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Are investors hedging their International Equity return potential?

Schroders believes it is important to remember the intended purpose of hedging currency exposure – to maintain neutral exposure from the perspective of the investors' local currency. In this report, we explore whether hedged currency exposure is likely to help or hinder performance amid an environment where misaligned intentions may result in unsuccessful outcomes.

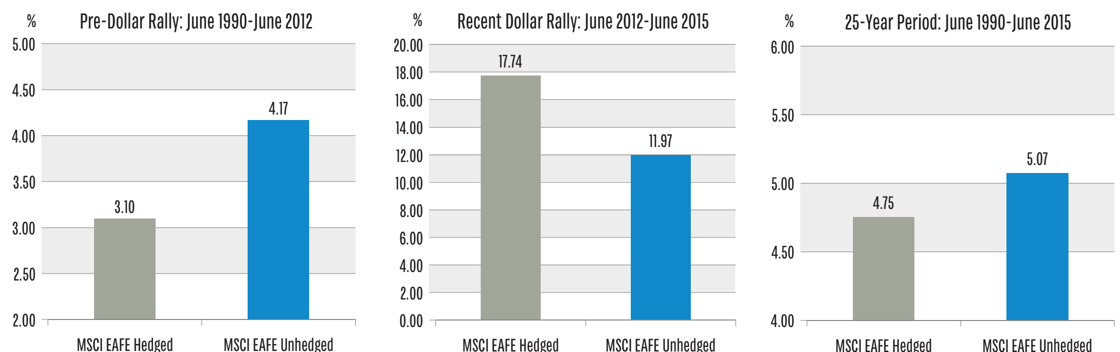
Simply put, we believe international equities represent one of the best opportunities for active managers to add value…and is one of the last places investors should simply accept passive market exposure.

To hedge or not to hedge

As US investors in international equities continue to contemplate hedging their non-US exposure given the divergent paths of international central banks and their potential impact on currencies, it is important to remember that the Fed's actions are only one factor to consider. Other key considerations are:

1. **Economic growth rates in other countries.** In late 2014 there was a lot of concern about whether the rest of the world could keep pace with the US. However, a combination of low oil prices and weaker currencies enhancing competitiveness began to provide favorable economic tailwinds in Europe and Japan. Economic data has picked up elsewhere and despite the divergent monetary policies of the US, Europe and Japan, the improving economic strength in the two latter regions has supported local currency resiliency this year. This demonstrates that global growth rates also can have an important impact on exchange rate movements.
2. **Over time, unhedged exposure has resulted in higher returns.** Despite the recent strength in the US dollar relative to most local EAFE currencies, over the long term equity investors have been rewarded by maintaining local-currency exposure. In our view, this supports having unhedged exposure over the long term. It could also be beneficial to split your client's exposure for more defined short-term periods, given today's environment.

Recent Dollar Strength Has Overshadowed the Excess Returns of Unhedged Equity Exposure



Source: Morningstar for 25-year period through June 30, 2015. Performance shown is past performance, which is no guarantee of future results. Actual results would vary. The value of an investment can go down as well as up. Please refer to the Important Information section for complete details.

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So while passive strategies offer a level of 'beta' exposure that may meet an investors' objective, we believe it's worth asking is this 'beta' worth missing out on the 'alpha' potential?

3. **It is STILL important to consider the cost of hedging.** While low borrowing costs have made hedging a favorable proposition for many managers in today's low rate environment, it can be zero sum game with implementation costs as the determining factor in the long run. Our analysis shows that an unhedged index has historically generated superior returns with the difference largely explained by the cost of implementing the hedge. The cost of hedging has varied over time. Generally costs have been modest (i.e. less than 20bps and can be as low as a few basis points) but have varied during periods of elevated volatility which at times have driven the cost up further. It can also be more expensive to hedge emerging markets countries with the cost being dictated by the specific countries that you need to hedge.

In our view, not many equity investors (or rules-based platforms) have the skill to effectively hedge and many tend to make the hedging decision at the worst possible time. It is worth noting that it was not that long ago, European based investors buying US equities were all looking for hedged share classes due to the Fed's QE initiative and the then-prevailing dollar free fall. In hindsight most investors would have made that decision to hedge at the worst possible time. Investors who poured into hedged ETFs earlier this year may already be regretting that decision as the currency hedge has not worked since March. This is likely compounded by the large ETF premiums that were likely paid for hedged ETFs due to the significant investor momentum.

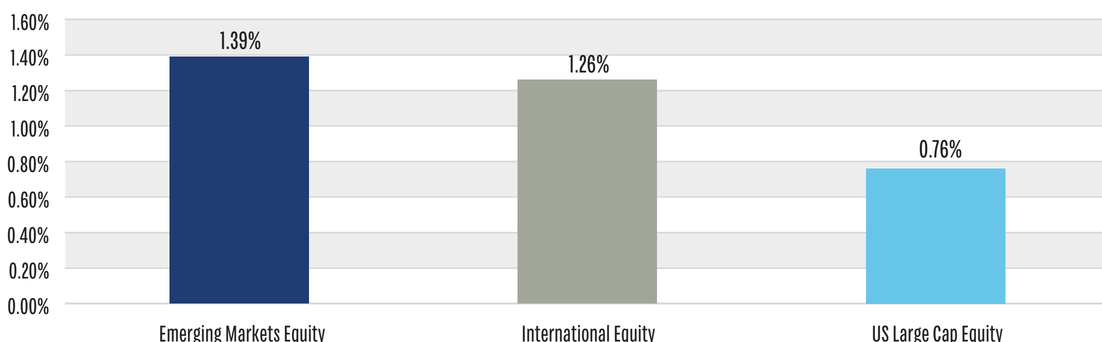
All things equal, we believe an unhedged international fund should outperform a hedged version over the long run, especially in today's environment.

