Aon Hewitt
Retirement and Investment

Does Currency Hedging Matter in DC?

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Executive summary

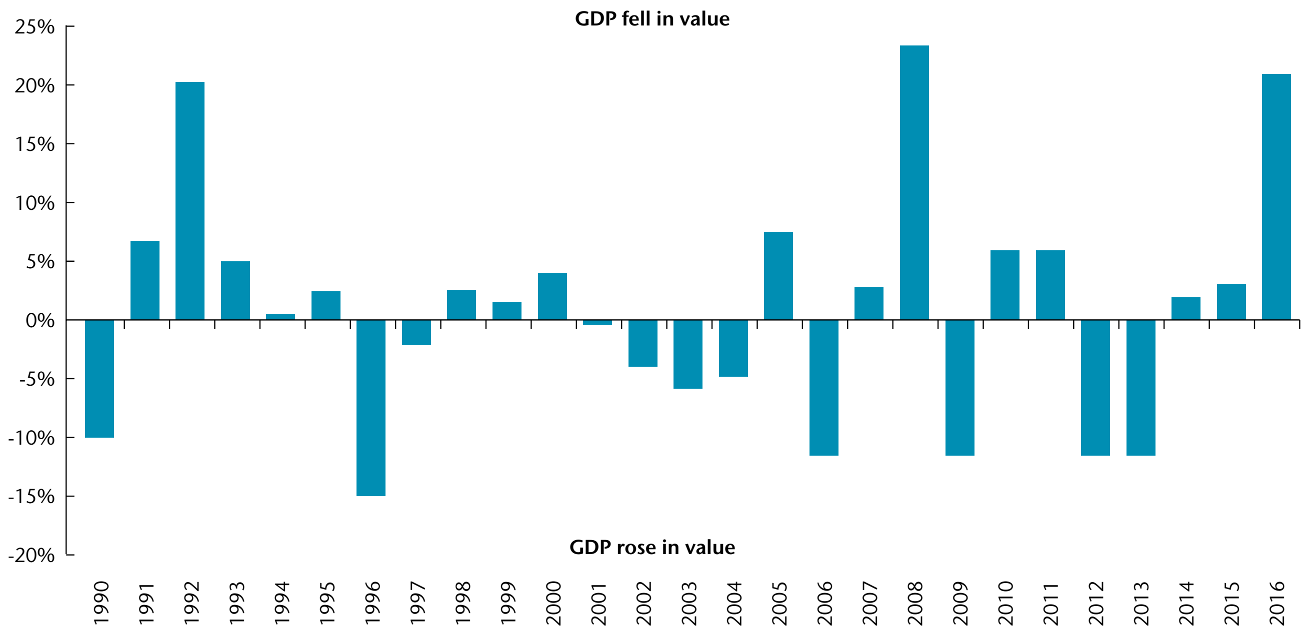
- Currency movements can have a significant impact on portfolio volatility and can dominate returns at times. Trustees should consider members' exposure and likely tolerance for currency risk.
- We believe currency hedging back to sterling will generally dampen overall portfolio volatility over the medium term. However, for long term investors the risk reduction benefits may be viewed as more modest. As such, for defined contribution schemes, we support:
  - Hedging the full currency risk for asset classes with relatively stable underlying values, such as overseas bonds or absolute return strategies.
  - A pragmatic approach of hedging half of the currency risk associated with overseas equity. However, Trustees should consider their specific circumstances and investment beliefs to ensure that currency hedging yields significant enough risk reduction benefit for the added cost.
- When considering **currency risk in defined contribution schemes**, Trustees need to consider a number of factors, including:
  - Current availability of "DC-friendly" currency-hedged funds (which, in practice, is limited but improving) including platform availability.
  - Any added costs to members of investing in currency-hedged funds, even though these aren't expected to be significant (most important within the default strategy where member-borne deductions must be below 0.75% p.a. to meet the charge cap requirements).
  - Whether to make a strategic decision (for the long term) or tactical decision (for the medium-term). Clearly a tactical decision requires ongoing monitoring and periodic adjustment, which increases the required governance capacity, and may also increase tracking error which would require careful communication with members.
  - The long-term time horizon of members in the "growth" phase of a typical lifestyle strategy. For these members risk tolerance is typically at its highest and so they are generally able to accept a higher degree of volatility in returns. This may reduce the need to introduce currency hedging on the basis of risk reduction.
- Following the recent depreciation of sterling, we believe the Pound has fallen to a level sufficient for Trustees to consider whether to introduce a strategic currency hedge, if not already in place.
- Implementation challenges can be material and options should be considered up front. A first step for Trustees is to consider the availability of (or feasibility of making available) appropriate currency-hedged options and how currency hedging can be incorporated into the default strategy.

