LOGICAL THOUGHTS

logical financial management

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IMPACT OF A FALLING DOLLAR

Gavin Shepherd
Portfolio Construction & Investment Research Manager

The Australian dollar is now worth around USD 0.74, a level not seen for more than six years. This is a timely reminder that when investing offshore, your currency exposure (foreign currency exchange rate movement relative to the Australian dollar) can have a significant effect on your international investment returns. The total returns from international shares are derived from the change in the value of the investment and currency.

When the Australian dollar falls or rises relative to overseas currencies, the performance impact for Australian investors who hold international assets will vary depending on whether their portfolio is hedged or unhedged.

When the Australian dollar is depreciating (falling) the returns from the international shares portfolio are enhanced if the portfolio is unhedged. When the Australian dollar is strongly appreciating, then to avoid currency losses, it's better to have currency management (hedge) in place (see Table 1).

Table 1: The impact on hedged and unhedged international share portfolio returns when the Australian dollar falls or rises

	Australian Dollar Falls	Australian Dollar Rises
International Shares Portfolio **Hedged**	Detracts from performance	Enhances performance
International Shares Portfolio **Unhedged**	Enhances performance	Detracts from performance

Chart 1 (below) shows the impact currency hedging has on an international shares portfolio. In this example, the Vanguard International Shares Index Fund was used as it has a fully hedged version and unhedged version. The chart demonstrates the difference in performance between the fully hedged fund and the unhedged fund between September 2000 and June 2015 – a positive return indicates that the unhedged fund has outperformed the hedged fund. A negative return indicates that the unhedged has underperformed the hedged fund.

Chart 2 (below) shows the movement in the Australian dollar against the US dollar over the same period.

The two charts clearly show that when the Australian dollar falls against the US dollar then the unhedged fund performs better whereas when the dollar increases the unhedged fund underperforms. For example, if a client's portfolio had been unhedged over the 12 months to the end of February 2010, currency would have detracted 39% from total returns due to an appreciation in the Australian dollar. During this time, the Australian dollar rose from approximately 64.4 cents in January 2009 (relative to the USD) to approximately 90 cents (relative to the USD) by January 2010. In contrast, in the 12 months to January 2014, an unhedged portfolio would have added 18% to returns due to a favourable depreciation (fall) in the Australian dollar.

During the Global Financial Crisis, the Australian dollar relative to the US dollar fell back below USD 0.70 (monthly low of USD 64.38) and unhedged international shares were provided with currency gains that cushioned some of the negative returns from shares over this period. For example, if a client's portfolio had been unhedged over the 12 months to the end of October 2008, currency would have added 22% to their international share portfolio value.

Both the Vanguard hedged and unhedged versions of the funds contain the same underlying assets with the same objective. The only difference is the hedged version assets are hedged to Australian dollars, so the return is relatively unaffected by currency fluctuations while the unhedged version is fully exposed to the fluctuating values of foreign currencies. In other words, the difference in performance is solely explained from currency movements.

Chart 1: Currency impact on international share returns over rolling 1-year periods

