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Invest the market newsletter - June 2013 - Volume VI, number 6

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Dear ,

ETFs and Currency Hedging

Special collaboration: Ian Gascon

In portfolio management, it has long been understood that the return on a portfolio depends mainly on asset allocation, and that it is preferable to diversify a portfolio over many asset classes. Appropriate diversification, combined with regular rebalancing, usually increases a portfolio's risk-adjusted return. Given that Canada is a relatively small country in relation to the rest of the world (Canada represents approximately 4% of the world's market capitalization) and that the major Canadian companies are concentrated in a few sectors, it is very important for Canadian investors to have part of their portfolios invested abroad.

However, Canadian investors looking to diversify a portfolio globally face a major dilemma: How should they manage exposure to foreign currencies? When investors buy securities that are traded abroad (directly or through an ETF), they become exposed to a broad range of currencies. For example, according to a recent study conducted by Standard & Poor's, approximately 46% of the income of S&P 500 companies originates abroad (outside of the U.S.), and each of these companies may have its own policy on how to manage currency risk. This makes it difficult to determine a portfolio's exact exposure to each currency, even if the portfolio holds only S&P 500 companies in the U.S. So how can you decide whether to hedge this risk, in full, in part or not at all?

This problem has a relatively simple and intuitive solution. Because Canada has a resource-based economy, the value of our currency may rise more when the global economy is expanding and fall more when the global economy is in recession. In times of crisis, the Canadian dollar generally falls against safe haven securities such as the U.S. dollar. This relationship is not perfect, and may play out differently in the future for a variety of reasons, but this is nevertheless an interesting working assumption. Why is this observation important? Well, when Canadian investors hold foreign investments, these can act as a natural hedge against a general decline in the markets. Not hedging currency risk may be a simple approach to reducing long-term portfolio volatility.

Until recently, virtually all international equity ETFs offered by Canadian ETF suppliers hedged currency risks. Why did they do this? There are two main reasons. First, it is always easier to offer investors a fund boasting of a better return in recent years, and since the Canadian dollar has appreciated considerably against the U.S. dollar over the last 10 years, hedging currency risk should have been beneficial. Second, by incorporating currency hedges, ETF suppliers differentiate Canadian ETFs from those traded in the U.S.

However, the international equity ETFs that hedged currency risk did not deliver very good results over the last few years. The largest ETF of this type is the iShares S&P 500 Index Fund (CAD-hedged), which has over \$1.8 billion in assets. Its objective is to reproduce the return of the S&P 500. The annualized deviation from the index of this ETF for the last three years has been 0.93% (the deviation is even greater over longer periods), while it has had a management expense ratio of only 0.25%. This is not the only ETF to have obtained such

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returns, and the large deviations from the index appear to stem mainly from the approach used to hedge currency risk. In short, not only is hedging currency risk probably not in the best interests of Canadians investing in international equities, but applying such a practice would appear to significantly reduce long-term expected returns.

Fortunately, ETF suppliers have been gradually tweaking their approach. Over the last few months, several suppliers have announced the launch of U.S. equity ETFs without currency hedges. This includes the Vanguard S&P 500 Index ETF (VFV) and the BMO S&P 500 Index ETF (ZSP). Horizons has also changed the mandate of its Horizons S&P 500 Index ETF (HXS), removing the foreign currency hedging policy. In international equities, iShares recently launched two ETFs without currency hedging: the iShares MSCI EAFE IMI Index ETF (XEF) and the iShares MSCI Emerging Markets IMI ETF (XEC). These changes now provide more choices to investors looking to manage the currency exposure in their portfolios with ETFs.

In closing, it is important to note that this approach to currency hedging applies only to equities. In the case of bond ETFs, one is almost always better off hedging currency risk, and virtually all Canadian international bond ETFs include currency risk hedges. This difference may be due in part to the fact that bonds are less volatile, and there is more certainty surrounding the cash flows from bonds (coupon payments and capital repayments) than those from equities.

About Ian Gascon

Ian Gascon is president of Idema Investments (www.idema.ca), a portfolio manager specialized in exchange traded funds that offers personalized portfolios for independent investors, among other services. He is the author of an ETF blog on lesaffaires.com.

Mr. Gascon holds a Masters in Finance from HEC Montreal (M.Sc.), as well as a Graduate Diploma in Management (DESG) and a bachelor's degree in engineering, aeronautics major, (B.Eng.) from Polytechnique Montréal. He is registered with the AMF as a Portfolio Manager, Designated Person and Chief Compliance Officer.

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Upcoming seminars

Subject (Language of the event)	Date	Place
Portfolio management demystified – Idema Investments (French)	Tuesday June 4, 2013 Time: 7 P.M. to 9 P.M. Thursday June 27, 2013 Time: 7 P.M. to 9 P.M.	Boucherville Laval
Introduction to ETFs in the context of portfolio building (French)	Thursday June 6, 2013 Time: 7 P.M. to 9 P.M. Wednesday June 12, 2013 Time: 7 P.M. to 9 P.M. Wednesday June 19, 2013 Time: 12 P.M. to 1 P.M.	Laval Sherbrooke Online
Introduction to ETFs in the context of portfolio building (English)	Tuesday June 18, 2013 Time: 12 P.M. to 1 P.M. Thursday June 20, 2013 Time: 5:30 P.M. to 7 P.M.	Calgary Calgary
Learn about investment basics (French)	Thursday June 6, 2013 Time: 12 P.M. to 1 P.M.	Online
Take advantage of NBDB research and analysis (French)	Tuesday June 11, 2013 Time: 9 A.M. to 11 A.M.	Montreal
ETF strategies and tactics (French)	Wednesday June 12, 2013 Time: 12 P.M. to 1 P.M.	Online
Learn about ETFs (French)	Thursday June 13, 2013 Time: 12 P.M. to 1 P.M.	Online
Discover Market-Q, the real-time streaming quotes tool (French)	Thursday June 13, 2013 Time: 9 A.M. to 11 A.M.	Montreal
Tools for self-directed investors (French)	Tuesday June 18, 2013 Time: 7 P.M. to 9 P.M.	Laval
Learn about active and passive investing (French)	Wednesday June 26, 2013 Time: 12 P.M. to 1 P.M.	Online

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[Learn about bond investing](#) (French)

Thursday June 27, 2013
Time: 12 P.M. to 1 P.M.

Online

New Issues

Diversified GICs

Canadian Advantage 8 GIC (5 years)

Canadian Advantage 8 GIC (3.5 years)

Issue Date: July 5, 2013

Sales Period: May 20, 2013 to June 28, 2013

Maturity Date:

- Diversified GICs: July 4, 2018
- Canadian Advantage 8 GIC (5 years): July 4, 2018
- Canadian Advantage 8 GIC (3.5 years): January 4, 2016

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Information:

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