Why is currency hedging important?

Defined contribution schemes offer investment options which increasingly invest on a global basis, using overseas assets to diversify returns and gain access to attractive assets outside the UK. While this is beneficial, it does expose members to exchange rate movements.

The chart below shows the difference between the returns to a UK investor on an unhedged overseas equity portfolio and one with currency hedging on an annual basis.

Impact of currency exposure on overseas equity returns

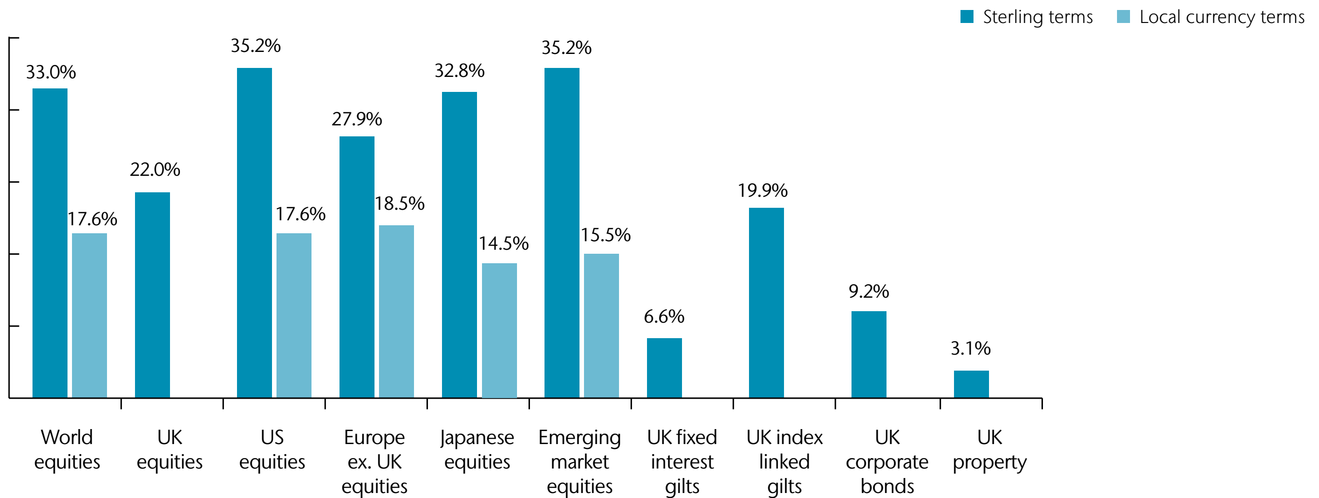


Source: MSCI. Difference shown is between MSCI World ex-UK (GBP) minus MSCI World ex-UK (hedged)

As the chart demonstrates, the impact of currency movements is not stable and can be significant. An appropriate level of currency hedging needs to be carefully considered and be consistent with the trustees investment beliefs.

