THE Guardian

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To Hedge or Not to Hedge?

For most Canadians, the impact of a rising or falling Canadian dollar relative to the US dollar is first felt when we are buying our produce at the grocery store or booking a vacation to the US. A weakening Canadian dollar makes both more expensive.

However, for investors that hold US stocks either directly or indirectly in their mutual funds or ETFs, a weakening Canadian dollar is a potential benefit. Conversely, a rising Canadian dollar vis-à-vis it's US counterpart will reduce the return on their US holdings. Investors do have an option to minimize this currency risk with the proliferation of global mutual funds and ETFs that are hedged back to the Canadian dollar.

So we circle back to the question we started with. Does it make sense to hedge our global equity holdings?

Any period when the Canadian dollar rises in value (whether against the US dollar or some other foreign currency), using ETFs or mutual funds with currency hedging will lead to higher returns in foreign equity investments. Whenever the Canadian dollar loses value relative to foreign currencies, the unhedged versions will win out.

There is no question currency hedging will work in the investors favour during many periods, even some lasting many years. The most dramatic example comes from early 2000 to late 2007 when the Canadian dollar increased from $.62 USD to almost $1.09 USD, punishing investors who held US equity funds or ETFs without currency hedging.

Duly noted, while there are divergent opinions, most money managers believe that hedging currency risk within equity mutual funds or ETFs (as opposed to fixed income mutual funds or ETFs which will be discussed later), is not a winning strategy for a couple of reasons.

i) Hedged portfolios are not necessarily less volatile. Specifically, it is misleading to say hedging strategies “eliminate currency risk“ because this implies that non-hedged ETFs are more risky. In fact, there is evidence that adding currency diversification actually lowers the volatility of a portfolio, at least for Canadian investors. That is because the US dollar has some negative correlation with the global stock market during periods of falling stock prices. Many investors see the US dollar as a safe haven which drives up its value.

ii) Human nature dictates the investor will be tempted to switch back and forth dependent upon their predictions of currency movement. If the investor could get the timing right this would work brilliantly. Unfortunately, reliably predicting currency movements is futile, resulting in a potential cycle of guessing games. And if switching back and forth takes place in a non-registered account, it is likely that taxes will reduce the impact of the gains, even if the currency movement was predicted correctly.

Further reinforcing the argument not to hedge is found within the commentary of the 2013 Canada pension plan annual report, where it states “the CPP investment board sees no compelling reason to hedge equity related currency exposure, largely because hedging would unduly tie returns to the price of oil and other commodities as they drive the foreign-exchange value of the Canadian dollar”.

The discussion to this point has focussed on whether or not hedging make sense for equity investments. The same question can be asked of fixed income holdings. The global fixed income market is substantially larger than the global equity market and a truly diversified fixed income portfolio should include non-Canadian bonds. To this point, there is a much clearer consensus amongst the investment community.

An informal poll of the 15 largest retail equity mutual funds in Canada reveals that three of the funds employ a comprehensive hedging strategy, six utilize a partial hedging strategy and six don’t hedge at all.

Conversely, of the 11 largest fixed income funds that addressed the same question, all were fully hedged.

The rationale for hedging fixed income investments but not equity investments is driven largely by investor needs. Specifically, one of the objectives of fixed income investments is to diversify an equity portfolio, providing ballast during periods in which equity markets are delivering negative returns. For example, if foreign denominated fixed income investments are delivering a positive yield of 4%, a swing in currency values of 10% results in a yield to the investor of -6%, hardly the ballast the investor was looking for in a period of equity volatility.

A Word on Market Volatility

Recent stock market volatility has quite understandably spooked equity investors, with the current bull market in US equities now extending beyond nine years. Depending on how you are reading the tea leaves, there are reasons to be both optimistic and pessimistic over the near term.

Bulls say:

- The IMF's April outlook revised global growth estimates higher to 3.9%.
- Corporate earnings continue to exceed expectations. Roughly 50% of the S&P 500 companies have reported first quarter earnings and 80% have surpassed earnings forecasts.
- A recent pull back in equity markets has made valuations more attractive, particularly in Canada.

Bears say:

- Housing markets appear to have peaked and not just in Canada.
- Rising interest rates in the US will dampen growth.
- Global debt continues to expand.

Predicting short term market movements is a futile endeavor. Conversely, we know that regardless of short term gyrations, the inexorable, long-term path of equity markets is upwards. Investors with a long-term perspective and an asset allocation that reflects their risk tolerance and timeframe need not worry. Conversely, the investor positioned aggressively or with a shorter time horizon would be wise to heed some of the negative sentiment and look to trim back on their more aggressive equity positions.

As always, your Solguard/Manulife Securities advisor welcomes any questions you may have.

REGISTERED RETIREMENT INCOME FUND (RRIF)
STATUTORY MINIMUM MONTHLY INCOMES BASED ON $100,000
COMMENCING ONE MONTH FROM ISSUE

Best Current Rate: 3.2% [1]

Age	1st Year	TOTAL PAYMENTS TO AGE 100
55	$239.00	$197,039.08
60	278.00	180,896.60
65	334.00	166,848.49
71	440.00	152,825.13

A R.R.I.F. can also be structured to pay a level income for a shorter period. Based on current interest rates, $100,000 will produce the following monthly income.

For 5 years: $1804.00
For 10 years: $946.00
For 15 years: $670.00

MONTHLY ANNUITY INCOMES COMMENCING ONE MONTH FROM ISSUE BASED ON $100,000 [1]

Age	LIFE (Payments cease at death)		LIFE 10 Year Guarantee		JOINT LIFE 10 Year Guarantee
	MALE	FEMALE	MALE	FEMALE	MALE & FEMALE
65	$545.23	$490.78	$530.27	$488.66	$442.93
70	639.37	569.05	605.61	554.95	499.51
75	756.27	671.18	681.47	627.39	573.29
	940.67	823.00	778.48	727.70	678.06

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[1] CANNEX