SOUND AS A POUND

October 2024

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THE PURSUIT OF BETTER INVESTMENT PERFORMANCE

Money is the only trust system created by humans that can bridge almost any cultural gap...

Thanks to money, even people who do not know each other and don’t trust each other can nevertheless cooperate effectively

Yuval Noah Harari
Sapiens: A Brief History of Humankind
2011

For most of the period from 1717 to 1931, the British pound had operated a gold standard whereby any holder of banknotes issued by the Bank of England could present the note at the Bank and demand immediate payment in gold at a fixed conversion rate.

Given this certainty, the phrase "sound as a pound" made complete sense.

However, economic pressures induced by the First World War and endemic trade imbalances led to the demise of sterling as the world's reserve currency.

In the aftermath of the Second World War, there was a desire to bring stability to world trade and finance and given the political and economic dominance of the US it was clear that the US dollar needed to be at the centre of the solution.

July 1, 2024 marked the 80th anniversary of the opening of the 1944 Bretton Woods Conference that birthed the World Bank, the International Monetary Fund and establish a currency exchange regime system where currencies were pegged to the US dollar, which was in turn pegged to the price of gold.

The Bretton Woods system fixed the US dollar to gold at $35 per ounce, with all other currencies having fixed, but adjustable, exchange rates to the dollar.

Photo: British Online Archives

To support the system, capital controls were permitted to enable governments to stimulate their economies without suffering from financial market penalties. It worked well and the world economy grew rapidly.

However, strains started to show in the 1960s. Persistent, albeit low-level, global inflation made the price of gold too low in real terms, while a chronic US trade deficit drained US gold reserves. Yet there was considerable resistance to the idea of devaluing the dollar against both gold and many of its trading partners.

In August 1971, President Nixon announced that the US would end on-demand convertibility of the US dollar into gold for the central banks of other nations. The Bretton Woods system had ended and the value of currencies was henceforth a matter for foreign exchange markets, rather than a function of the gold price.

The fiat currency era had arrived.

IN GOD WE TRUST

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Since the American Civil War, first coins and then since 1957 all US dollar-denominated currency have had the motto "In God We Trust" printed on it.

But, with the US dollar, and by extension all other currencies, no longer underpinned by a physical asset, investors in the 1970s had to accommodate a new risk factor into their thinking, that of currency fluctuations. Currency was no longer merely a unit of account but an investment decision.

More than fifty years later, little faith remains that Western currencies can be viewed as a store of value.

Persistent inflation and secular government deficits have led to the task of selecting a reference currency for an investment portfolio being likened to an "ugly contest". More than a decade ago, David Bloom, a foreign exchange strategist at HSBC in London stated, "*The problem with FX is when the ugly get uglier it becomes harder to differentiate between the US dollar, euro, pound sterling and Japanese yen.*"

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>
> **David Bloom, foreign exchange strategist**

Over the last fifty years, the default behaviour for investors has been to select their portfolio reporting (or reference) currency based on their nationality.

Thus, UK private clients saving for their retirements have sterling-orientated portfolios, while US investors measure their performance in US dollars. Such a decision tends to be justified on risk control grounds rather than on an expected return basis.

In other words, currency is seen as a source of risk rather than a provider of enhanced return.

Viewing foreign currency exposure as a source of risk has undoubtedly encouraged many discretionary fund managers ('DFMs') to hedge some or all of the foreign currency exposure within client portfolios.

This article examines two inter-related questions:

- **Has hedging historically made sense for investors?**
- **What is the typical stance to currency hedging by DFMs today?**

