rise financial

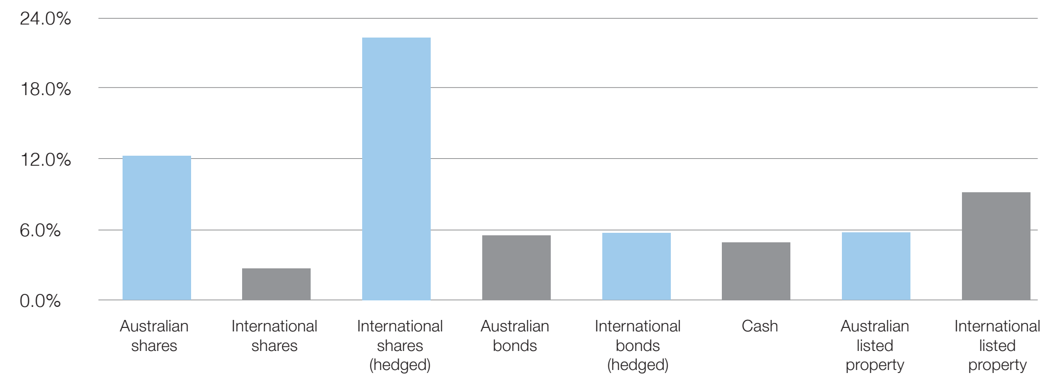
Snapshot

Hedging against uncertainty

Australians love a winner and for the past year the Australian dollar has been punching above its weight on global currency markets. The strong local currency is a windfall if you are planning an overseas holiday or shopping for imported goods, but it is bad news for overseas investments that are not hedged against currency movements.

As the chart below shows, in the year to 30 June 2011, international shares were the best performing asset class with a return of 22.3 per cent, streets ahead of local shares, bonds and property. But there was a catch. This excellent return was only available to investors in hedged share funds. Unhedged international shares were last year's wooden spooners, with a return of just 2.7 per cent.

2010–2011 financial year total returns (%) by asset class



Source: Vanguard® 2011 Index Chart

The difference in returns came down to the soaring Aussie dollar. In the year to June 30, the Australian dollar appreciated by almost 29 per cent against the US dollar, up from US83.6c to US$1.07.

When you buy overseas assets you pay for them in Australian dollars, converted into local currency at that day's rate of exchange. When it comes time to sell, the proceeds are converted from local currency back into Australian dollars. If the Australian dollar rises during that time it reduces the value of your investments, and vice versa.

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What is hedging?

Hedging is a form of risk management used by companies and fund managers to lock in a future exchange rate or asset price. They use a variety of strategies to achieve this, including forward sales and put and call options, but that is a topic for another time.

You can think of hedging as a form of insurance to protect investors against adverse currency fluctuations. There is a financial cost in entering into these contracts so investors need to take this into account when making the decision to hedge or not to hedge.

Global opportunities

Local investors are generally advised to allocate some of their money to overseas investments to spread their risk and boost returns, and rightly so. The Australian sharemarket is a minnow by world standards, at just 2.5 per cent of the global sharemarket value. Australia has only a handful of international companies and there will be times, like last year, when other markets will outperform local shares.

Developing nations are expected to grow at twice the rate of the developed world this year, so investors should be aware of exposure they have to these opportunities. One approach might be via an international share fund, with the fund manager looking after the hedging strategy. Many of these international funds are offered in hedged and unhedged versions.

Alternatively, you can buy shares in Australian companies with overseas operations. An investment in BHP Billiton or Cochlear, for example, provides exposure to the global market. Often these companies will do their own currency hedging.

Hedging is important for Australian mining companies which face a double whammy when it comes to exchange rates. Not only do they have to deal with currency fluctuations when they export the metals and minerals they produce, but commodities are priced in US dollars. Some local gold miners, for example, hedge against unforeseen changes in international gold prices. They might also hedge against exchange rate fluctuations. Other gold miners choose not to hedge at all.

There is no right or wrong answer to the question of whether to hedge or not to hedge. Currency fluctuations tend to even out over time, as do the returns from hedged and unhedged investments.

Swings and roundabouts

So before you rush out and buy a hedged international share fund — or anything else, if you are tempted to base your decision on last year's returns — it is worth noting the long-term performance figures. In 16 of the last 30 years, or roughly half the time, it was unhedged international shares which outperformed their hedged equivalent.

Looking at average returns paints a different picture. The average return for unhedged international shares over the past 30 years was 11.5 per cent a year compared with 13.4 per cent for hedged. A difference of 1.9 per cent is not to be sniffed at, but the scales could tip either way depending on your investment timeframe.

Rather than chopping and changing between hedged and unhedged share funds in a vain attempt to catch next year's winner based on last year's results, a better approach is to choose a good quality fund, either hedged or unhedged, and stick with it.

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