In particular, trustees need to understand which investment options incorporate unhedged currency exposures and consider whether members appreciate the impact on investment performance. For example:

Index returns from 31/03/2016 to 31/03/2017



Source: Datastream/IPD

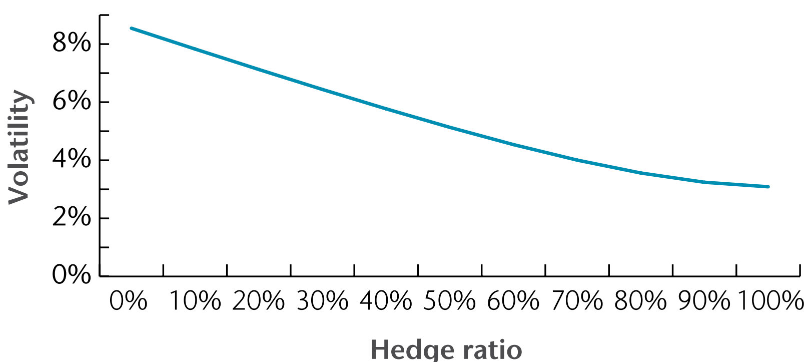
Past performance is not an indicator of future performance.

Whether to hedge against currency movements

Reducing currency risk has historically helped to reduce overall portfolio risk and, looking forward, some currency hedging makes sense from a risk reduction perspective. The significance of this risk will depend on specific circumstances and in particular members' investment time horizon. To provide general guidance, we have focussed our analysis on the two most common asset classes that give rise to currency risk; overseas bonds and equity.

For lower volatility asset classes, such as overseas bonds and most absolute return strategies, currency contributes a significant proportion to risk. Therefore, currency hedging considerably reduces volatility. The chart below shows how the historic volatility of a global bond portfolio varies with the level of hedging. As you can see, volatility continues to fall as hedging rises towards 100%. **For overseas bonds and most absolute return strategies we therefore support full currency hedging.**

Global bond volatility across different hedge ratios (1/90 – 7/16)



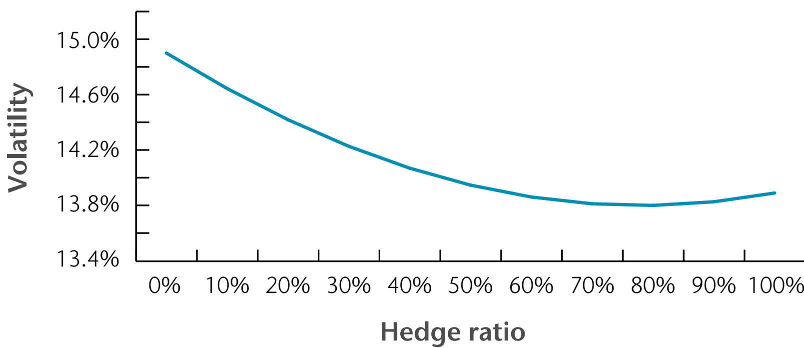
Source: Barclays Capital Global Aggregate Bond Index

The good news for defined contribution scheme Trustees is that most bond and multi-asset investment options already incorporate full (or at least partial) currency hedging, carried out directly by the investment manager.

Global equities, on the other hand, are more volatile and, broadly speaking, most equity options provided by defined contribution schemes, tend to be unhedged. For global equity funds a greater portion of the overall risk comes from equity markets rather than currency. Looking historically, most of the risk reduction is achieved by increasing the level of hedging from zero up to around 50%. Beyond this level, there are diminishing benefits to additional hedging (as shown in the chart below). Over the time period used in the analysis, risk would have been minimised with a currency hedge ratio of around 70% to 80%, but repeating this historical analysis over different time periods shows that this optimal point varies considerably.

Looking forward, **a single optimal level of currency hedging does not exist for overseas equities.** We believe that in an effort to control volatility in a pragmatic way, rather than relying on historical precedence over a specific time period, and to avoid the additional governance of tactical allocation, strategically hedging 50% of the currency exposure from overseas equities is reasonable. However, trustees should consider their specific circumstances. In particular, currency hedging overseas equity may not be viewed, based on your investment beliefs and member time horizon, as yielding enough risk reduction benefit for the added cost.

