

Speed Read

- While most investors understand the role that stocks, bonds and even commodities play in a portfolio, currencies remain opaque.
- Yet, in a globalized world, currency exposures are having an outsized impact on portfolio returns.
- Currencies can become wildly overvalued and undervalued; similar to stocks and other assets. Therefore, a large opportunity exists for active currency management.
- Most importantly, currencies provide some of the best diversification exposures for client portfolios.

WHY IS ACTIVE CURRENCY MANAGEMENT IMPORTANT?

For many investors, currencies are an afterthought; a byproduct of investing in stocks, bonds and other asset classes in foreign countries. Frequently viewed as an additional source of risk and volatility, it is common practice to hedge foreign currency exposures back to a portfolio's base currency.

At Forstrong, currency analysis is an integral part of our investment management process. Exchange rate fluctuations can have a sizable influence on an economy's competitiveness, trade balance and inflation rate (amongst numerous other important implications). Understanding the interconnectivity between currency and the real economy and formulating an informed view is thus a critical component in the analysis of all asset classes.

Viewing currencies as a distinct asset class and actively managing exposures bolsters our ability to manage risk and generate returns. With generally low correlations to domestic stocks and bonds, adding foreign currency exposure to an investment portfolio helps improve diversification. The ability to create a more robust and resilient portfolio is the predominant reason why our default currency positioning is unhedged on foreign asset class allocations.

HOW DOES FORSTRONG IMPLEMENT CURRENCY VIEWS FOR CLIENTS?

Forstrong gains exposure to foreign currencies through the exchange-traded funds (ETFs) we use to build client portfolios. Consider the example of a hypothetical Japanese equity ETF, trading in Canada on the Toronto Stock Exchange (TSX). The ETF exclusively holds stocks which trade in Japan and are denominated in yen. On any given trading day, a Canadian investor simply sees that the ETF has gone up or down in value. This daily performance can be broken down into two distinct components: the performance of the Japanese stocks in local currency (equity component), and the change in the yen versus the Canadian dollar (currency component). In mathematical terms, this can be represented as follows:

$$\underbrace{[1+\% \text{ change in Japanese stocks}]}_{\text{Equity Component}} \times \underbrace{[1+\% \text{ change in yen vs. Canadian dollar}] - 1}_{\text{Currency Component}}$$

The above example illustrates two active decisions facing the Forstrong Investment Management team:

1. Whether or not to take exposure to Japanese stocks in client portfolios
2. Whether or not to hedge the Japanese yen exposure

HOW DO U.S.- LISTED ETFS AFFECT CURRENCY EXPOSURE?

Forstrong also use ETFs which trade in the U.S. to gain exposure to asset classes outside of North America. A common misconception is that this creates U.S. dollar exposure. Consider the same example of a hypothetical Japanese equity ETF, but in this case trading in the U.S. on the NYSE Arca Exchange. Daily performance in Canadian dollar terms will be equal to that of the Canadian-listed version. In the previous example, performance was broken

down into two components: equity and currency. In this case, the equity component is unchanged, as the ETF owns the same Japanese stocks. However, the currency component requires an additional step. The ETF is exposed to the change in the yen versus the U.S. dollar, while a Canadian-domiciled portfolio is exposed to the change in the U.S. dollar versus the Canadian dollar.

