Dimensional

OUTSIDE THE FLAGS

Jim Parker,
Vice President
DFA Australia Limited

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Jumping Off the Currency Cart

Australian investors spend a lot of time worrying about currencies. Will the Australian dollar keep rising? Has it topped out? Does its recent fall signal a substantial decline? The truth is that nobody knows.

Each year, the Fairfax newspapers poll about 30 of the nation's top economists from business, the markets and academia. Year after year, they get the currency wrong. And not just a little bit wrong.

The median forecast in that survey in 2008 was for the Australian dollar to rise to 90 US cents from 88c at the start of the year. The currency ended up falling by more than 20% to around 70c by year end as the global financial crisis hit.

The following year, the economists in the same survey picked the currency to stay down around 70c. Instead, it rose 30% all the way up to 90c. In 2010, they thought the dollar would fall short of its long tilt at parity. It broke on through.

And on and on it goes. In fact, the more you follow currencies, the more you realise that former Federal Reserve chairman Alan Greenspan was onto something when he said currency forecasting was no better than a coin toss.

And that brings us up to 2013. After spending most of the last two and a half years above the 100 US cent mark, the Australian dollar has fallen below parity—an event that has sparked a new round of soothsaying from the usual suspects.

"How low can it go?" was one recent headline in an Australian newspaper, quoting analysts as saying the local dollar is now headed back to the low 80s or further.

There are a few points to make about currencies. Firstly, no-one has shown any ability to correctly and consistently predict foreign exchange movements. Secondly, why should it matter to you as an investor?

One view being put about, is that with the local currency now apparently in decline, it is time to diversify into international shares.

The response to that statement is that the argument for international diversification stands regardless of what exchange rates are doing. If you are buying shares in anticipation of a currency fall, you are not really investing in equities, you are speculating on exchange rate movements.

Currencies are not like shares or bonds. They do not pay dividends or interest payments. There is no positive expected return from currencies.

However, currency movements can have a big impact on your investments. The chart below shows the monthly movements of the Australian dollar against the US dollar since it changed from a fixed to a floating, market-driven rate in late 1983.

In that period of nearly 30 years, the Aussie dollar has moved in a range from as low as 48 US cents in early 2001 (when Australia was being written off as an "old" economy) to as high as 110 US cents in mid-2011. The average rate in this three decade period is 75c.

What the chart shows is that currencies can go on long excursions. For instance, the dollar virtually halved in value from 1996 to 2001. In the subsequent decade, it more than doubled. It also reached record highs in trade-weighted terms, which measures its performance against currencies of our trading partners.

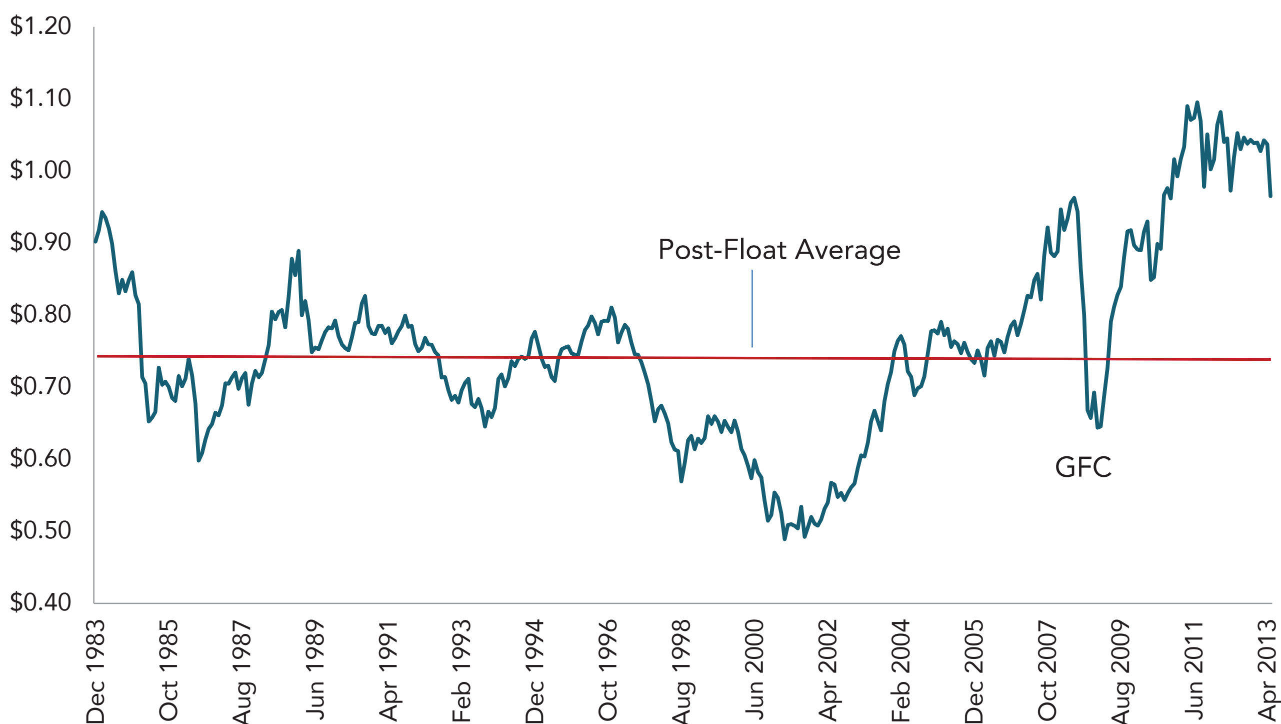
With the benefit of perfect hindsight, Australian investors with international portfolios would have left their global equity exposures unhedged in that earlier period, and then hedged them from 2001 onwards.

