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# Hedging comes at a cost

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Since being re-elected in December 2012, Shinzo Abe, the Japanese Prime Minister, has presided over an economic policy aimed at restoring growth to help the country repay its large government debts that have accumulated over recent decades. This policy has become known as Abenomics as it has focused on three distinct ‘arrows’: monetary reflation, fiscal consolidation and sustained structural reforms. Ultimately the execution of this policy will dictate its success, however the interesting point for us at Tacit is how these policies were forecast to play out and what actually has been the outcome for a UK investor.

The initial primary impact of the ‘three arrows’ approach was to devalue the Japanese currency. This led to most international investors seeking hedged exposure to Japanese equities, which were themselves trading at very low valuations when compared to other developed markets. A simple trade that could only go one way, right? Not in reality for most investors.

Hedging costs money. Whether you see this as an explicit cost or not, there is ultimately a cost to buying this form of insurance. There are varying estimates of the cost of hedging currencies as market dynamics alter on a daily basis and also as no hedge is perfect in a volatile environment. It is for this reason that Tacit strategies do not hedge equity market exposure, we use currency movements as a risk management tool within our portfolios. If an equity market is falling and its currency is expensive, it is likely that the currency will weaken also, creating a larger loss for a UK investor. If on the other hand, a currency is deemed to be cheap (or only likely to fall) by market participants, it may not fall but rise in such an environment.

Now, a UK investor investing into Japanese equities through our favoured holding at the beginning of 2013 (data is sourced from Morningstar) had the option of hedging their currency exposure or not doing so. Money flows show that the majority of investors purchased hedged exposure as their economic teams will have been explaining how the Yen would only fall and the investment was a certainty to outperform the unhedged investment.

Well, we know from experience that there are no certainties in investment and Tacit strategies have held the unhedged exposure to Japan over the period. In fact, both investments have provided very strong returns, more than doubling your money, however, the hedged exposure has cost 10% in total returns.

More important we believe however is the behaviour in a portfolio of the exposure as hedging the currency can either reduce the volatility of an investment or increase it. Investing into Japanese equities via hedged currency exposure has, for a UK investor, actually increased volatility by over 50% when compared to the same unhedged exposure.

So, UK investors have got a lower return, experienced materially higher volatility and paid higher costs. This is just another example of why we continue to believe that currencies are actually a risk management tool within portfolios and would question why others do not.

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