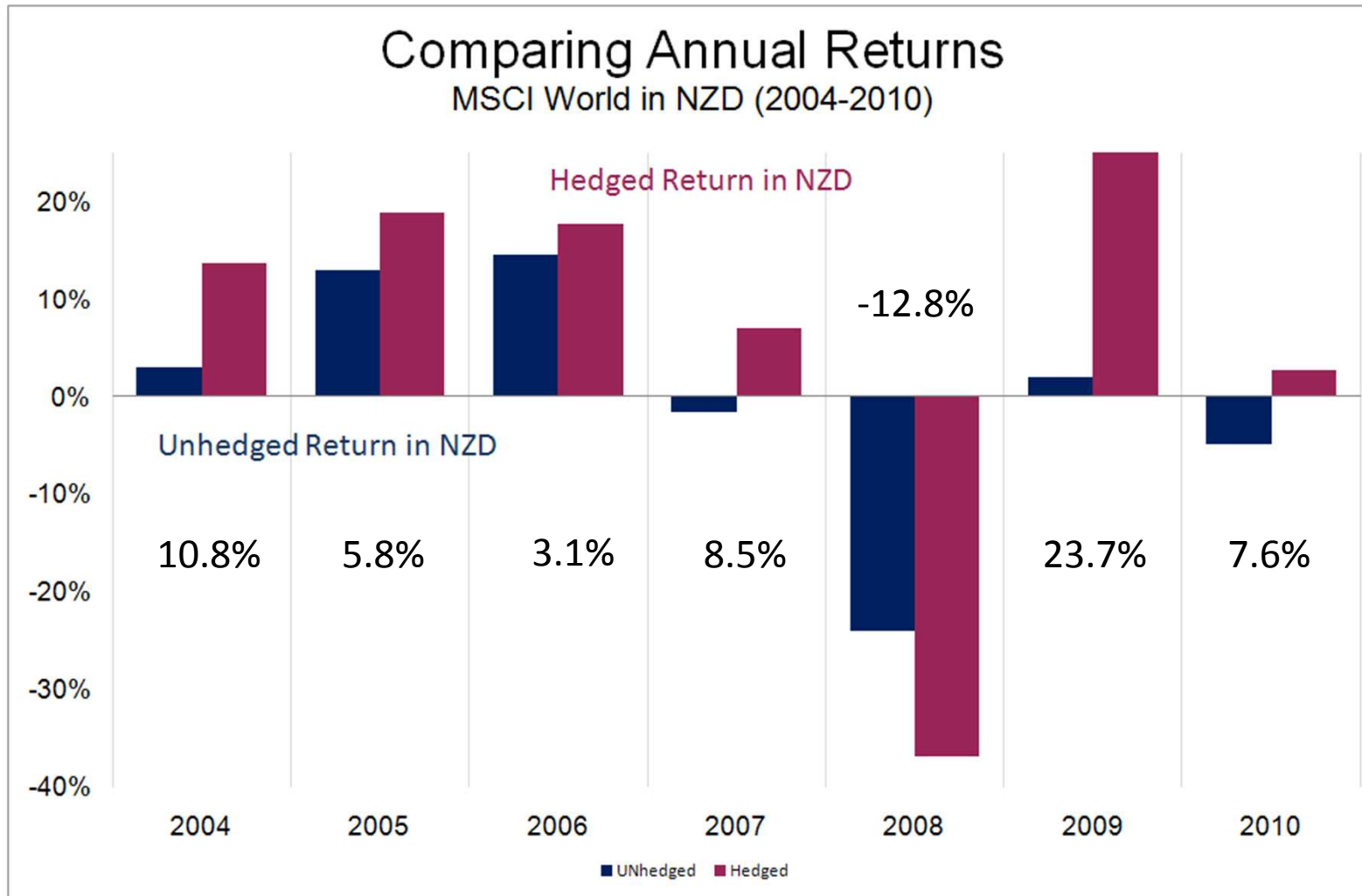
Hedging In Theory

Summarising Hedging Benefits



Hedging In Practice

The GFC put the spotlight on hedging



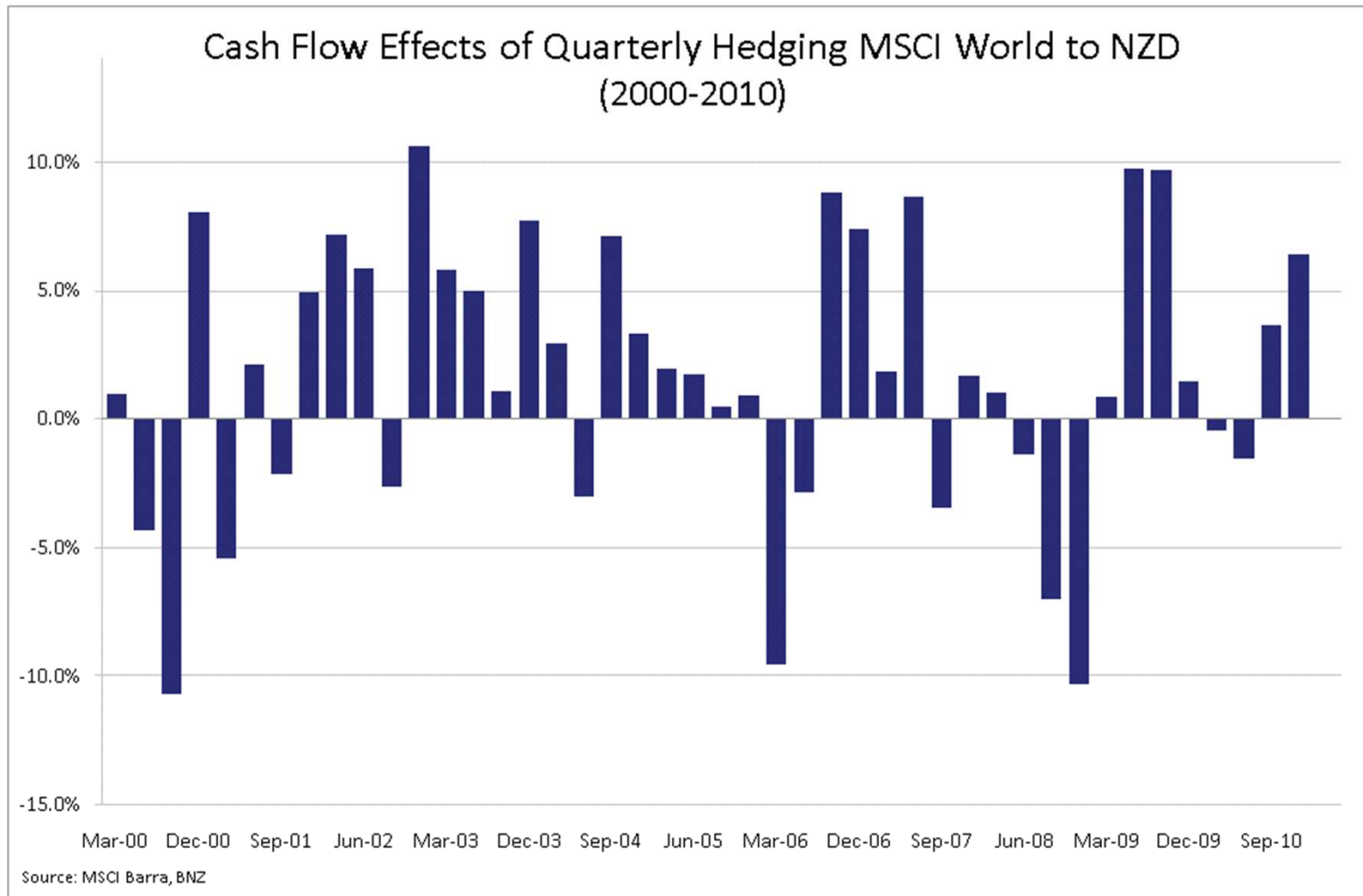
Hedging In Practice

How does it work in practice?

	NZD Value	NZD/USD	USD Value	Forward Rate at Initiation	Hedge Value	Total NZD Value
Initial Portfolio Value	NZ\$100,000	0.7000	US\$70,000	0.6920		
Equities Unchanged, NZD falls	NZ\$127,273	0.5500	US\$70,000	0.6920	-NZ\$20,520	NZ\$106,752
Equities Unchanged, NZD rises	NZ\$82,353	0.8500	US\$70,000	0.6920	NZ\$22,832	NZ\$105,185

Hedging In Practice

Cash flows can be large



Hedging In Practice

What have we learnt from the GFC?

- How you hedge matters
 - Greater focus on where the returns are coming from and what the actual risks are.
 - Structure of the hedge can make a huge difference to hedged returns.
 - Growing focus on performance reporting and attribution analysis.

Hedging In Practice

What did we learn about cash flows?

- Better understanding of cash flows
- Better cash flow management
 - Daily mark-to-market valuations
 - Provisions to realise losses and gains early
 - Growing interest in semi-passive currency management

Hedging In Summary

What will the future bring?

- Looking forward, we expect most fund to continue to reduce currency risk through hedging.
- However, the GFC did put currency management in the spot-light. Hedging remains popular, but:
 - Greater focus on how hedging is managed
 - Greater demand for clarity and performance attribution
- What will the 2011 NAB Super Survey show about hedging trends?
 - Lower hedge ratios on illiquid asset classes?
 - Growing interest in specialist currency managers?