Elston

Elston Insights

5th May 2022

Hedging currency risk requires careful policy

- Currency hedging approach is key to asset allocation design
- Strategically we believe equities should be unhedged
- Volatile Sterling distorts equity returns

Should equity returns be hedged into investor's base currency? We don't think so. From a UK perspective, part of the risk-return opportunity of global equity investing is a diversified revenue stream from multiple currencies.

The revenue make-up of the FTSE 100 is more global in nature than, say, a UK small cap index. That's why in time of Sterling weakness, the FTSE 100 can be going up even if risk appetite is going down. We saw this pattern in Brexit and we are seeing it again this year.

Sterling has declined -7% YTD against the USD this year to $1.25 per £1, on UK's deteriorating economic outlook and the ongoing energy crisis.

Fig.1. GBP weakness relative to USD, year to date

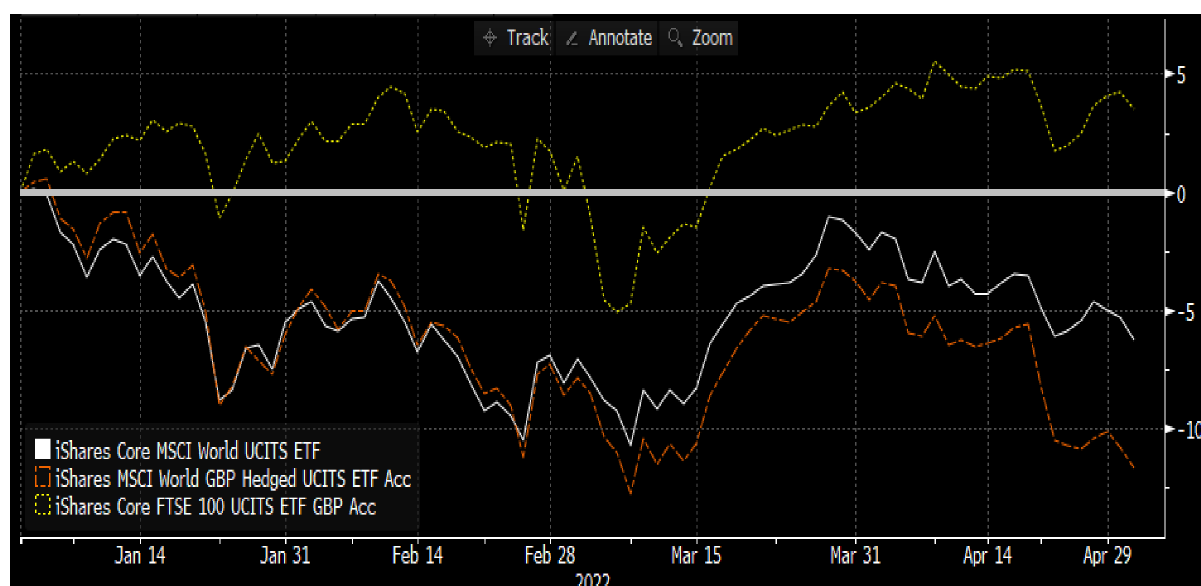
Source: Bloomberg as at 5th May 2022

The relative resilience of the FTSE is not reflecting equity sentiment, but simply the translation effect of a devaluing currency.

Managers and advisers who hedge equity returns into a declining currency, are importing, rather than exporting, foreign exchange risk into a portfolio.

Underlying currency exposure, and currency hedging policy are therefore key considerations. Looking at YTD performance, UK equities +3.49%, World Equities -6.25%, but World Equities (GBP hedged) -11.67%.

Fig.2. GBP weakness relative to USD, year to date



Source: Bloomberg as at 5th May 2022

When does currency hedging make sense?

For pension schemes involved in liability-matching with a stream of future liabilities in Sterling, there is greater rationale for using GBP-hedged equity exposures, the nearer the liability.

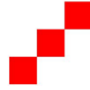
On a tactical view, for managers using a return-based tactical allocation approach, if the outlook for Sterling was positive, with high confidence, there is a rationale for using GBP-hedged share classes.

What about bonds?

On the bond side of the portfolio, we typically advocate that the majority (70-80%) is GBP-based (with respect to interest rate exposure) and, if required, GBP hedged. This is because bonds are intended to provide stability. There is less of a case for incorporating return-seeking currency exposure on this side of the portfolio.

Summary

Our policy of leaving equity returns unhedged as provided some additional resilience within equities. However level of overall equity allocation is primary determinant of risk-return positioning.



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