Asset Class Investment Strategies

Foreign Currency Strategy

This is a financial promotion. Your capital is at risk, the value of investments may fall and rise and you may not get back the full amount you invested. Past performance is not indicative of future returns.

We recommend that international investors with large non-home currency exposure adopt a hedging policy in which the home currency accounts for 60-80% of the portfolio's overall look-through FX exposure. Some foreign currency exposure is appropriate within a portfolio due to the benefit of diversification, liquidity constraints and elevated cost of hedging certain currencies.

A well-diversified investment portfolio will hold some assets that are not denominated in an investor's home currency, where home currency is defined as the currency (or basket of currencies) in which future liabilities are likely to be incurred and consequently the currency in which purchasing power must be protected.

With the exception of occasional dislocations that may occur in volatile markets, our general view is that currency markets tend to be highly efficient, rapidly adjusting to new information. In this regard, investors should view hedging as a means to reduce currency risk even though this may come at a small cost. Similarly, not hedging should be viewed as a deliberate decision to accept additional portfolio risk without any commensurate improvement in the portfolio's expected return.

Asset Class Definition

Foreign currency exposure is normally a by-product of an internationally diversified portfolio. It requires careful management as it can have a large impact on portfolio returns when translated back to home currency. Our preferred approach to managing this source of risk is to use currency-hedged share classes of underlying investments where available and managed in a cost-efficient manner, and to use forward FX contracts to hedge residual FX exposure back to the target level. This approach offers the best compromise between cost, liquidity and operational simplicity.

Role in the Portfolio

At a basic level, investors hold an asset to earn the risk premium offered by that asset. This premium is typically defined as the difference between the asset's expected local currency return and the local currency risk-free rate. By currency hedging, an investor can still fully capture the desired risk premium but changes the risk-free rate back to their home currency, thereby removing the volatility of the FX exposure. In efficient and open markets there is no additional risk premium earned by holding cash irrespective of its currency, since the flow of capital theoretically arbitrages away any risk-free interest rate differential. However, currency moves can be highly volatile, so holding an unhedged asset provides no additional risk premium but does significantly increase the uncertainty of the future total return.

To justify not hedging, an investor is either assuming that a positive return can be captured from market-timing of foreign currency changes, or that the foreign currency is sufficiently negatively correlated to their existing portfolio such that exposure to that currency improves the overall risk adjusted return of the portfolio. We find little empirical evidence to justify either hypothesis.

Should an investor with a very long-term time horizon hedge at all?

Some investors believe that currency movements are unpredictable but largely cyclical, and hence simply avoid hedging these exposures altogether in the confidence that they will average out to a near-zero impact over the long-term. If this were the case, one would expect a 5-year rolling exchange rate to not vary very much. In reality, the 5-year rolling averages of common FX pairs such as GBPUSD and EURUSD have a standard deviation that is only marginally smaller than that of the spot rate, as shown in Exhibit 1a and 1b.

For GBP investors holding USD assets, the impact of currency fluctuations would have added or detracted more than a cumulative 10% over rolling 5-year periods for more than 25% of observations since 1990. For EUR investors this same threshold is breached 17% of the time. In short,

Exhibit 1a

EURUSD and GBPUSD have a high standard deviation even on a rolling 5-year average basis, indicating that FX continues to be an unwelcome source of volatility over longer time periods

