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Insight INVESTMENT

EMERGING MARKETS HARNESSING CURRENCY RETURNS

DON'T MISS OUT ON THE RETURN POTENTIAL FROM EMERGING MARKET CURRENCY

NOVEMBER 2017

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A BNY MELLON COMPANY℠

A large part of the return from investing in emerging market assets comes from currency exposure. However, Australian dollar (AUD) investors typically lose out on this due to the economic links between Australia and Asia, and the impact of changes in commodity prices. By separating the currency exposure into its three component parts and actively managing the part which provides unrewarded risks, we believe Australian investors can better capture the available returns from emerging market currency exposures, enhancing their overall return potential from emerging market investments.

EMERGING MARKETS
HARNESSING CURRENCY RETURNS

MANY INVESTORS VIEW THE EMERGING MARKETS AS AN ATTRACTIVE SOURCE OF INVESTMENT RETURNS. WHETHER THESE RETURNS ARE ACCESSED PASSIVELY THROUGH INDEX FUNDS OR THROUGH HIRING SKILLED PORTFOLIO MANAGERS TO SELECT THE BEST-PERFORMING ASSETS, THE IMPACT OF VOLATILITY IN THE INVESTOR'S BASE CURRENCY ON THE OVERALL RETURN OF EMERGING MARKET BONDS AND EQUITIES IS OFTEN IGNORED.

Even in the case of active emerging market portfolio management, a portfolio manager is making active decisions on which currencies to favour or avoid. However, typically, they do not consider an investor's base currency-specific risk.

The overall emerging market currency return relative to an investor's base currency can be separated into three components:

1. The active portfolio manager's currency selection relative to the emerging market currency market in general (emerging market currency-specific risk)
2. Overall emerging market currency moves relative to the developed market currency market (the emerging market versus developed market currency beta)
3. An investor's base currency movement relative to the developed market currency market (the base-currency-specific risk)

An investor will typically retain the first component as this is where active portfolio managers aim to add value. We believe the second component will also be attractive for many investors as this element has historically added value. However, we believe investors can benefit from actively managing the third component – base-currency-specific risk – as this is unrewarded risk exposure that can dilute the performance outcome. For AUD-based investors this base-currency-specific risk has been costly, resulting in a negative return from emerging market currency exposure over the past 20 years.

EMERGING MARKET RETURNS: CURRENCY CAN PLAY AN IMPORTANT PART

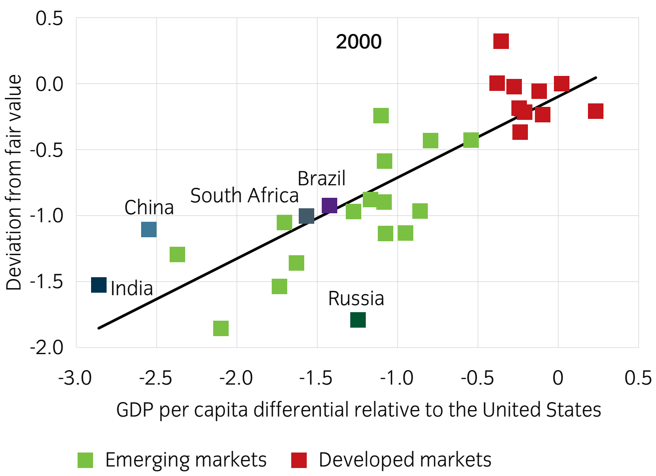
Emerging markets account for nearly 80% of global economic growth, almost doubling their share from 20 years ago[1]. As a result, emerging market equities and bonds have become an important source of attractive, diversified returns for international investors. Often neglected, however, is the fact that a significant part of emerging market asset returns can be derived from currency. Figure 1 shows that as emerging markets have become more productive relative to developed markets, they have also experienced real exchange rate appreciation. Particularly notable, when comparing data from 2000 and 2016, is the real appreciation (illustrated in Figure 1 by a general shift up and to the right of the green squares) of emerging market currencies toward the developed market currencies, consistent with the emerging markets' increased relative productivity over time. While short-term bouts of currency volatility are to be expected, depicted in these charts as deviations from the fair value line, the expectation is for this appreciating trend to continue over the longer term.

