

# Russell Update

## Russell Hedges US Currency

Russell Investments Canada Limited (Russell Investments) is committed in continually refining our process with the objective of improving the investment experience for our clients. One of the ways this can be achieved is by persistently monitoring the investment landscape for return enhancing and/or risk reducing opportunities. Currency is one such area where we believe this opportunity exists for the following reasons:

- Returns on foreign holdings for Canadian investors can be significantly impacted when those returns are repatriated back into the Canadian dollar (CAD).
- From the perspective of a globally balanced investor, one of the biggest sources of currency risk would be via their allocation to US equities – which is more than likely to be their largest foreign exposure to any single country
- Commodities have increasingly become the driving force in the determinant of the CAD/USD exchange rate.
- While global non-US equities can also pose similar challenges, when this region is considered in aggregate, for instance the exposure to the EAFE<sup>1</sup> region, the multi-country/multi-currency exposure within this basket has the tendency to neutralize some of the volatility that a straight exposure to a single country is subject to.

As such, Russell Investments has decided to hedge our exposure to US equity for our balanced fund clients<sup>2</sup>. This article will highlight the current investment landscape which makes this a suitable decision from a risk/return standpoint.

---

<sup>1</sup> EAFE refers to the following regions: Europe, Australia, and Far East. As of June 2007 the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

<sup>2</sup> Corporate class versions will also have their US Dollar exposure hedged.

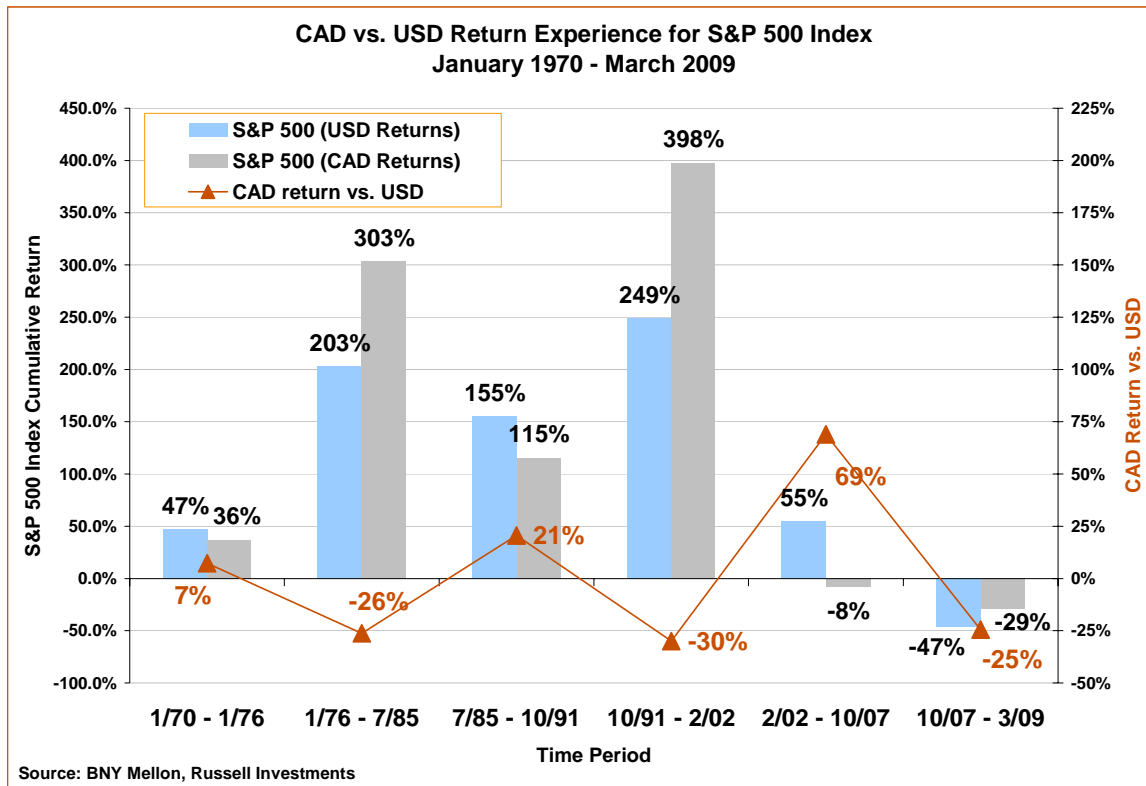
## What you see is not always what you get

For Canadian investors with a sizeable exposure to US equities in their portfolios, the volatility in the exchange rates between the two countries can cause significant disparity in returns when the US equity market return is measured in CAD versus the US dollar (USD).