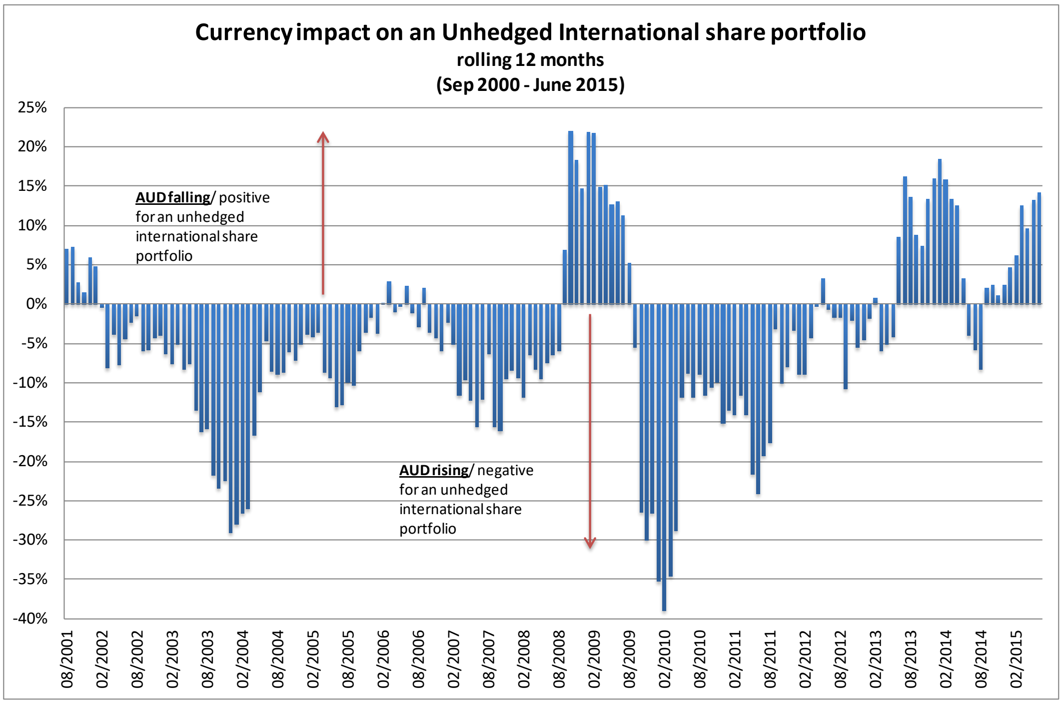
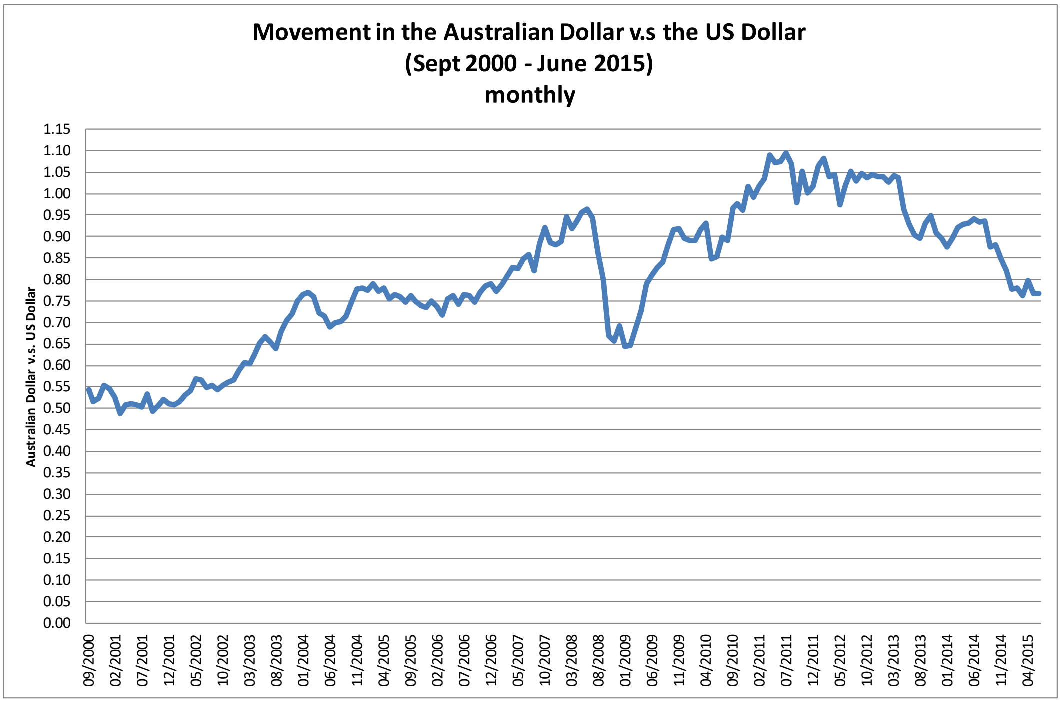


Chart 2: Monthly movement in the Australian dollar vs. the US dollar between September 2000 and June 2015.