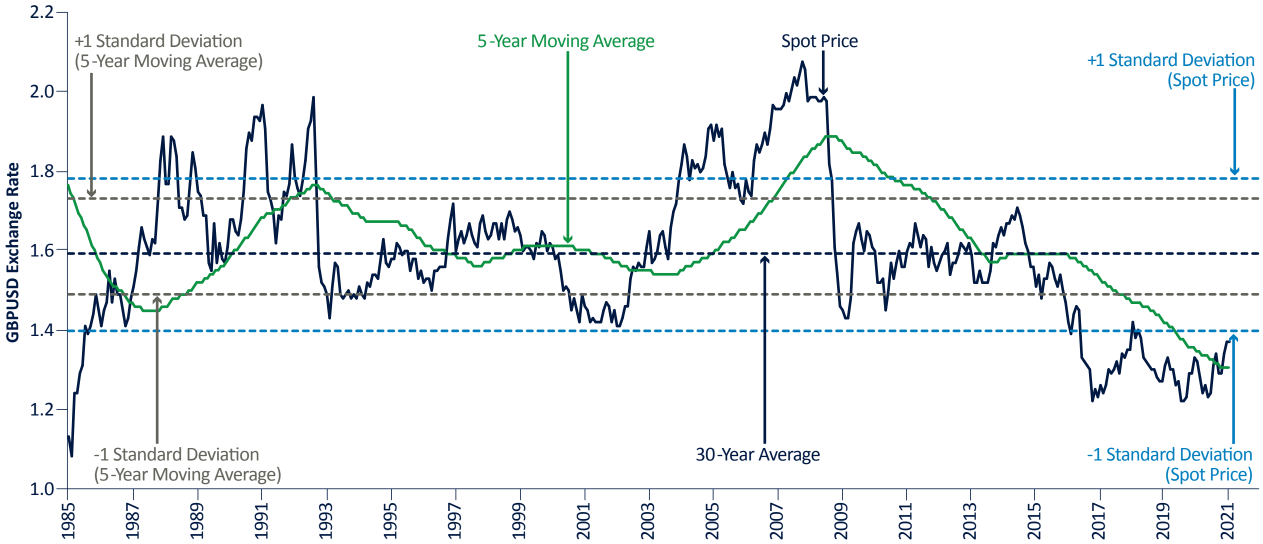
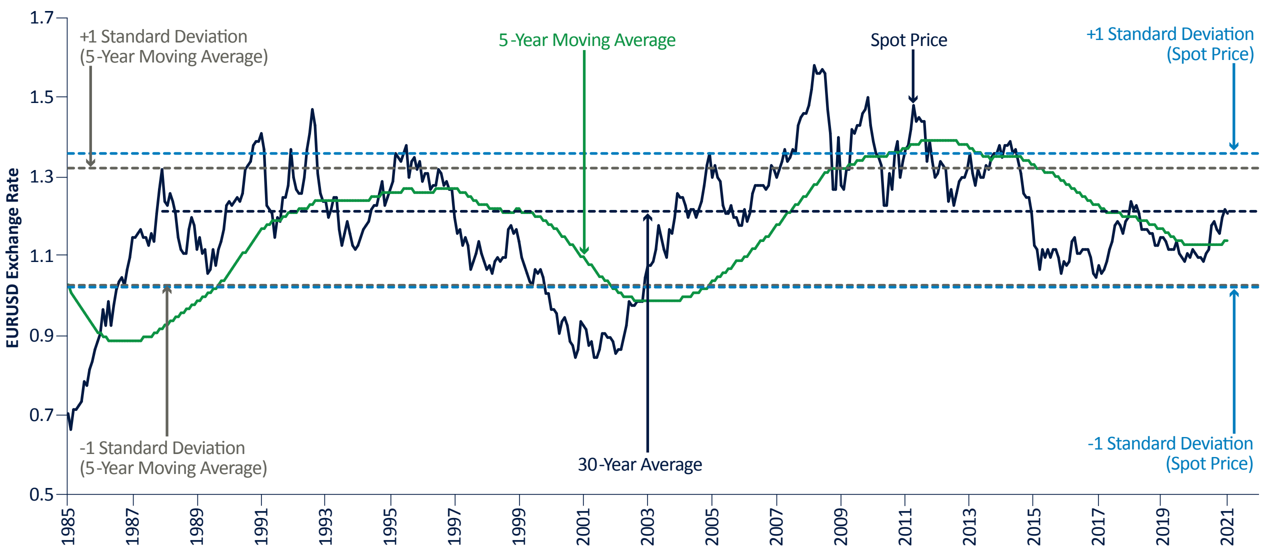


Exhibit 1b



Source: *Bloomberg*

where investors need a higher degree of certainty in their expected future returns, they should take steps to minimise the FX volatility within the portfolio.

