

Currency Update: The Long-Term Perspective For Canadian Investors

Many Canadian investors investing in non-domestic equities have had a tough period so far this decade. Even after the recovery from the bear market low in 2002, Canadians' returns from world markets generally have been trimmed back by the strength of the Canadian dollar. In this article, we examine whether the last few years have been particularly unusual compared to a longer-term history. We also look at the issues facing Canadian investors considering hedging their non-domestic currency exposure.

In 2005, the Brandes Institute, a division of Brandes Investment Partners, L.P., published a study, "Currencies and Hedging: The Longer-Term Perspective," (available at www.brandes.com/institute) on the historical long-term impact of currency on equity investors around the world, reviewing the history back to the start of the era of floating exchange rates at the end of 1972. For this article, we focused primarily on the historical impact on Canadian-based investors, and updated our data through the end of 2005.

What does the long-term record tell us?

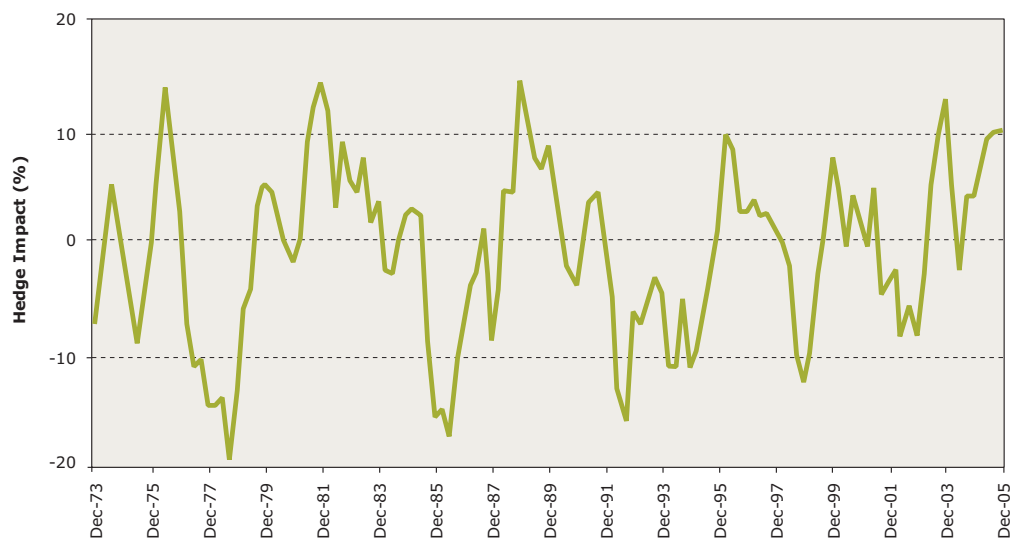
Hedging impact¹ shows a pronounced cyclical pattern in our study. By charting the impact on a one-year rolling² basis, we see that it has frequently exceeded a 10% band around zero. However, the long-term results over the full 33-year period show an average hedging impact of only -0.3% annualized. In other words, a Canadian investor who had fully hedged a non-Canadian portfolio over that whole period would have lowered the portfolio return by 0.3% per year. Note that even a long-term series is dependent on starting and ending dates: if we measured the same series, but started in 1980 instead of 1973, the hedging impact would have been a positive 0.7% per year.

¹ We measured "hedging impact" as the geometric difference in return between a hedged equity portfolio, and its unhedged equivalent. Quarterly hedging was simulated using quarterly equity and currency returns and local 3-month Treasury interest rates. We included the 23 developed countries in the MSCI World Index in our study, but weighted equity returns using GDP weights, not market capitalization weights. Note that "hedging impact" has an inverse relationship with the currency component of non-domestic returns. Thus a positive hedging impact generally occurs when the base currency is strong, and thus the currency component of non-domestic returns is negative.

² Rolling returns are annualized returns for a series of overlapping, smaller time periods within a single, longer-term period. For example, the 32-year period from 12/31/73 through 12/31/04 includes 121 three-month, or quarterly, segments. The first segment is the 12-month period 12/31/73-12/31/74, the next segment is the 12-month period 3/31/74-3/31/75, and so on.

The Long-Term Perspective For Canadian Investors

ROLLING ONE-YEAR HEDGE IMPACT, WORLD EX-CANADA, 1973-2005



Source: Brandes Institute, based on data from FactSet, Global Financial Data, U.S. Economic Research Service, and the International Monetary Fund.

This approach lets us put the most recent period in context. Since mid-2003, the hedging impact for Canadian investors has been strongly positive, with non-domestic currencies falling overall against the Canadian dollar. Since 1980, there have been nine “cycles” of positive and negative hedging impact including the current “positive” one (defining a change of cycle as three successive quarterly numbers of the opposite sign). On average, each cycle has lasted just under three years, with the longest being 5½ years (1980-5), and the shortest just 1¼ years (1998-9). The current cycle has run for 2¾ years through year-end 2005, in line with the average cycle length. Of course, that’s not a prediction or a guarantee.