QUESTIONS

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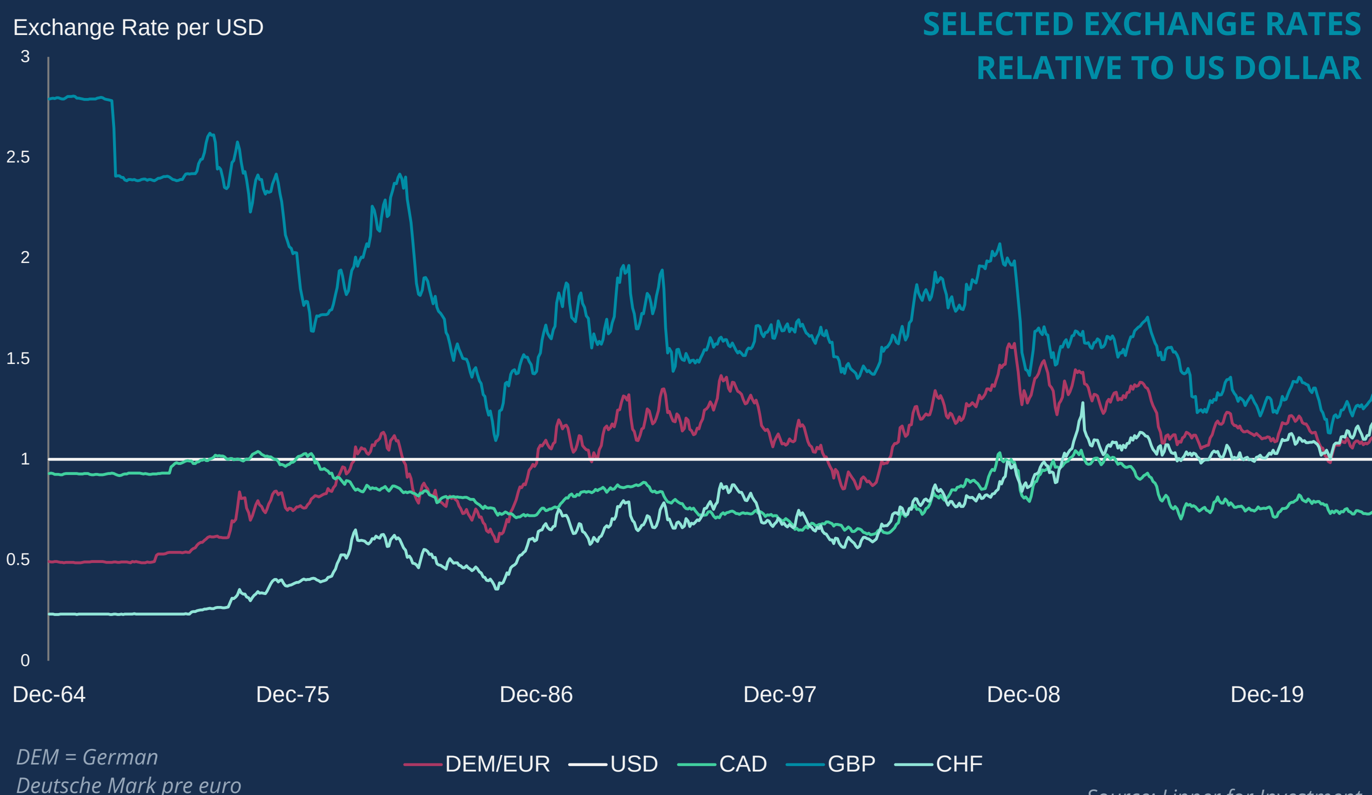
HAS HEDGING HISTORICALLY MADE SENSE?

The answer to this question depends on the selection of reference currency. For the purposes of this analysis, it is assumed that the investor is UK-based and has selected sterling as their reference currency.

Findings for other currencies are different and analysis can be provided upon request for all five of the ARC Private Client Indices series: Sterling; US Dollar; Euro; Canadian Dollar; and Swiss Franc.

The first observation to make is that sterling appears to suffer from secular depreciation versus other currencies.

In the chart below monthly exchange rates versus the US dollar have been plotted from 1964 to date. The data reveals that the sterling : US dollar exchange rate has fallen from 2.79 to 1.32 over the last 60 years, a decline of over 50% in relative buying power. By contrast the Swiss franc : US dollar exchange rate has risen from 0.23 to 1.18, a fivefold appreciation.



Source: Lipper for Investment Management, LSEG

However, the depreciation of sterling versus US dollar has not been in a straight line. There has been a huge amount of variability.