Currency as a safety asset

In a "flight-to-safety" environment, funds typically flow into US Dollars, Japanese Yen and the Swiss Franc. This gives these currencies the additional benefit of acting as a safety net asset. This is one of the core reasons cited above to hedge less than 100% of FX exposure. Exhibit 2 below illustrates the performance of these currencies on a trade-weighted basis during times of crisis. The Yen and Franc have been particularly consistent diversifiers in a crisis. Unhedged US Dollars are slightly less reliable, particularly when the US is the primary source of a crisis, as witnessed when the dotcom bubble burst in 2000.

Golden Rules

The main objective of currency management is to protect a portfolio's purchasing power in the currency of future spending liabilities. To achieve this, we recommend that international investors with large non-home currency exposure adopt a hedging policy in which the home currency accounts for 60-80% of the portfolio's overall look-through FX exposure. There are several reasons why we usually recommend leaving a portion of a portfolio unhedged:

1. Many of the underlying foreign currency investments, primarily public and private equities, will be in companies whose financial prospects are internationally dispersed already, so hedging 100% may amount to over-hedging.
2. Beyond a certain level of hedging the marginal reduction in portfolio volatility from additional hedging becomes less significant.
3. Currency hedging requires additional portfolio liquidity as forward contracts require the posting of collateral and the funding of potential hedge losses.
4. Certain currencies tend to appreciate in a crisis, such as the US Dollar, Japanese Yen or Swiss Franc. Having an allocation to these currencies may potentially act as a diversifying safety net in a large market drawdown for those clients with a different home currency.
5. Most emerging market currencies are difficult and expensive to hedge. The additional risk should thus be incorporated into any consideration of investing in emerging markets.

Market Overview

The outlook for the US Dollar is generally negative. Of the ten major investment banks and research houses we sampled for FX views, nine had a negative view on the Dollar in 2021 and one was neutral. Their arguments generally highlight the large current account deficit and budget deficit in the US relative to history, with the potential for further fiscal stimulus and continued accommodative monetary policy to cause further Dollar weakness.

We agree that fundamentals appear negative for the Dollar. However, much of this has already been discounted by the market. As per Exhibit 3 overleaf, Dollar futures positioning is close to the lowest levels of the last 12 years. It is therefore possible that the market has overly discounted the degree to which the Dollar will decline, which could in turn cause an unexpected Dollar rally, as has been observed in the past. Furthermore, if Treasury yields were to rise by more than currently expected in the US, potentially unsettling equity markets, the ensuing risk-

Exhibit 2

Dollar, Yen and Swiss Franc tend to perform well in times of financial stress

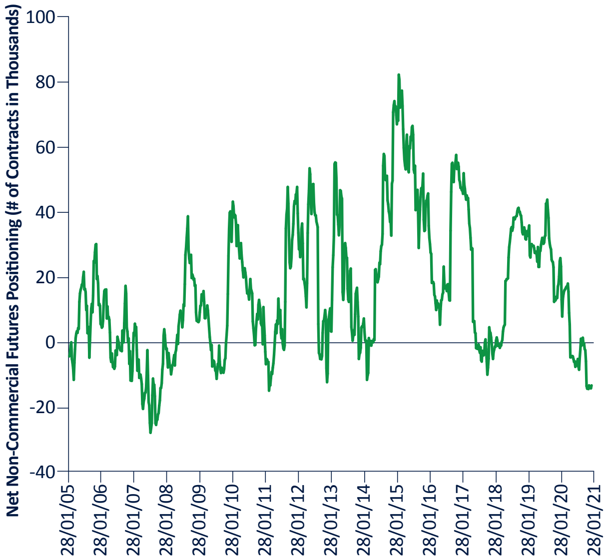
Start Date	End Date	MSCI World TR	Trade Weighted FX Index				
			USD	EUR	GBP	JPY	CHF
Aug-00	Sep-02	-45.7%	-5.9%	5.2%	-4.6%	-33.4%	6.9%
Oct-07	Feb-09	-50.8%	15.7%	-1.6%	-24.7%	29.4%	11.4%
Apr-11	Sep-11	-17.2%	7.2%	-6.8%	0.0%	10.6%	3.3%
Sep-18	Dec-18	-13.1%	1.7%	-1.1%	-1.5%	4.6%	1.0%
Jan-20	Mar-20	-19.9%	2.5%	1.5%	-5.6%	2.0%	1.3%
Straight Line Average		**-29.4%**	**4.2%**	**-0.5%**	**-7.3%**	**2.6%**	**4.8%**
Median		**-19.9%**	**2.5%**	**-1.1%**	**-4.6%**	**4.6%**	**3.3%**