Even if the present currency cycle turns out to have nearly run its course, has there been something different about it, compared to the prior history of the floating exchange rate era? The answer is yes, but to see why, we need to separate the two big components of the non-domestic pie, the United States and EAFE (Europe, Australia, Far East).

We look first at the hedging impact produced by the U.S.-Canadian dollar relationship. The hedging impact chart below shows the results for a Canadian investor holding a 100% U.S. equity portfolio, comparing hedged versus unhedged returns. Like the prior chart, this also shows a pronounced cyclical pattern. Compared to that prior chart however, the peaks and troughs since 1980 have been much more moderate – until 2003. The spike to a positive 23% at year-end 2003 was the highest number recorded in either chart, positive or negative. The previous record was the 21% positive impact recorded in mid-1976 on this same U.S.-Canadian chart.

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ROLLING ONE-YEAR HEDGE IMPACT, U.S. EQUITY, 1973-2005



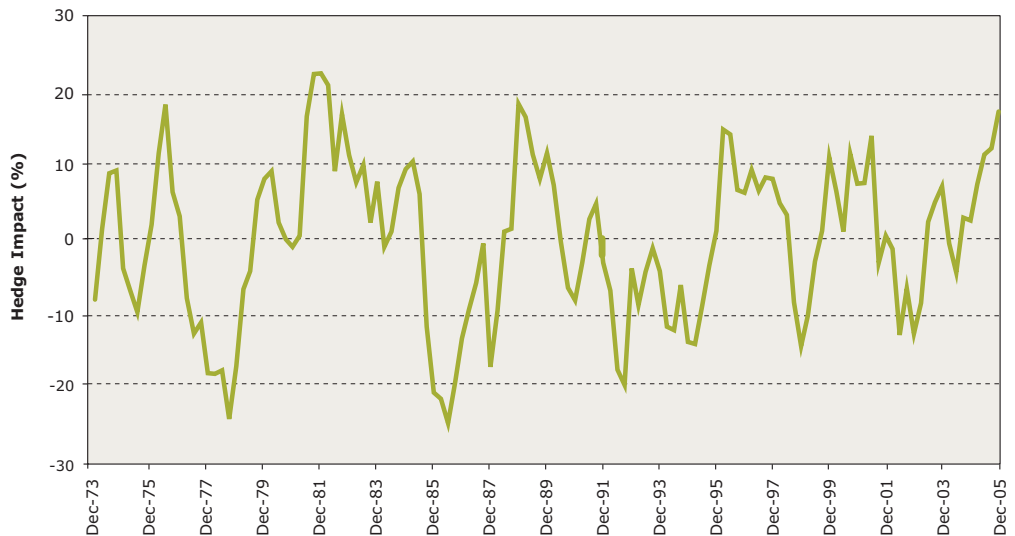
Source: Brandes Institute, based on data from FactSet, Global Financial Data, U.S. Economic Research Service, and the International Monetary Fund.

Now let's take a look at the rest of the developed world (EAFE). When we separate out this segment, we see a similar, cyclical pattern to the World ex-Canada chart, which is not surprising as the only difference is that now we've excluded the United States. That exclusion reveals one noteworthy feature. The size of the swings pre-1990 is noticeably larger than for the more recent period.

The standard deviation of the Canadian dollar hedge impact against an EAFE portfolio (measured quarterly) has been declining since the 1980's, in direct contrast to an increasing trend for the hedge impact against a U.S.-only portfolio. For example, in the 1980's, the quarterly standard deviation against the EAFE portfolio was 5.9%, and that falls to 4.4% for the 2000-2005 period. In contrast, the equivalent measure against the U.S.-only portfolio was 2.3% in the 1980's, and that has risen to 3.9% in the 2000-2005 period. This suggests the Canadian dollar has become somewhat less tied to the U.S. currency, and is responding more to global influences.

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ROLLING ONE-YEAR HEDGE IMPACT, EAFE, 1973-2005



Source: Brandes Institute, based on data from FactSet, Global Financial Data, U.S. Economic Research Service, and the International Monetary Fund.

