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.

Major trends

End of the "race to debase": The key trend in 2022 will be the change in policy stance by developed market central banks as they move away from ultra-accommodative policy in response to inflationary pressures. US and UK are expected to increase interest rates the most, with USD and GBP priced to depreciate against the EUR in forward markets such that covered interest rate parity holds.

Golden Rules

- Currency markets are highly efficient and rapidly adjust to new information. The innumerable factors affecting FX prices mean they can be very volatile and are largely unpredictable.
- Investors are not compensated for the incremental currency risk they bear, and seldom have any knowledge that would give them an advantage in predicting future currency directions. As such, investors should seek to hedge as much foreign currency as is practical to minimise the differences between the currency mix of the portfolio's assets and the currency of the portfolio's liabilities, on the basis that they wish to narrow the potential range of portfolio outcomes.
- Investors should view hedging as a means to reduce currency risk even though this may come at a small cost. However, reasons to not hedge all foreign currency exposure include:
  - i. Currency hedging requires additional portfolio liquidity as forward contracts require the posting of collateral and the funding of potential hedge losses.
  - ii. 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.
  - iii. Beyond a certain level of hedging the marginal reduction in portfolio volatility from additional hedging becomes less significant.
  - iv. 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.
  - v. 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.

2022 Strategic Priorities

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.

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