Hedging

Global investing and currency hedging: Performance and impact

There are a whole host of factors that come into play when investing in a global selection of assets. Often disregarded, a key element of global investing is currency exposure, and with that, the associated exchange rate risk.

The Russell Investments Multi-Asset Growth Funds are among a group of funds that hedge currency in order to combat that exchange rate risk. Over the long term, currency hedging can provide you with valuable protection and returns, particularly in volatile markets. However, against the market backdrop of 2018 which saw significant sterling volatility, currency hedging had a negative impact on the short-term performance of the Russell Investments Multi-Asset Growth Funds.

Here we outline some of the key considerations for UK investors exposed to global equities and explain how currency hedging can impact or benefit a global, multi-asset portfolio.

Global equity investing: Currency exposure is an automatic by-product

You don't just have to think about currency and exchange rates when travelling abroad, it applies to investing, too. To put it simply, if you're a UK investor with any stocks or bonds in your portfolio from outside of the UK, you are automatically exposed to the currency of those countries.

Take for instance the MSCI World Index, which is only made up of 6**%** UK equities.[1] The rest is comprised of equities from outside the UK such as the U.S., Europe and other countries. An investor in this index therefore, doesn't just have equity holdings – they also have direct exposure to the other countries' currencies such as dollar, euro and yen. In other words, this currency exposure is an automatic 'by-product' of a global equity investment.

Currency exposure and exchange rate risk

You wouldn't want only 8% of your salary to be paid in sterling, and the rest in dollars, euros and yen etc. – would you? So why accept your investment income like this?

Ideally, it needs to be converted into your home currency. Therefore, a global equity investor is subject to an additional layer of risk: the risk of loss when these other currencies are exchanged for their equivalent in sterling, i.e. exchange rate risk.

In order to manage this exchange rate risk, the currency exposure can be hedged using forward exchange contracts.

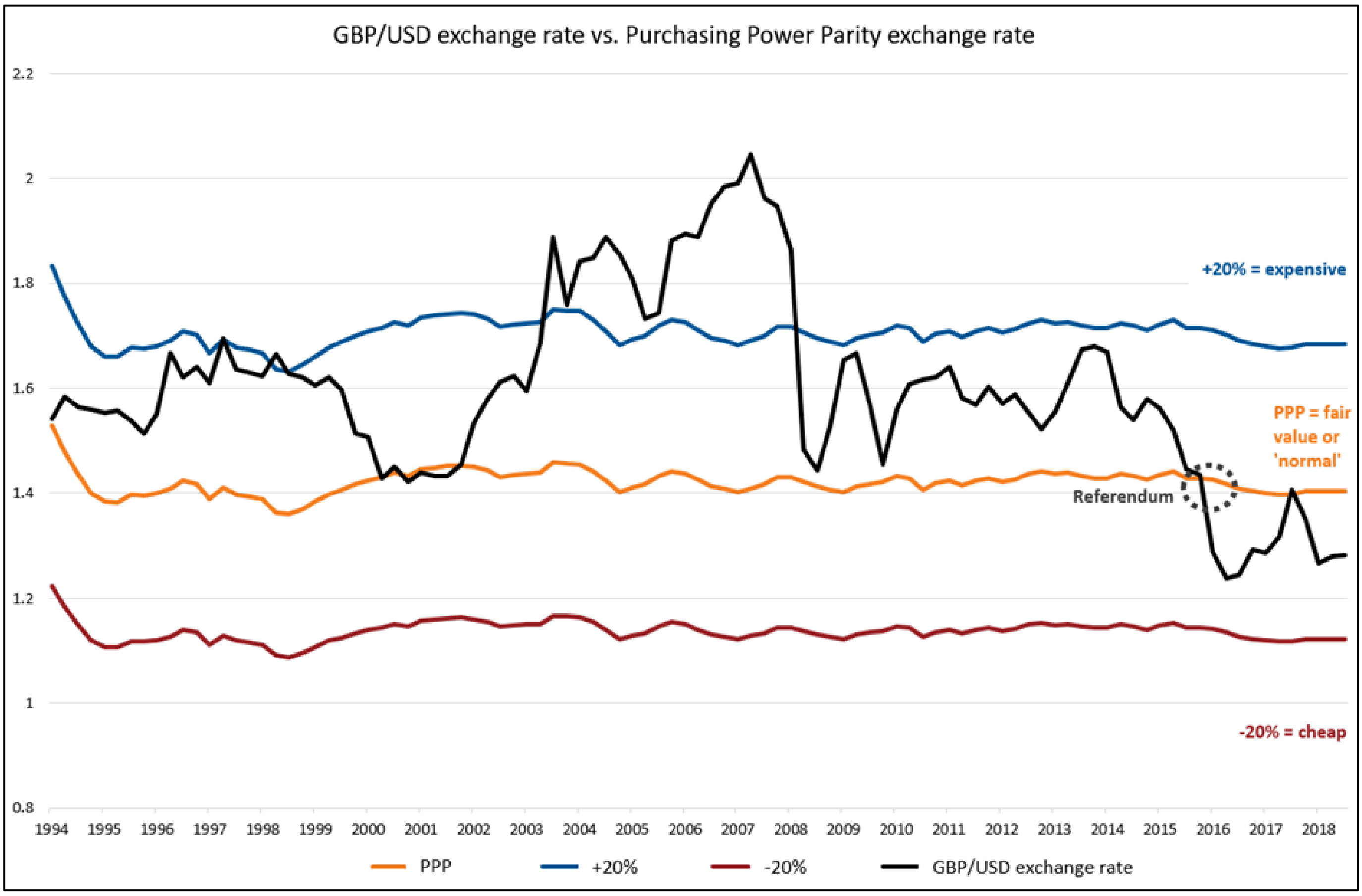
Currencies move up and down: Use Purchasing Power Parity as a value anchor