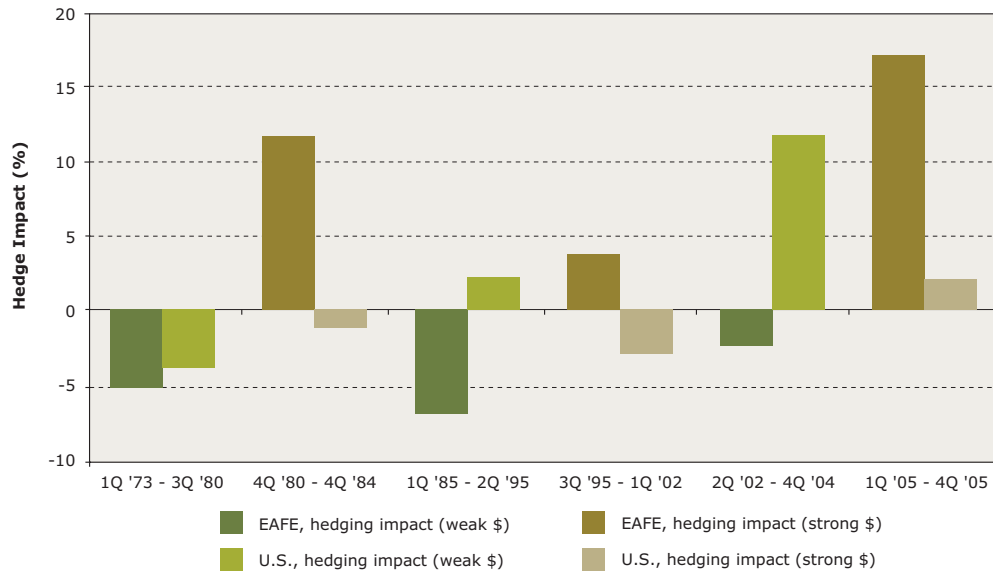
As well as the Canadian dollar's own cyclical, we gain additional insight from analyzing hedging results depending on whether the U.S. dollar was in a weak or strong phase. In the Brandes Institute study referenced earlier, we identified five U.S. dollar cycles:

1. Weak 1Q1973-3Q1980
2. Strong 4Q1980-4Q1984
3. Weak 1Q1985-2Q1995
4. Strong 3Q1995-1Q2002
5. Weak 2Q2002-4Q2004

To this we must add the (perhaps partial) strong U.S. dollar period of 2005.

The Long-Term Perspective For Canadian Investors

HEDGING IMPACT, WEAK AND STRONG U.S. \$ PERIODS, 1973-2005



Source: Brandes Institute, based on data from FactSet, Global Financial Data, U.S. Economic Research Service, and the International Monetary Fund.

We show in the above chart the hedging impact for Canadian investors over these cycles, for both EAFE and U.S.-only equity portfolios. The hedging impact for EAFE portfolios is cyclical (and on average larger than that of the U.S.-only portfolio). The impact is positive in strong U.S. dollar periods and negative in weak U.S. dollar periods, consistent with the generally close “association” of the Canadian dollar with the U.S. currency. The U.S.-only equity portfolio shows smaller hedging impact numbers, except for the 2002-4 period. This is an important exception and ties directly into the currency conditions that produced the 2003 “spike” in our earlier charts.

The four periods that span 1980-2004 (excluding the sets of bars at either end) are characterized by the EAFE and U.S.-only hedging impacts having opposing signs. This is the result of the Canadian dollar’s movements generally being “in the middle” between the U.S. currency and EAFE currencies. In the pre-1980 period (the left-most bars), the U.S. dollar was weak and the Canadian even weaker. The right-most bars (the shortest period, consisting of just 2005) saw the U.S. dollar strengthen, and the Canadian outpace it.

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So what conclusions, if any, can we draw from these charts and their underlying data history? We'll start by noting that our views are not predictions of the currency markets, nor are we asserting that past patterns should repeat themselves. We offer our comments in the context that investors may be able to use this financial history to understand better the risks inherent in their actions (or their decisions not to take action).

QUESTION 1: HAVE THE PAST FEW YEARS BEEN PARTICULARLY UNUSUAL COMPARED TO A LONG-TERM HISTORY?

Yes. Based on the strength of the Canadian dollar against all developed currencies, our research indicates that the resulting positive hedging impact for Canadian investors since the start of 2003 has been unusual, and against the U.S. dollar has been unprecedented in the floating exchange rate era.

QUESTION 2: DOES THIS UNUSUAL 2003-5 PERIOD SUGGEST THAT "THIS TIME IT'S DIFFERENT" AND THE HISTORIC CYCLICAL PATTERN IS NO LONGER EVIDENT?

We don't try to predict future currency trends. We can observe that these cyclical patterns have prevailed generally since the start of floating exchange rates at the end of 1972. It certainly would appear that investors who hedge portfolios (or avoid international diversification) on the expectation that the Canadian dollar will continue to strengthen from here, are implicitly assuming that "this time it's different." Leaving aside the topic under review, our experience as long-term investors generally has been that when majority opinion believes that "this time it's different," it isn't.

QUESTION 3: IF THE CYCLICAL PATTERN IS INTACT, WHAT HAPPENS NEXT?

If this is a cycle, and if 2003-5 represented the "up-phase," then observations of the length and amplitude of past cycles would be consistent with a "down-phase" sometime in the 2006-7 period. Again, this is not a prediction; this time it may indeed be different!

QUESTION 4: GIVEN THE STRONG CANADIAN DOLLAR IN RECENT YEARS, IS NOW A GOOD TIME TO HEDGE?

We believe that any financial strategy should be evaluated in the context of its long-term impact on portfolios. Reacting to any short-term "investment stimulus" is risky in our view, especially one that has historically shown a cyclical pattern.

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