US VS UK

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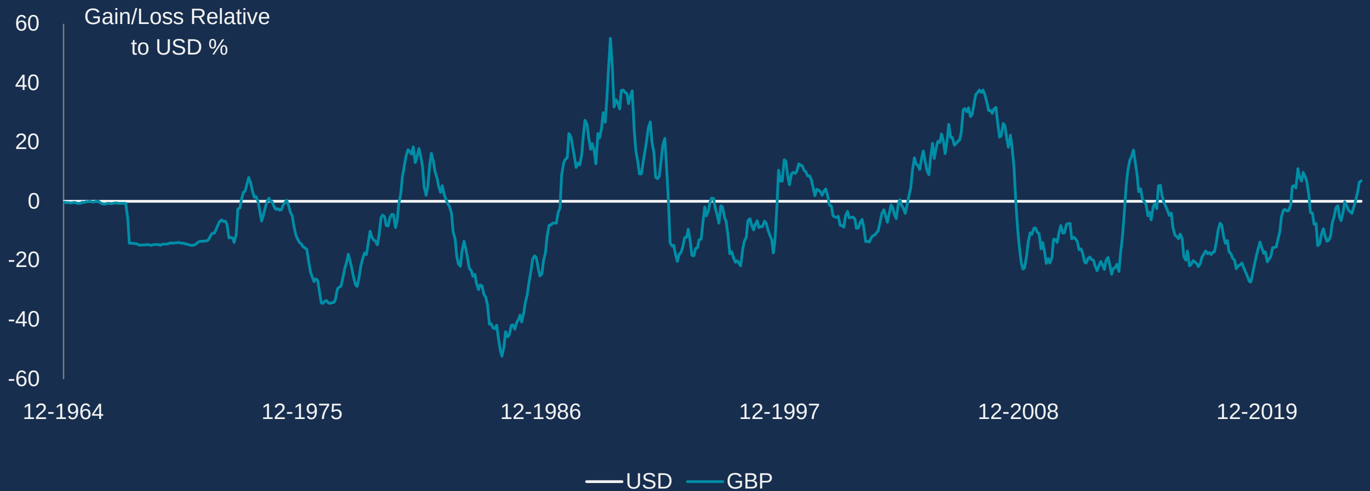
The chart below plots the five-year rolling performance of sterling versus US dollar.



Source: Lipper for Investment Management, LSEG

In around 70% of the five-year rolling periods sterling has depreciated, with an average depreciation over a five-year period of circa 5%.

However, there have been extreme moves in both directions.

In the first half of the 1980s sterling halved in value only to double in value in the second half of that decade after the 1985 Plaza Accord agreement.

PERIODS OF STERLING

70%

DEPRECIATION

Interestingly, since the launch of the ARC PCI Indices in December 2003, sterling has weakened against the US dollar from 1.75 to 1.32, a depreciation of around 25%.

2003

2024

Thus, a systematic hedging policy would have created a material performance drag for the average sterling reference currency investor.