But we don't have that benefit and we have seen that forecasts of currencies are inherently unreliable. In any case, the evidence shows that hedging currency exposure in an equity portfolio does not reduce risk as measured by volatility, and that the effect of hedging on returns is ambiguous. As well, hedging entails additional costs and taxes that can reduce an investor's return.

The chart below compares the volatility, as measured by standard deviation, of hedged (dark bar) and unhedged (light bar) portfolios over 25 years to 2012. The allocation to Australian equities ranges from 100% at the left to 0% at the far right.

In this period overall, hedging made no significant difference to volatility. In fact, the standard deviation in the unhedged portfolios was a little lower.

AUSTRALIAN DOLLAR VS. US DOLLAR

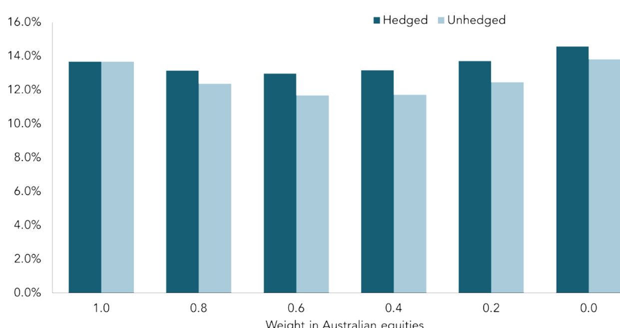


Source: RBA

HEDGING IS NOT A VOLATILITY DECISION FOR EQUITIES

Equity Portfolio Annualised Standard Deviation (%)

Monthly: January 1988–December 2012; Currency: AUD



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This still leaves the question about what to do about these long excursions in currencies and the impact they can have on your portfolio.

One way of neutralising this issue is to hedge half your portfolio and to leave the other half unhedged. This means your global equity portfolio does not gain as much from a fall in the $A, but neither does it lose as much from an $A gain.

Ultimately, though, focusing on currencies is a diversion from the real reason for investing internationally, and that is to diversify your sources of return away from the Australian market, where a handful of stocks (banks and resources) dominate.

While the Australian equity market showed strong gains last year of just over 20%, it was outperformed in $A terms by Austria, Hong Kong, Singapore, Denmark, Germany and Belgium (where annual returns were 38%).

Aside from returns, global diversification lowers volatility. That's because these different markets are subject to different influences. As the Australian economy slows, other economies may gain traction. You are less reliant on a single market.

This benefit of diversification doesn't change because currencies are rising or falling. Currencies, as we have seen, are a separate issue.

They are entirely unpredictable, they have no expected return, there is little evidence that hedging their impact makes any difference to volatility over the long term, and the evidence about hedging and returns is ambiguous.

Putting currency concerns above the benefits of global diversification is like putting the cart before the horse.

"Outside the Flags" began as a weekly web column on Dimensional Fund Advisors' website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor's control—including portfolio structure, fees, taxes, and discipline. Jim's flags metaphor has been taken up and recognised by Australia's corporate regulator in its own investor education program.

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