Hedge or Not to Hedge

The issue that needs to be considered by the investor is whether they should hedge, be unhedged or partially hedge their international exposure.

Typically, an unhedged position provides better diversification benefits and allows the investor to benefit from a weak Australian dollar than a hedged position.

Research carried out by Logical showed that the Vanguard international portfolio unhedged version exhibited lower correlations (see Table 2) against 4 major asset classes when compared against the Vanguard international portfolio hedged versions over the last 10 years. For example, there is a high correlation (0.83) between the returns in the Australian share market and the Vanguard hedged version. In contrast, if you invested in the Vanguard unhedged version and introduced currency risk the diversification benefits improved, and the correlation falls to 0.46.

(Note: Correlation is a measure of potential diversification. A correlation of 1 indicates assets move completely in line with each other and -1 indicates an inverse relationship in price movement).

Table 2: Correlations between major asset classes and Vanguard international fund - hedged and unhedged (10 years to end June 2015)

	Australian Shares	International Fixed Interest (Hedged)	Australian Fixed Interest	A-REITs
Vanguard International Shares **(Unhedged)**	0.46	-0.20	-0.41	0.49
Vanguard International Shares **(Hedged)**	0.83	-0.03	-0.01	0.62

Indices: Australian Shares: S&P/ASX 300 TR, Australian REITs: S&P/ASX 300 A-REIT TR, International Fixed Interest: Barclays Global Aggregate TR Hedged AUD, Australian Fixed Interest: Bloomberg AusBond Composite 0+Y TR AUD

There are many studies carried out about whether the investor should hedge, not hedge, actively hedge or some combination. There are no definitive answers.

Some investors expect that the effect of currency on international equity returns mostly washes out in the long term. Therefore, taking costs (hedged strategies are more expensive than unhedged strategies) into account and the benefits of diversification, then these investors would maintain an unhedged exposure to international shares.

Others believe in the practical world, this may not be the case particularly given some of the structural issues affecting currency markets following the Global Financial Crisis. These structural issues include: different economic growth levels and interest rates going forward and central banks pursuing other policies that are likely to lower their currency to improve their export position and ultimately improve economic growth.

Summary

Clients need to be aware that currency movements will have a significant impact on unhedged portfolios. Therefore, they need to understand the implications of hedging currency or remaining unhedged on international assets. At Logical, we believe that unhedged portfolios should provide diversification benefits and especially provide protection or enhance returns during distressed periods such as the Global Financial Crisis.

t 02 9328 3322
f 02 9328 3323
e team@lfma.com.au
w www.logicalfinancial.com.au

Suite 21, Level 2, 8 Hill Street,
Surry Hills NSW 2010
PO Box 103
Darlinghurst NSW 1300

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LOGICAL'S INVESTMENT BELIEFS

There are essentially 7 fundamental investment beliefs regarding the key aspects of investment risk and returns. These beliefs have been formed on the basis of experience and rigorous analysis and provide an important foundation for formulating the various investment strategies.

Risk Diversification

Diversification among assets (Australian and International Shares, Australian and International Fixed Interest, Property, Infrastructure and Alternative Assets) is an essential instrument to create portfolios with a lower expected risk given the targeted total return.

Add uncorrelated assets proven in "normally" functioning markets and "distressed times" (Global Financial Crisis). This ensures investments in client portfolios will uphold diversification advantages. Note: Correlation is a measure of potential diversification. A correlation of 1 indicates assets move completely in line with each other. -1 indicates no relationship at all in price movement.

Inefficiencies

In a number of cases the pricing of securities, markets and asset classes are not perfectly efficient or less than perfectly efficient. It may be possible for investment specialists to find and buy these securities, markets and asset classes that don't reflect their true worth (intrinsic or fair value) and add value after fees.

Investment Horizon

In most cases 'best of breed' growth investments (e.g. unlisted wholesale managed funds) should generate a relatively strong long-term performance, even though they may suffer short term "on-paper/unrealised" losses. This has to be expected and tolerated.

Also, a long-term investment horizon increases the likelihood of meeting the overall target objectives (often retirement planning) of our clients. Reacting or panicking to short term volatility can destroy investment value…and importantly confidence.