US VS UK

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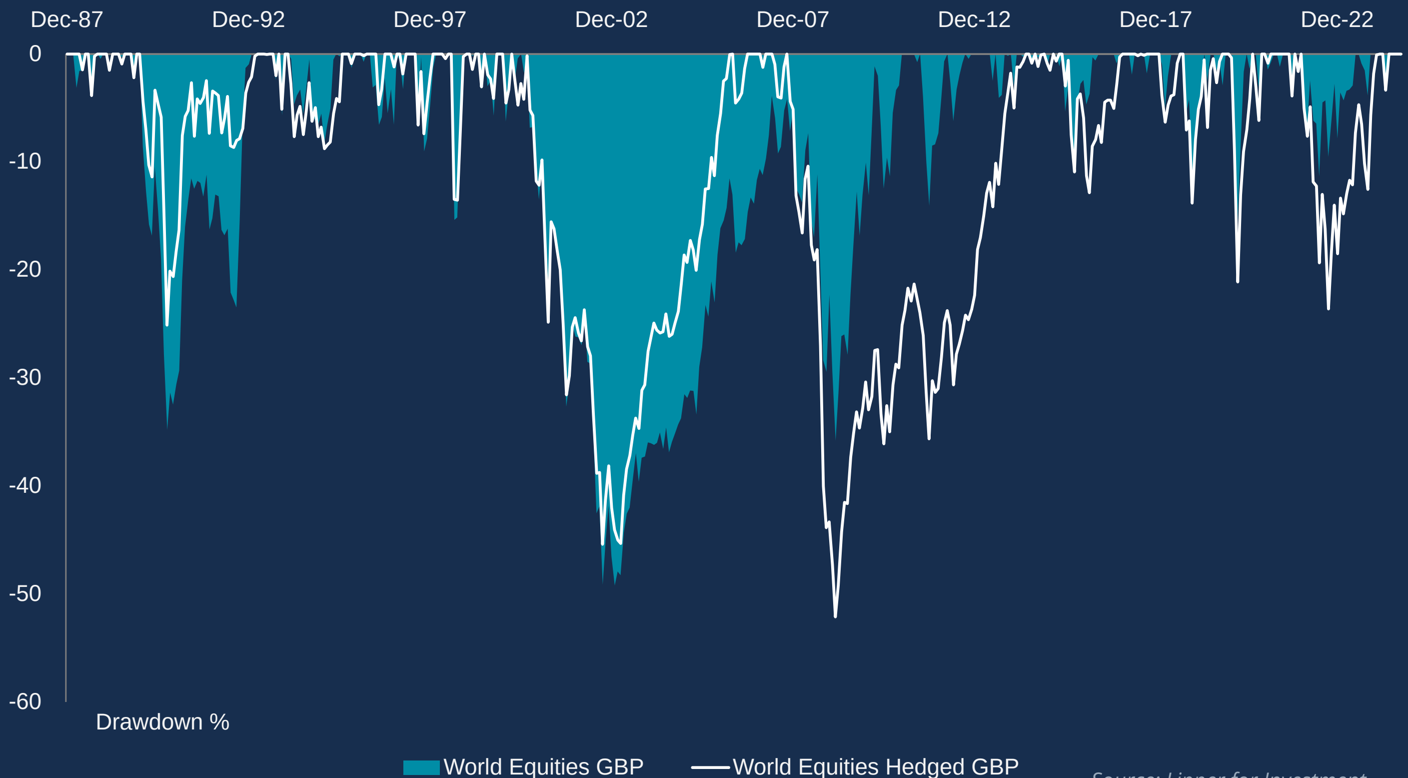
The second observation is that it is instructive to map the periods of sterling weakness against the performance of the world equity market. The pattern that is revealed is that for sterling investors hedging generally exacerbates losses during periods of world equity market stress.

The chart below plots drawdowns for the world equity market unhedged and the world equity market hedged into sterling.



Source: Lipper for Investment Management, LSEG

During the period plotted, there have been five occasions when world equity markets experienced a drawdown greater than 10%.

During the 1990s hedging was a sound investment strategy. Thereafter, it has tended to exacerbate losses rather than reduce them.

Perhaps the starkest example is that of the global financial crisis in 2008 when an unhedged world equity portfolio would have fallen around 35% and recovered within 2 years.

By contrast, a hedged world equity portfolio would have fallen by 52% and taken five years to recover.

10% + DRAWDOWN PERIODS

- the 1990 recession
- the bursting of the dot com bubble in 2000
- the global financial crisis of 2008
- Covid in 2020
- the energy crisis of 2022

So, has systematic hedging historically made sense for a sterling reference currency investor?

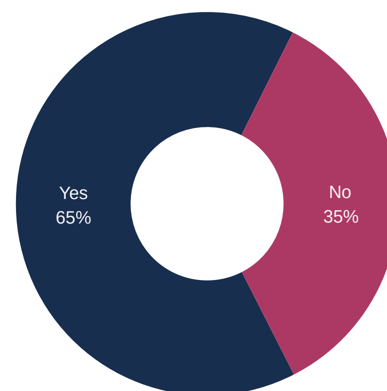
The answer appears to be no! sterling has tended to depreciate over time versus the US dollar and has exhibited episodes of weakness that coincide with global equity market downturns.

What about tactical hedging?

Examining five-year rolling periods reveals that tactical hedging could add value for a sterling base currency investor about 20% of the time and that it might be possible to spot these currency trends as they appear to exhibit a degree of persistence.

IS HEDGING BEING DEPLOYED BY DFMS?

Given the apparent difficulties in generating positive incremental returns and achieving downside volatility reduction by hedging, it might be surprising to discover that when the ARC PCI data contributors were polled, 65% of respondents stated that they used currency hedging as part of their investment strategy.



