Investment Tutor Surgery

Chris Wagstaff, head of Aviva Investors Investment Tutor programme looks at the importance of asset allocation in determining a portfolio's performance and considers if foreign currency hedging is a good idea

My investment consultant tells me that asset allocation typically accounts for over 90 per cent of our pension fund's performance. Does this mean that manager and stock selection are of negligible importance?

In short, the answer is yes and no! Let me explain. The seminal work in this area is often misquoted as concluding that strategic asset allocation, or the strategic asset mix, accounts for over 90 per cent of pension fund performance: the remaining 10 per cent being attributable to active fund management and, of course, luck. In fact, what this and subsequent academic studies have concluded is that, for a broadly conventional asset allocation that employs conventional active management to manage the main asset classes within the strategic asset mix, 90 per cent or so of the *variability*, or ups and downs, of a fund's returns *over time* are attributable to its strategic asset allocation. However, the more actively you manage each of these asset classes and the composition of the asset mix, the more meaningful the contribution of active management becomes to these ups and downs.

By contrast, approaching the asset allocation question from a different angle, only around 40 per cent of the *difference* in the performance of any two funds over time can be attributed to their respective strategic asset allocations. That is, active fund management determines far more of the *difference* in returns between pension funds, than the ups and downs of returns for any one fund, over time. Moreover, in a separate study, Nobel laureate Bill Sharpe found that around 90 per cent of the variation in a fund manager's monthly returns are due to the investment style that dictates the type and key characteristics of stocks the manager holds: whether they are growth or income oriented for example. Finally, about (and sometimes more than) 100 per cent of the absolute *level* of pension funds returns can be explained by the strategic asset mix. That is, on average, active manager stock selection adds little, if anything – and at times detracts from – the *level* of returns.

So whilst strategic asset allocation is undoubtedly a hugely important source of return, depending on how you phrase the question of its relative importance to pension fund performance, the answer can lie anywhere between 40 per cent and 100+ per cent!

We tend to hedge most of the currency risk of our overseas investments. However, sterling's recent weakness has meant the losses on these holdings have been compounded by this hedging. Is foreign currency hedging such a good idea?

Whilst pension schemes suffered heavy losses on their domestic investments in 2008 – with only gilts and gold generating positive returns – sterling's recent steep slide cushioned losses from their overseas investments. In particular, sterling's 40 per cent decline against the Japanese yen, 28 per cent weakening against the dollar and 24 per cent drop against the euro, meant that losses in major overseas equity markets – some of which posted local currency denominated declines in excess of 40 per cent - were limited to single or low double digits. In addition, sterling's weakness added significantly to some of the spectacular gains delivered by the world's government bond markets. As a result, it is estimated that, on average, UK defined benefit pension schemes, which typically hold 26 per cent of their assets in overseas equities and 3 per cent in overseas bonds, restricted losses on their assets to around 13 per cent in 2008. Those who hadn't hedged their overseas currency exposure, whether by luck or judgement, fared slightly better.

Although hedging any asset against adverse price movements will prove expensive from an opportunity cost perspective, if the asset in question moves in the opposite direction to which you expected – in this case an overseas currency appreciating against sterling – many investors are reluctant to leave their foreign currency exposure unhedged. This is because empirical evidence shows that currency risk is generally unrewarded. So broadly speaking, and notwithstanding very recent experience, currency hedging, principally through the use of, so-called, forward contracts, is beneficial as it reduces unnecessary risks, allowing the scheme's "risk budget" to be spent more efficiently to ultimately boost the expected return on the scheme's assets.

However, academic research suggests there are two exceptions to this broad brush approach to hedging currency risk. Firstly, in the short run, the tactical management of currency positions can prove to be an attractive source of return as, on average, currencies with high short-term interest rates deliver high returns. Indeed, a popular strategy employed by active currency managers is financing positions in high yielding currencies by simultaneously selling low yielding ones. That said, this so-called "carry trade" is best exploited as a standalone source of return, by means of a currency "overlay" rather than as a finessing of a fund's hedging policy.

The second exception relates to whether foreign currency movements are positively or negatively correlated with – that is move in the same or opposite direction to – overseas investment returns. If the correlation between the movement of the overseas currency and the overseas investment is negative, then risk is best minimised by not hedging the currency, as the currency acts as a means of diversification. If the correlation is positive, the opposite is true. Whilst academic research suggests it is advisable to hedge overseas equity returns in "growth" countries, such as those in Asia ex-Japan, where currency movements tend to be positively correlated with local stock market returns, some emerging market currencies, such as China's remnimbi or India's rupee, which are not fully convertible in the currency markets, are difficult to hedge. Moreover, for others – the Brazilian real for instance – the costs of hedging are prohibitively high. As to developed country currencies, whereas the historically negative correlations of the euro and Swiss franc with local equity returns would suggest that the optimal policy is to remain unhedged, the evidence for the US dollar and the Japanese yen is decidedly mixed. For a global bond investor, most studies conclude that the risk-minimising currency strategy is to adopt close to a full currency hedge.

Finally, if you decide to undertake currency hedging, you should ensure you have sufficient liquid or near liquid assets to provide the necessary collateral to the foreign currency forward counterparty – the other side of the contract who is taking the opposing view to you – should the currency hedge move against you. That is, should sterling weaken. ■

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The opinions expressed are those of Aviva Investors as at 9 January, 2009.
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