Risk and Return

There is a close relationship between risk and return of investments. Achieving returns above a risk-free rate requires accepting risk. There is no alternative.

Strategic Asset Allocation

The focus on strategic asset allocation is a key element, reflecting that the decision between the allocation to asset classes (Australian and International shares, Australian and International fixed interest, Alternative assets and Property/Infrastructure) plays a significant role in shaping risk and the final total performance of investment portfolios.

Investment Management Styles

There are really two investment management styles: passive (index) and active. Passive aims to achieve performance equal to that of a relevant index (often an exchange traded fund [ETF]) and active management attempts to outperform a relevant index by a certain amount or percentage over a certain period. In some cases combining active management (to take advantage of inefficiencies in the pricing of markets) with passive management (to take advantage of efficient pricing of individual securities in that market) may enhance the risk and net return of an investment portfolio.

Investment Management Approaches

Australian and International share funds will vary in their investment styles. The 'style' of an investment fund manager refers to the way they choose stocks from their investment universe. Fund managers generally may be classified either as Value, Growth or Neutral based on their stock selection process. For example, value managers favour companies that they believe are undervalued relative to their current share price and growth managers favour companies with higher growth prospects.

A successful combination of these styles can smooth the volatility of a portfolio while attempting to maximise returns. Generally different styles perform better at different periods of the economic cycle.

LOGICAL'S INVESTMENT & TECHNICAL STRATEGIES

Logical endorses where appropriate the following investment and technical strategies:

Outlook Implications

After share markets have outperformed in the last several years it may be prudent to err on the side of caution. Australian share market gains have been driven by re-ratings and this has not been through earnings. Money supply has been strong around the world, with debt to GDP at higher ratios now than those that existed immediately pre GFC, global growth continues to disappoint and deflation is now a reality in the EU.

Ensure that your mix between growth (shares, property/infrastructure and alternative assets) and defensive (fixed interest and cash) assets are in line with your risk profile (e.g. moderate, balanced, growth etc.). Continue to invest in quality, liquid, solid businesses with strong balance sheets and low levels of debt and try to remain focused on your long-term investment and financial objectives.

Unhedged International Shares

Use unhedged international investments in your portfolios. Our rationale for this is that the Australian dollar is still potentially relatively high (post the 1983 floating of the $AUD) vs. the US dollar, Euro and Pound sterling. Australian investors as such are able to pay comparatively less for quality international investments than at any time in the last 25 years or so and we recommend Australian based investors to do so. Then if the Australian dollar were to potentially weaken (revert back to its long-term mean) over time, unhedged investors would directly benefit as a result of a falling $A currency. In addition, diversification benefits are introduced into the portfolio.

Low interest rates and income generation

The historically low rates mean that clients such as retirees relying on cash and term deposits to generate income will see their returns remain low. Investors in maturing term deposits may need to accept lower rates to lock in their return. We recommend you move marginally up the risk spectrum and invest into quality diversified fixed income investments. Clients need to be aware that moving up the risk curve will involve a higher level of risk than cash or term deposit, but they should be more than adequately compensated over a 2-3-year period.

Cash plus Capital Growth (Retirees)

Isolate a proportion of your portfolio and invest in cash and conservative fixed income investments that provide you with two to three years of essential income needs. The rest of your portfolio should be structured to generate capital growth and income distributions and dividends over the medium to long term.

Core plus Satellite

This involves anchoring a "core" part of your equity share portfolios in a diversified, low cost index fund that provides broad exposure to the share markets and then adding a number of smaller allocations to specialist, concentrated investment funds and direct share "satellites" that complement this core diversified investment.

Wealth creation through Superannuation

Where appropriate, utilise the very tax-effective superannuation environment for long term wealth creation and retirement income generation. We strongly advise that all investors ensure that they track their contributions so they adhere to current annual concessional caps (currently $30,000 or $35,000 if you are over age 49) and non-concessional caps ($180,000 pa) or $540,000 - 3 yr bring forward rule if under age 65.

Non-deductible debt payments

Continue paying down non-deductible debt where possible.