Source: ARC Research Market Sentiment Survey September 2024

Furthermore, this was deployed across each of the equity, bond and alternative asset classes in roughly equal measure.

Examining the responses for equities as an asset class, 25% of respondents stated that they hedged non-sterling equity exposure as a strategic or systematic decision, with another 32% stating that hedging would be deployed tactically or opportunistically. That was a surprise given the behaviour pattern of sterling versus the US dollar over the last 30+ years.

The *a priori* assumption for hedging fixed income was that most DFMs would generally use foreign bonds to improve liquidity and credit risk in the corporate bond space, but that exposure would be routinely hedged. Our survey suggested that 49% of DFMs did adopt this systematic approach. Another 12% stated that they hedged opportunistically, whilst 39% claimed that they did not hedge foreign currency-denominated fixed income exposure.

As for alternatives, the expectation was that most DFMs would hedge all their foreign currency exposure to enjoy pure alpha, unaffected by currency gyrations. Respondents challenged that assumption, with the majority of DFMs stating that they do not tend to hedge their alternatives exposures.

These findings, which came as part of our quarterly market sentiment survey in September, provide food for thought.

Despite the statistical analysis suggesting that hedging foreign equities is generally a negative alpha strategy, 25% of DFMs hedge systematically, with another 32% hedging tactically. Of course many DFMs offer their clients investment solutions both with and without systematic hedging, leaving the decision to the client.

Over the longer term, it is difficult to see why hedging foreign equity exposure makes sense.

MORE QUESTIONS

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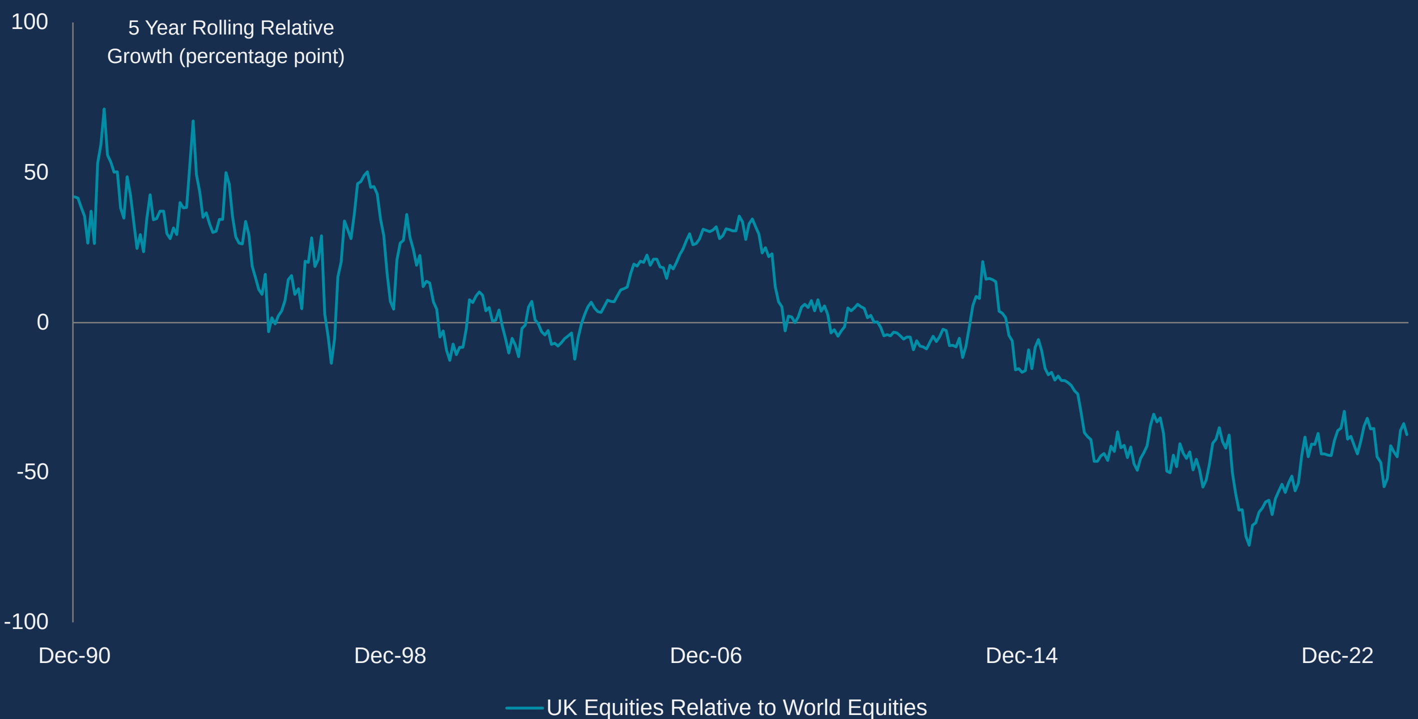
ARE STERLING-BASED CURRENCY PORTFOLIOS INFERIOR?

