UNHEDGED PORTFOLIOS; PERFORMING WELL OVER THE PAST 12 MONTHS, BUT AT WHAT COST?

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Retail clients investing in globally diversified portfolios have enjoyed fantastic returns over the past year.

Equity markets have made significant gains all over the world; Japan has seen the Nikkei 225 return 25% whilst in Europe the MSCI European Small Cap Index TR rose 24%. Not to be left out, the S&P 500 jumped 28% and the FTSE All-Share Index rose 31%.

So, a UK retail client with exposure to Asia, Europe, America and the UK would have made consistently good profits across their entire equity portfolio. In fact, if a client had an equal allocation to each of the 4 geographical areas their aggregate return would be somewhere in the region of +27%. What is interesting however, is that UK clients with unhedged overseas exposure have actually made considerably more than this over the past 12 months.

The returns I have quoted are for the indices in question, in local currency terms.

That is to say the Nikkei 225 returned 25% in Japanese Yen terms, the MSCI European Small Cap Index gained 24% in Euro terms, and so on. A UK client however does not invest in the Yen share class of a Japanese equity fund, nor in the Euro share class of a European equity fund.

They invest in the GBP share class.

When we look at the returns of the GBP share classes vs the local currency share classes – it tells a different tale. Using the relevant IA sector for each geographical region we can see the sector return (the average manager trying to outperform the benchmark) in local currency terms and in GBP terms:

<table>
<thead>
<tr>
<th>IA Sector</th>
<th>Local Currency Return</th>
<th>GBP (Unhedged) Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>IA Japan</td>
<td>25.75%</td>
<td>46.89%</td>
</tr>
<tr>
<td>IA European Smaller Companies</td>
<td>19.74%</td>
<td>31.65%</td>
</tr>
<tr>
<td>IA North America</td>
<td>27.53%</td>
<td>47.74%</td>
</tr>
<tr>
<td>IA UK All Companies</td>
<td>26.38%</td>
<td>26.38%</td>
</tr>
<tr>
<td>Aggregate Return</td>
<td>24.85%</td>
<td>38.17%</td>
</tr>
</tbody>
</table>

As we can see the UK investor, using unhedged GBP share classes, would have achieved an aggregate portfolio return of 38.17% when the aggregate return of the underlying equity markets, in local currency terms, was only 24.85%.

How does this happen?.....
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It is because over the same 12-month period the GBP has depreciated vs the Japanese Yen, the Euro and the US Dollar.

A UK client’s return of 38.17% is made up of the 24.85% return of the underlying equity markets and a 13.32% ‘boost’ from the currency markets. This ‘boost’ is equal to 54% of their original return – in other words the UK client has achieved 154% of the return they should have made.

I say “should have made”, because these clients would have been told they were investing in an equity portfolio. These clients would have been told how their equity portfolio comes with an expected level of risk and an expected level of return. In our example, the client may have been told the historical return of their portfolio was 25%. They may also have been told the portfolio would subject them to a risk profile of 8 on a scale of 1-10. In reality, the client’s portfolio; should the overseas exposure be unhedged, will not experience a long-term average return of 25% nor a long-term average volatility of 8. An unhedged portfolio is no longer just exposed to the equity markets, and for a UK investor, will be hugely impacted by what GBP is doing against every other currency represented within the client’s portfolio.

In this example, and over the past year...

For as long as the GBP has been falling against other currencies, the returns achieved by UK retail clients have been ‘boosted’. This is a long-term trend that dates back to the days of $2:£1. However, those financial advisers that are currently recommending globally diversified unhedged portfolios, should be mindful that the GBP will not fall forever.

Like any market, currency markets move in both directions. When the GBP rallies, UK retail clients invested in unhedged portfolios will suffer in terms performance. Many will also realise that they are being exposed to a type of risk they did not sign up for. They will ask their financial adviser for the reason why.

The answer you give is down to you...

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