AUSTRALIAN INVESTORS HAVE BEEN MISSING OUT

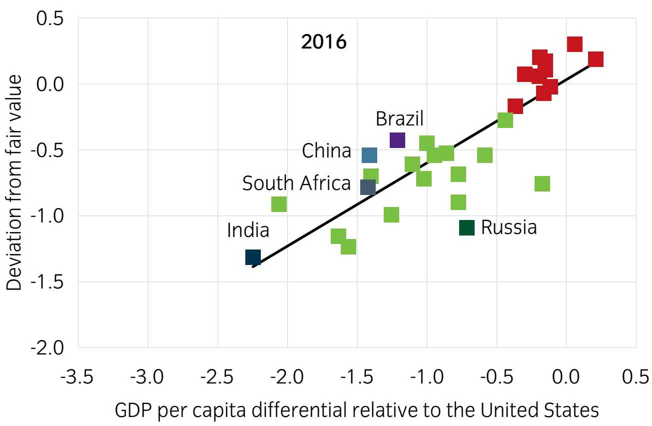
Emerging market currency returns can vary significantly depending on the investor's base currency – in other words, their base-currency-specific risk (see Table 1). Emerging market currencies have provided a positive return to most investors, with the exception of AUD-based investors. In addition, Australian investors have experienced high levels of currency volatility.

Why did investors around the world experience such different outcomes? The answer is inextricably tied to movements in investors' base currencies – the third component of emerging market currency risk described above. The AUD has a high historical correlation with the MSCI Emerging Markets Index currency basket. This is due to the both the economic links between Australia and its largest trading partners in Asia, and the impact of changes in commodity prices on the Australian economy and the economies of other commodity exporting countries (many of which are emerging markets).

Figure 1: Real exchange rate deviation from fair value[2] versus productivity as at 2000 and 2016



Source: DataStream, IMF and Insight. As at end December 2000.



Source: Datastream, IMF and Insight. As at end December 2016.

Table 1: Emerging market currency statistics from different currency bases

Base currency	Currency return (%)	Volatility (%)	Sharpe ratio	Correlation with hedged EM equity
US dollar	2.37	5.52	0.43	0.51
Australian dollar	-1.25	10.93	-0.11	-0.24
Canadian dollar	1.07	8.32	0.13	-0.03
Euro	2.72	9.48	0.29	0.19
Swiss franc	2.08	11.16	0.19	0.29
British pound	2.85	9.01	0.32	0.12
Japanese yen	4.52	11.82	0.38	0.43

Period: December 1998 to September 2017. The effective currency return includes the spot exchange rate movements and the local interest rate differential against the base currency. All statistics are annualised. Source: DataStream, Insight.

[1] JPMorgan GBI-EM Global Diversified Index.

[2] Fair value is based on two calculations:

- Cyclical deviations from fair value based on purchasing power parity – these deviations are represented by vertical movements above or below the 45% line.
- Longer term structural deviations based on productivity improvements – as GDP per capita increases (relative to developed market currencies), this productivity improvement increases the fair value of the emerging market currency and its fair value moves up along the 45% line, towards the developed market currencies.

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Emerging market currency returns can vary significantly depending on the investor's base currency – in other words, their base-currency-specific risk

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Australian investors are exposed to two unmanaged currency risks in emerging markets. The first component represents the performance of the basket of emerging market currencies versus developed market currencies – this is the long-term risk premium which we expect to be positive and relatively stable and can be captured passively and unhedged. The second component arises from the behaviour of the investor's base currency, in this case the AUD, against a basket of developed market currencies. As investors typically do not expect this component to generate a long-term positive return, we believe it is appropriate to diversify the base currency exposure. This logic applies to investors of any base currency, but the case for doing so may be amplified in the case of the AUD due to the currency's high historical correlation with emerging market currencies.