Source: *Partners Capital Analysis, Deutsche Bank Trade-Weighted FX Indices, Bloomberg* off move would likely drive a flight to safety and result in a strengthening of the Dollar, thus reinforcing the potential safety net characteristics of holding unhedged US Dollars.

For our UK clients, we would also note that Sterling faces similar challenges of current account and fiscal deficits, so it is difficult to predict relative strength of weakness vs. the Dollar. With such uncertainties and limited conviction, we continue to recommend that clients refrain from making any large bets on FX markets, and instead stick closely to their target FX exposures.

Exhibit 3

Dollar weakness has been discounted – Dollar positioning in futures markets is at a 12-year low



***Source:** Bloomberg*

A note on Bitcoin and cryptocurrencies

While there has been a great deal of speculative trading around cryptocurrencies (and Bitcoin in particular) in recent months, we see little evidence that cryptocurrencies offer the requisite characteristics to justify inclusion in a diversified multi-asset class portfolio, either as an alternative currency or as a safety net allocation. This view is largely predicated on the high degree of volatility, regulatory uncertainty, risk of substitution and operational challenges. While we recognise that there is theoretically an upside scenario where Bitcoin and cryptocurrencies may be worth significantly more than today, we also see significant downside risks. Bitcoin should thus be regarded as a highly speculative investment, and not an alternative currency or a safety net allocation.

Bitcoin has no intrinsic value in the form of commercial applications or associated cash flows (interest or dividends). Its worth is dependent on a collective belief that it should serve as a store of value and potentially a medium of exchange. The degree to which the collective who hold this belief grows or shrinks will ultimately determine Bitcoin’s value. Recently, the collective has expanded to include a number of more institutional investors. This perceived increase in credibility, combined with high valuations in traditional assets contributed to an eight-fold surge in the price from the March 2020 lows (Exhibit 4).

For now, however, we echo the sentiments of Ray Dalio at Bridgewater who recently described Bitcoin as “a long-duration option on a highly unknown future”, and as with buying any out-of-the-money option, an investor should only spend what they are prepared to lose. Unlike gold, which has become a widely-accepted store of wealth and hedge against currency debasement with thousands of years of price history, the continued adoption of cryptocurrencies faces challenges and risks which include the following:

Volatility: Over the last 5-years Bitcoin has had an annualised standard deviation of 72%. For context, gold and equity markets have an annual standard deviation of about 15% and 16%, respectively. Since the start of 2018 the price of Bitcoin has declined by more than -5% on 1 in every 11 trading days. Just in January 2021 alone, the median absolute value of the daily price movement was 5.8%, with a max of +13.2% and a min of -18.1%. These are not the return characteristics of a currency or a long-term store of value.

Exhibit 4

Bitcoin rose 720% from the March 2020 lows to the recent January peak

Source: *Bloomberg*

Proponents of cryptocurrencies argue that both the volatility and high stress beta are just a function of nascency, and that the adoption of Bitcoin by larger institutions will result in a decline in volatility. This may ultimately be correct, but with two peak-to-trough declines of -84% and -63% in the last 5-years, we would rather adopt a "wait and see" approach. Bitcoin has the potential to be a diversifying asset in an investment portfolio given the low correlation to other financial assets, but we would need to see greater evidence of price stability before warranting proper consideration.

Regulatory uncertainty: The successful adoption of a private and unregulated digital currency would pose fundamental challenges to the existing monetary systems, tax authorities and law enforcement agencies. As such, there is a material risk that authorities take steps to prevent wholesale adoption of cryptocurrencies. An outright ban is unlikely, but we would expect stricter regulatory requirements on the on-ramps and off-ramps to the Bitcoin ecosystem (i.e., the conversion to and from fiat currency). This could significantly curtail the adoption of cryptocurrencies. Furthermore, several major central banks are evaluating establishment of their own digital currencies. Central banks are likely to strike a different balance in design, with an emphasis on robust regulatory oversight and fraud protection rather than privacy and scarcity. While this would not wholly undermine Bitcoin, it would significantly reduce its relevance and slow its adoption.