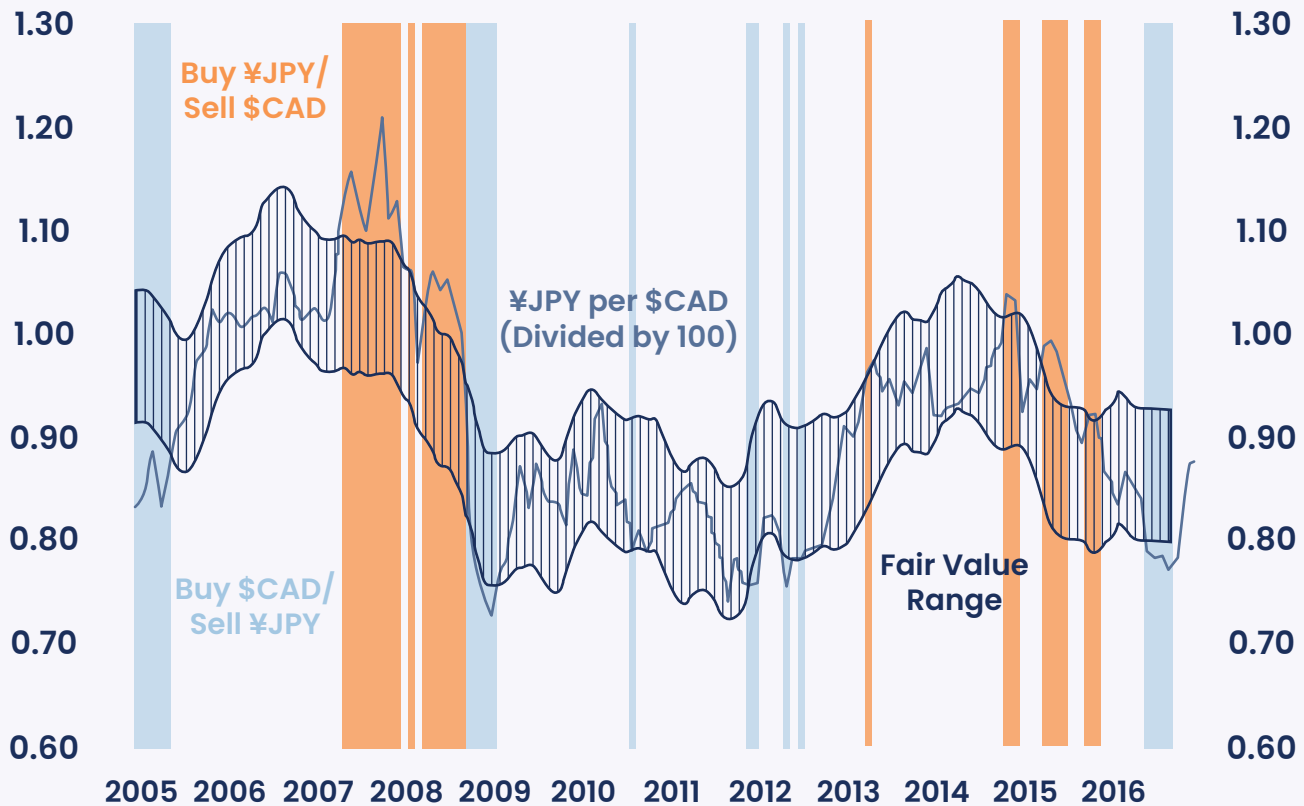
This can be displayed as follows:

$$\left[\frac{\text{Yen}}{\text{U.S. Dollar}} \right] \times \left[\frac{\text{U.S. Dollar}}{\text{Canadian Dollar}} \right] = \left[\frac{\text{Yen}}{\text{Canadian Dollar}} \right]$$

The U.S. dollar numerator and denominator cancel one another out, leaving a “cross-rate” currency exposure of yen versus Canadian dollars. After this simplification, the currency component is identical to that of the Canadian-listed ETF.

WHEN DOES FORSTRONG HEDGE FOREIGN CURRENCY EXPOSURES FOR CLIENTS?

In the above example, an investment in a Japanese equity ETF would represent a favourable assessment of both Japanese stocks and the yen. However, many times Forstrong’s outlook for a country’s stocks, bonds and currency run counter to one another. This is especially true for export-oriented nations where a strengthening currency can weigh on demand from trading partners. Forstrong’s extensive macroeconomic analysis allows us to establish and continually challenge our views across all global asset classes. We have developed proprietary models to help aggregate and methodically evaluate a broad collection of qualitative and quantitative data and research. This helps us determine when to increase or decrease exposure to a particular asset class.



HOW ARE CURRENCY HEDGES IMPLEMENTED IN CLIENT PORTFOLIOS?

Forstrong use currency-hedged ETFs to lower or remove exposure to currencies we have an unfavourable outlook on. Once again, consider the example of a hypothetical Japanese equity ETF trading in Canada, but in this case employing a currency hedge. The ETF will hold the same Japanese stocks, but will also hold forward contracts to sell yen and buy Canadian dollars. Forward contracts are essentially an agreement to buy one currency and sell another at a fixed exchange rate on a specified date in the future. In the case of a currency-hedged ETF holding Japanese stocks, the forward contract exposure is continually adjusted, such that the amount (or “notional value”) of yen being sold forward offsets the total value of the stocks held. A forward contract to sell a currency is akin to a short position in a stock, in that it profits if the currency depreciates and loses money if the currency appreciates. This inverse relationship effectively neutralizes the currency component of the ETF’s returns (in this case removing exposure to the yen); leaving the equity component as the sole contributor to the ETF’s performance.