In a world of increased globalization, large multinational companies typically have earnings that are exposed to a much broader set of currencies than their country of domicile might suggest. For example, the constituents of the S&P 500 actually derive approximately 45% of their revenue from overseas, yet investors don't typically worry about hedging that exposure. Most systematic hedging programs base their hedging rules on the country of domicile which can actually result in a mismatch based on true earning exposure and create additional portfolio risks. The earnings reports we just saw in Q1 2015 highlighted how the USD strength has become a headwind for the earnings of US companies while it is a tailwind for other markets as we saw a much higher percentage of top-line revenue positive surprises from Europe and Japan than in the US.

International equity investing may favor active management

Unlike domestic equities, the breadth of international investing strongly favors generating outperformance through an active approach, based on historical analysis. A review of institutional peer groups shows that the median manager in international equities (and emerging markets, separately) outperformed their respective index by over 125 (and 139) basis points over the last 10 years on an annual basis.

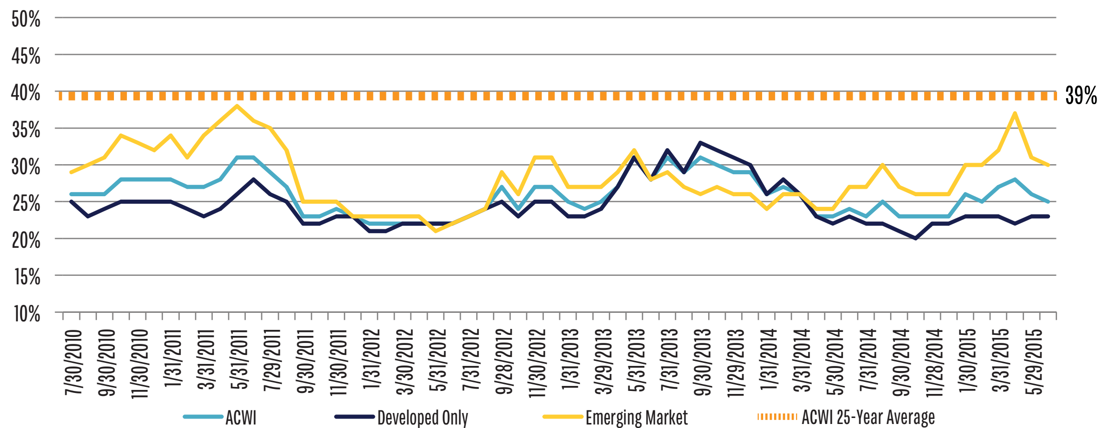
Foreign Equity Active Managers, At the Median, Have Outperformed Over the Past 10 Years



Source: eVestment for 10-year period through March 31, 2015. International Equity represents the annualized excess returns generated by the median eVestment EAFE Equity manager versus the MSCI EAFE. Emerging Market (EM) Equity represents the annualized excess returns generated by the median eVestment EM Equity manager versus the MSCI EM Index. US Large Cap Equity represents the annualized excess returns generated by the median eVestment US Large Cap Equity manager versus the S&P 500. Performance shown is past performance, which is no guarantee of future results. Individual results, and results for other periods, would vary. The value of an investment can go down as well as up.

One possible reason for this outperformance is the breadth of stocks within the foreign universe. Active management allows for skilled investors to increase their rate of success with greater market breadth. However, the level of alpha has declined in recent years as dispersion of stock returns has remained at historically low levels. Typically the higher the dispersion of returns the greater the opportunity for an active manager to add value. Central bank activity among other factors has contributed to the prolonged unusually low volatility in recent years. The market's cross sectional volatility remains well below its long term averages and the recent increase may be indicating that we are returning to a positive environment for active stock pickers. So while passive strategies offer a level of 'beta' exposure that may meet an investors' objective, we believe it's worth asking is this 'beta' worth missing out on the 'alpha' potential?

Rising dispersion may be signaling that a favorable environment for active managers is returning



Source: FactSet, Schroders through June 30, 2015. Dispersion based on Cross-Sectional Volatility on rolling 12-month periods. Please refer to the Important Information section for complete details.

Simply put, we believe international equities represent one of the best opportunities for active managers to add value – outside of the alternatives space – and is one of the last places investors should simply accept passive market exposure.

Our View on International Equity Investing

All things equal, we believe an unhedged international fund should outperform a hedged version over the long run, especially in today's environment. To want to hedge you have to either believe in the perpetual decline of a currency or believe that you have a clear skill in timing. Therefore, the question to ask in either scenario may be: *are you comfortable passively accepting this 'risk' factor within an ETF vehicle?*

We at Schroders view the international equity markets as a place where strong stock selection can be the greatest driver of excess return over long-term periods. For investors looking to potentially capitalize on changing market dynamics, we believe an active approach can provide a more optimal alternative to a hedged and/or passively managed international equity portfolio.

For those investors looking to continue managing volatility, we think that pairing hedged and unhedged strategies may also deliver a desirable risk/reward balance, assuming an investors' time horizon is geared toward more longer-term objectives as to account for any potential short-term fluctuations in currency valuations.

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