Like most asset classes, currencies go through prolonged return cycles, moving up and down over time. Purchasing Power Parity (PPP) is used to compare different currencies and is a value anchor for their moving prices. It works by calculating the exchange rate at which a basket of goods cost the same in two different countries by accounting for differences such as inflation rates and cost of living.

In this chart we have mapped the standard market exchange rate for GBP/USD (black line) against the Purchasing Power Parity exchange rate (orange line) since 1994. As you can see, it is not rare for the market exchange rate to deviate 20/30% above or below the Purchasing Power Parity exchange rate (blue and red lines). When the

[1] As at the 12th February 2019.

Chart 1: GBP/USD market rate regularly deviates from PPP, but eventually mean-reverts



Source: Thompson Reuters Datastream as at 11, February 2019.

exchange rate is very expensive or cheap like this, there is a tendency for it to eventually return back to the Purchasing Power Parity rate which is considered fair value or 'normal'.

Brexit and the depreciation of sterling: Performance implications

Over the second half of 2018, sterling depreciated significantly, falling well below its Purchasing Power Parity exchange rate. Since 1994, this has only happened once before – following the Brexit referendum on the 23rd of June 2016. We attribute this fall in the price of sterling then, and in 2018, to the political uncertainty surrounding Brexit.

As a result of this depreciation, sterling hedged equities suffered negative returns over 2018 due to the continued fluctuations and depreciations in sterling, and this impacted performance in the Russell Investments Multi-Asset Funds. As you can see in the table below, unhedged global equities benefitted from their currency exposures and were able to participate in the upside, losing less overall.

MSCI World total returns 1 January – 31 December 2018

Sterling-hedged global equities	-8.4%
Unhedged global equities	-2.6%

Source: Bloomberg as at 8, February 2019.

Sterling volatility looks set to continue in the face of ongoing uncertainty surrounding Brexit negotiations and the run up to the 29th of March. And this may see sterling-hedged

As in the chart above, past experience suggests that sterling is likely to appreciate and return to fair value, or to a more 'normal' price.

Russell Investments Multi-Asset Growth Fund range

Hedging policy

In the Russell Investments Multi-Asset Growth Fund range, we employ a static currency hedging programme as standard. Our hedging policy is as follows:

- Fixed income securities are traditionally considered to be the defensive part of the portfolio. It is because of this that we always hedge fixed income instruments back to sterling in order to protect against the additional layer of exchange rate risk.
- Within equities, the only securities available to hedge are non-sterling developed market equities such as those from the U.S. Japan and Europe. Emerging market currencies are not hedged within the funds as the cost of hedging is, in our view, too high to take on.
- We do not hedge the foreign currency exposures of our commodities investments

Overall, Russell Investments' strategic positioning approach hedges 50% of the eligible foreign currency exposures available within the funds, as indicated above. Over time and with changing market dynamics, the portfolio management team may tactically deviate from this strategic positioning if they have a strong view on a currency; but these deviations would only amount to a couple of percentage points.

On the back of this hedging policy, our foreign currency exposure within the Multi-Asset Growth Funds will strategically sit in a range of 9% (ICVC Multi-Asset 1) to 30% (ICVC Multi-Asset 5). This expresses our long-term view that overall, hedging reduces exchange rate risk. It also demonstrates our belief that the Brexit-related uncertainty will eventually be resolved.

2018 returns

Last year was a worse-case scenario for sterling-hedged assets and markets as a whole. Against this backdrop, the only asset class that performed well was foreign currency – an extremely rare market event. Due to our hedging policy, we were unable to participate in the upside available in foreign currency, and thus we suffered losses in our sterling-hedged positions, versus unhedged peers. In addition, many of our peers hold higher levels of foreign currency than the Multi-Asset Growth Fund range, allowing them to benefit from the strong performance.

It is important to remember that there are multiple drivers of currencies such as monetary policy, geopolitics and market sentiment. Because of this, it is impossible to predict the direction of global currencies. However, we take the view that, as it stands, we are best positioned by continuing to hedge our portfolio back to sterling on a long-term view.

About Russell Investments

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For more information

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