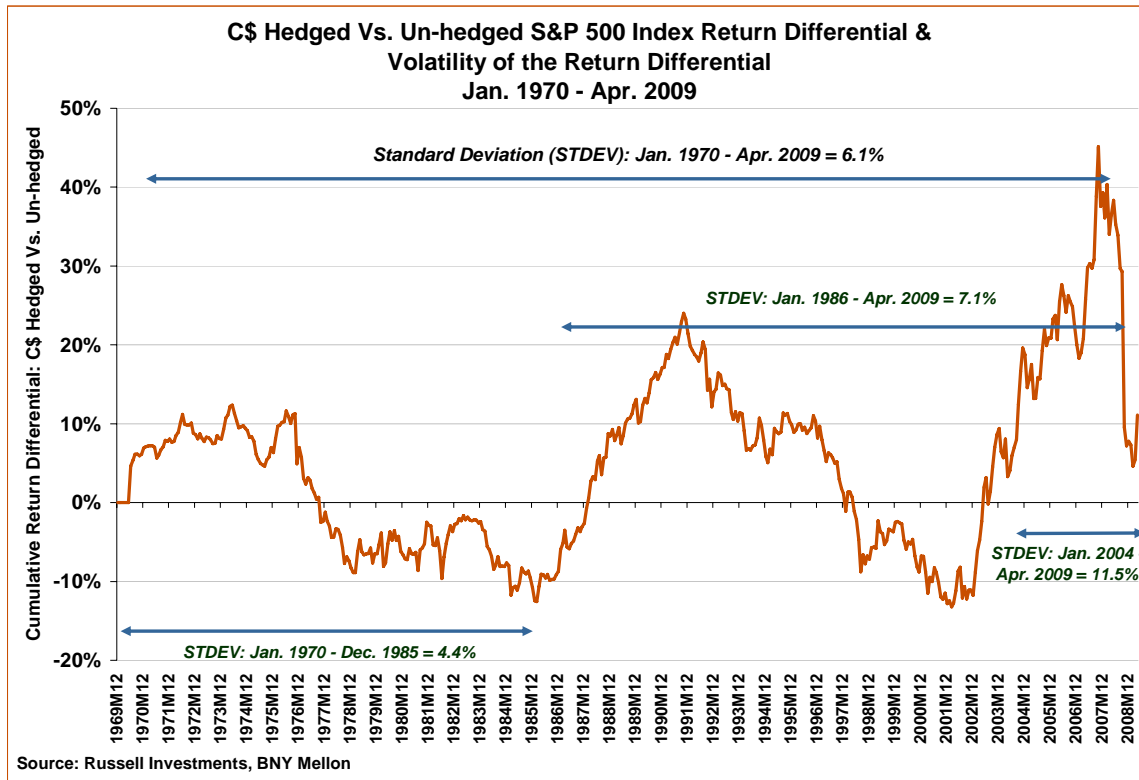
History suggests that the CAD/USD exchange rate is not steady through time; rather, it goes through multi-year periods of moving in one direction before reversing course. The implications are not trivial. For example, as illustrated in Figure 1, the S&P 500 Index returns in USD returned a cumulative 55% between February 2002 and October 2007. At the same time, the CAD appreciated 69% versus the USD, partially explaining the S&P 500 index return of negative 8% when measured in CAD. As such, otherwise impressive returns in local currency were completely masked when measured back into the respective domestic currency. This relationship can also go the other way, for example in the 1976 – 1985 timeframe, S&P 500 returns in CAD received a boost via the depreciation of the loonie versus the USD.