A NEW APPROACH TO MANAGING EMERGING MARKET CURRENCY RISK

We believe AUD-based investors can benefit from emerging market currency appreciation with a more sophisticated approach to currency management, which seeks to reduce the concentration of their base-currency-specific risk.

An unhedged AUD-based investor effectively has a single, concentrated, short position in the AUD. By moving from this to a more balanced short position across a basket of the most liquid developed market currencies (which might consist of the US dollar, euro, Japanese yen, British pound, Swiss franc and Canadian dollar), AUD-based investors can diversify their base-currency-specific risk. This currency diversification approach maintains the desired long emerging market currency exposure, while reducing the short AUD exposure by purchasing AUD currency forward contracts against the other G7 currencies.

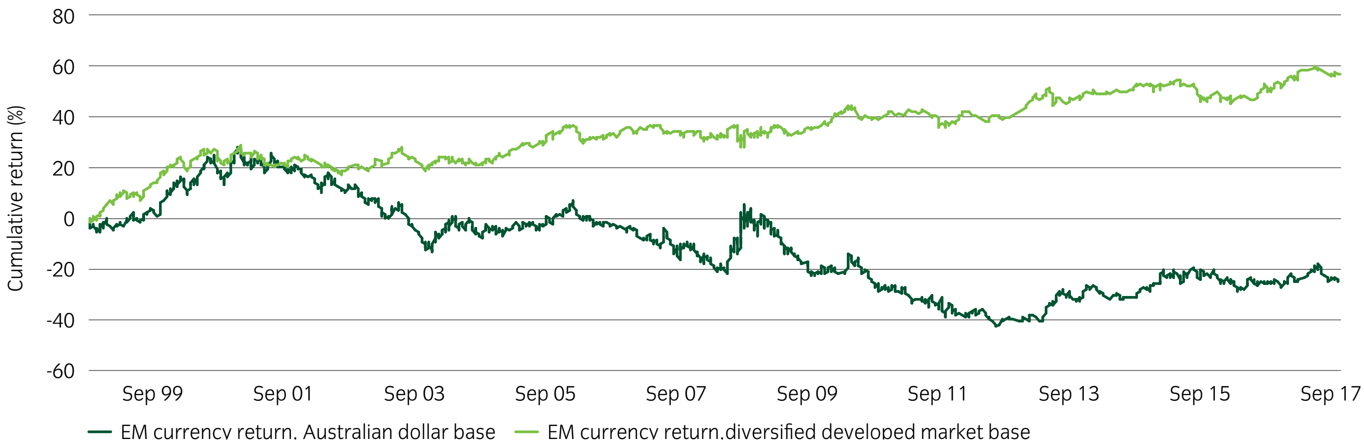
The result of applying this base currency diversification strategy historically would have been a positive return of 3.01% (annualised) pa from currency exposure (see Figure 2), compared to the previous negative return of -1.25% (annualised). Diversifying the base-currency specific risk has also significantly reduced the volatility of currency returns. The result of applying the strategy would have been a substantial reduction in overall currency risk, leading to greater confidence that emerging market currency returns will be captured.

Importantly, this approach maintains exposure to emerging market currency selected by an investor's emerging market portfolio manager, and so avoids the costs of directly trading emerging market currencies.

CONCLUSION

At Insight, we believe that through an actively managed currency strategy, which seeks to diversify the concentrated short AUD exposure implicit in an emerging market allocation, Australian investors can access the additional investment returns that emerging market currency exposure can offer.

Figure 2: Historical simulated performance of a base currency diversification strategy



Source: Insight Investment. Gross of fees, as at 30 September 2017. Past performance is not a guide to future performance. Simulated performance results have certain inherent limitations. Simulated results do not represent actual trading/returns and are not a reliable indicator of future performance.

FIND OUT MORE

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