With a secular downward trend in sterling versus other major currencies and a tendency for currency hedging to increase global equity downside volatility, is it the case that selecting sterling as the reference currency is a fundamentally poor investment decision?

One reason why that might be viewed to be the case relates to the five-year rolling performance of UK equities versus the world equity index, of which the UK equities weighting is less than 10%.

Between 1985 and 2008, UK equities tended to perform rather better than the world equity index as a whole. However, since the global financial crisis, the relative performance of UK equities has tended to be materially weaker.



Source: Lipper for Investment Management, LSEG

However, there is no compulsion on DFMs to overweight the 'home' equity market and over the last couple of decades, average weightings to UK equities have fallen significantly.

Indeed, many DFMs do not overweight UK equities but rather invest with a global mindset.

It is true that since the global financial crisis the performance of UK equities has been very weak relative to US equities but there is no endemic reason why sterling reference currency portfolios should have sub-optimal equity allocations.

MORE QUESTIONS

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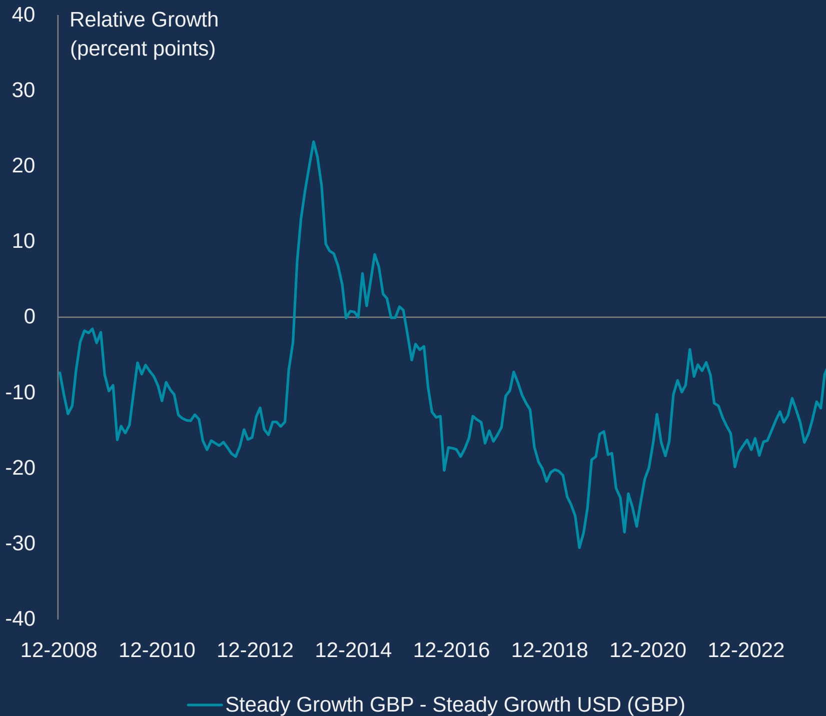
So, what does the evidence reveal?

The chart below plots the rolling five-year relative performance of the average sterling Steady Growth portfolio versus the average US dollar Steady Growth portfolio (expressed in sterling terms) since the commencement of the ARC PCI series in December 2003.



Source: ARC Research

The chart reveals that for the majority of the last twenty years, with a brief interlude in the period post-global financial crisis, the average US dollar private client investor has outperformed their sterling reference currency counterparts over any given five-year period.