Global equity volatility across different hedge ratios



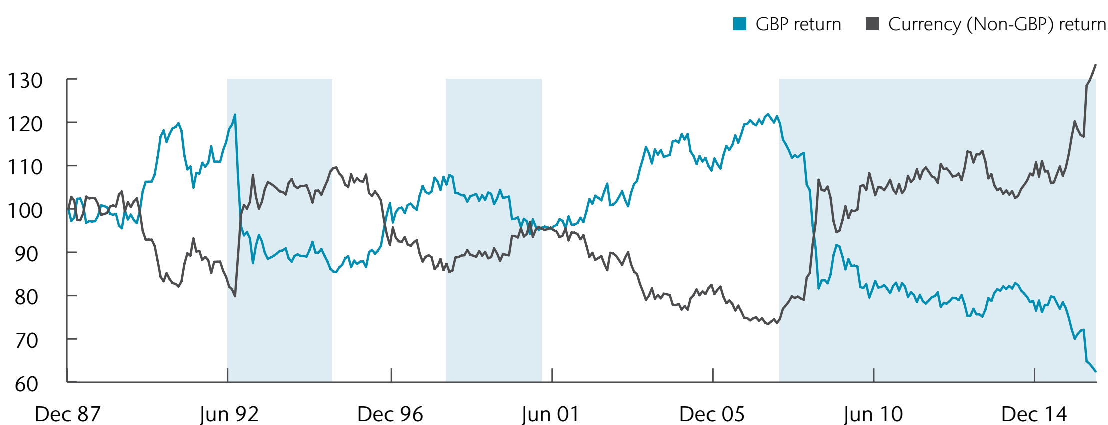
Source: MSCI

Why is now a good time to consider hedging?

We believe that currency markets will be increasingly volatile over the next few years, particularly as Brexit uncertainty is reflected in sterling. Moreover, the US election result continues to create uncertainty over US monetary and fiscal policy which impacts the US dollar exposure that is so dominant in global equity and bond portfolios. At the same time, changes to US trade policy have a widespread impact on other currencies. Hedging currency helps to protect a portfolio from resulting currency swings.

Furthermore, from a return perspective, we believe based on historic experience and academic research, that implementing currency hedging after recent significant sterling weakness, gives a good chance that the hedge will not be detrimental to overall portfolio performance. UK investors holding overseas assets with no currency hedging have benefited in the past from sterling weakness, gaining approximately 29% from unhedged equities since 2014 and a massive 48% since 2007 (see chart below).

Currency returns from overseas equities



Source: MSCL. Currency cumulative return indices are approxiamted from the MSCI World ex UK hedged and unhedged indices. Blue shaded areas denote periods of currency gain.

Now is therefore a good time to discuss whether to hedge overseas currency exposures within your defined contribution scheme.

For those schemes planning to implement investment strategy changes, we suggest investigating the feasibility of incorporating an appropriate degree of currency hedging across your investment options, both default and self-select.

Implementation and costs

Implementation choices will typically start with what is readily available to each scheme. Our preference is to use the most operationally simple and cost efficient option. However, in the current defined contribution market, the options available will generally be limited to those available on your platform.

Generally speaking, the additional management costs for currency hedging a global equity investment range from 0.02% to 0.06%, per annum, relative to the same unhedged fund. Moreover, Aon Hewitt has been working with investment managers of pooled funds and third party platform providers to provide suitable and cost effective solutions that will help our clients meet their currency hedging requirements.

Conclusions

- Trustees should consider the currency risk to which their members are exposed and confirm their currency hedging views and approach.
- Currency will be volatile and could dominate portfolio returns in the short term, particularly given uncertainty surrounding Brexit and US policy under a new President.
- Portfolio volatility can be dampened through strategic or tactical currency hedging. However there are important factors to consider which are specific to defined contribution schemes schemes including the investment time horizon of your members. In our experience, there may be cases where currency hedging is considered either not worthwhile or not practical.
- Operational aspects including fund availability, any additional costs to members and the practicalities around making changes to the investments offered also need to be factored into this decision.
- However, where Trustees plan to implement currency hedging, we believe now is a reasonable time to do so, in particular following considerable sterling weakness.

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