Recent rhetoric from influential policy makers suggest that the risk of regulation is rising. For example, during Janet Yellen's confirmation hearings for the role of US Treasury Secretary, she noted that "cryptocurrencies are a particular concern" when it comes to terrorism financing, saying "we really need to examine ways in which we can curtail their use and make sure that money laundering doesn't occur through those channels."

European Central Bank President Christine Lagarde was also recently quoted as saying that Bitcoin is "a highly speculative asset, which has conducted some funny business and some interesting and totally reprehensible money laundering activity... there have to be regulations... it's a matter that needs to be agreed at a global level, because if there is an escape, that escape will be used."

Substitution risk: There are over 5,300 actively traded cryptocurrencies. Bitcoin's market cap as a proportion of total cryptocurrency market capitalisation declined from 96% in February 2017 to 36% in January 2018 but has since returned to c.70% by the start of 2021[1]. While the supply of Bitcoin is limited, the supply of digital currencies is unlimited. Bitcoin's first-mover advantage may confer benefits as the "reserve currency" of cryptocurrencies, but we expect this dominance to be eroded over time by rivals that might compete on grounds of improved technology that reduces transactions times, energy intensity etc.

Operational challenges: At this point, institutional investment vehicles, custody solutions, insurance options and general market liquidity remain limited. Custody for digital assets is typically more expensive than for traditional financial assets such as gold or equities. For example, the

Empirical Assessment

[1]Journal of Alternative Investments, Fall 2020, Cryptocurrencies As an Asset Class? An

Grayscale Bitcoin Trust, the first digital currency investment vehicle to attain the status of a reporting company by the SEC, trades at a 20% premium to NAV and charges a 2% annual fee. If the industry continues to expand then the number of institutional investment options will certainly increase, but for the moment there are still too many operational red flags to merit institutional investment.

Losses as a result of fraud, theft and hacking still remain a significant challenge for cryptocurrencies with CipherTrace, a blockchain forensics company, estimating $4.5 billion in cryptocurrency-related losses in 2019. In early 2019, the 30-year old CEO of QuadrigaCX, one of Canada's largest cryptocurrency exchanges, unexpectedly died. Unfortunately, the CEO was the only person who knew the cryptographic key for the $137 million of cryptocurrency assets held in cold storage which therefore became unrecoverable. In mid-2019, hackers stole $40 million from Binance, one of the world's largest cryptocurrency exchanges. While the quality of institutional solutions is improving by the day, the safekeeping of one's cryptocurrency remains too vulnerable to hacking - or even just forgetting one's password.

Energy consumption and ESG considerations: Researchers at Cambridge University recently estimated that "mining" for Bitcoin currently consumes 121 terawatt-hours (TWh) of electricity per year, which is more than the total electricity consumption of Argentina (121TWh) or the United Arab Emirates (113TWh).

As crypto-currency prices rise, so does the incentive to mine. The Bitcoin protocol is designed to adjust to increased mining activity by increasing the difficulty of the 'proof of work' puzzle needed to successfully mine a coin. The protocol adjusts the difficulty level so that, on average, one new block is mined roughly every 10 minutes irrespective of the intensity of mining operations or efficiency of the mining hardware. This ensures growth in supply of Bitcoin in line with the originally intended path until the max limit is reached in 2140, but is also likely to ensure growth in energy consumption of mining operations unless prices suddenly slump, reducing the incentive to mine.

With the increasing costs of mining Bitcoin, production has also increasingly moved to jurisdictions such as China (estimated by Cambridge to be 65% of all production), Russia (7%), Kazakhstan (6%) or Iran (4%) which have access to cheap coal-fired electricity, dramatically worsening the environmental impact of bitcoin mining. This may also attract greater scrutiny and therefore regulation in the coming years, as well as potential backlash from consumers.

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