Indeed, on average US dollar reference currency investors have seen their wealth grow around 2 percentage points more each year.

To place that into context, commencing in December 2003, the average sterling Steady Growth private client would have seen an initial portfolio of £100 increase in value to £315.

If that same investor had selected US dollars as their reference currency, the initial portfolio of £100 would have risen to £377 as at the end of September 2024.

CONCLUSIONS

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When challenging conventional wisdom, it makes sense to tread carefully. The past may not be an accurate guide to the future and for those investors with regular withdrawals, the analysis may not be valid.

However, the empirical evidence strongly suggests that, for sterling reference currency investors, systematic hedging of foreign equity exposure does not reduce downside volatility and an overweight exposure to UK equities brings little long-term benefit.

Tactical hedging can certainly add value and, with the benefit of hindsight, currencies historically have followed relatively long cycles. However, it is sobering to note that when ranking performance of private client portfolios, those with the weakest performance over the last twenty years have tended both to hedge global equity exposure and overweight domestic equities.

The days when the pound was sound are sadly long gone. Its place has been taken by the US dollar.

Yuval Harari, author of Sapiens, suggests taking a US dollar bill and looking at it carefully. He says that you will see that it is simply a colourful piece of paper with the signature of the US Secretary of the Treasury on one side and the slogan “In God We Trust” on the other. Yet it is true to say that throughout the world, regardless of creed, gender, race or age, the statement “In US dollars We Trust” holds firm!

Looking forward to the next 20 years, the dominance of the US dollar may be tested as countries seek to diversify their foreign exchange reserves and digital currencies may yet find their place as a store of value rather than a speculative investment.

For investors, the risks associated with managing currency exposure are unlikely to reduce. The role of DFMs in helping investors optimise their currency exposure will be a key element in enabling private clients to attain their investment goals.

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A full list of Data Contributors to the ARC Indices is available at **www.suggestus.com**

ARC INDICES

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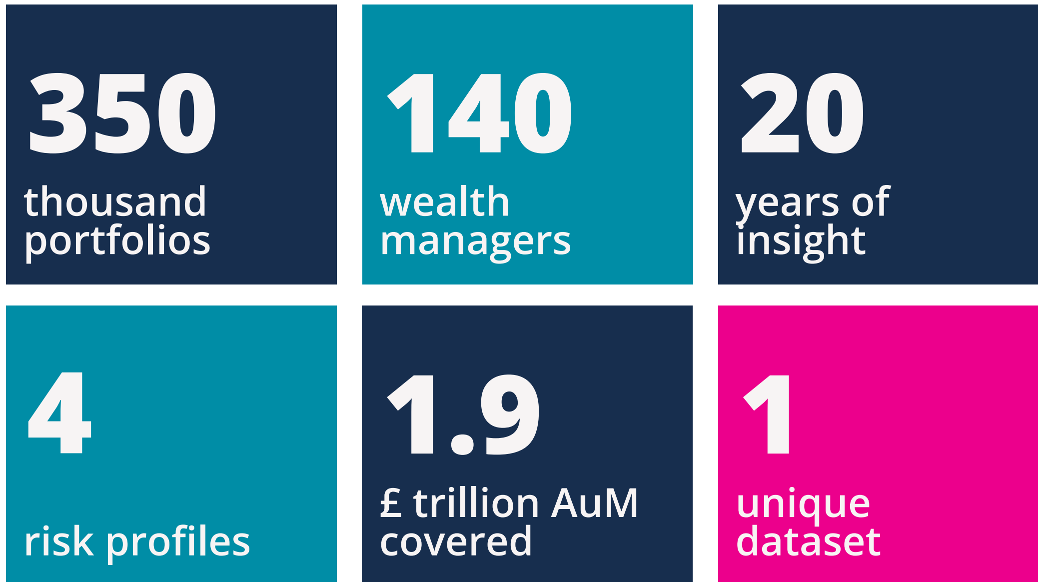
The ARC Indices are a set of benchmarks that reflect the real-world experience of investors that have their wealth professionally managed.

Based on the world's largest dataset of private client investment performance covering over 20 years of real-life outcomes, the ARC Indices allow all investors to really see what "good" looks like.



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