This poses a challenge for investors who are expecting certain returns in their portfolios when they see them reported in popular print and TV media but are quite shocked when comparative returns are different. Being shocked on the upside is always welcome but it is the downside deviation that is especially troubling for investors as well as investment managers.

**Figure 1: Cumulative S&P 500 returns measured in CAD vs. USD**



**Figure 2: Cumulative Hedged Vs. Un-hedged Return & Volatility Summary**



**Volatility rises**

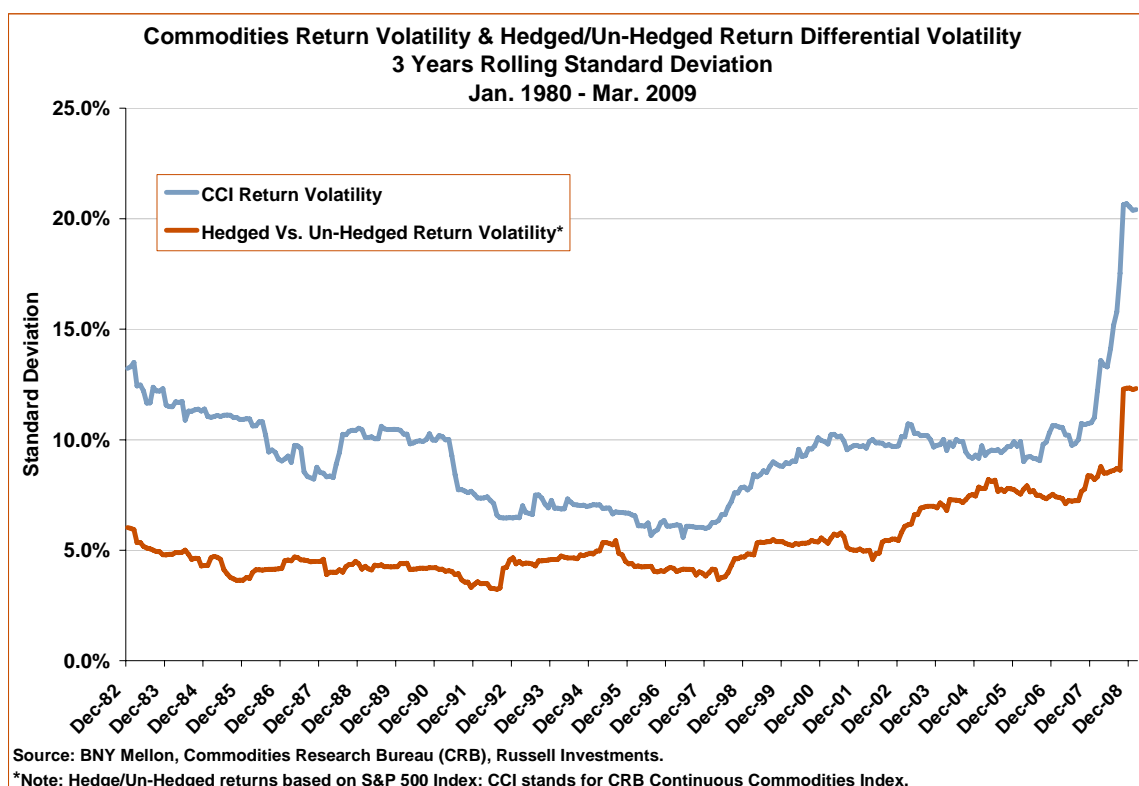
Return is one side of the equation, and risk is the other. Based on our analysis, as highlighted in Figure 2, we have seen volatility in relative returns of US equity measured in CAD versus USD increase significantly over time. For instance, the average volatility (measured in standard deviation) from January 1970 to April 2009 is roughly 6.1% as the top blue arrow indicates. During the first 16 years of this analysis (1970 – 1985), however, the average volatility was a much lower 4.4%. As we move closer to the current timeframe, volatility is increasing noticeably more than the longer term average. In fact, looking at the most recent timeframe from January 2004 – April 2009, volatility averaged 11.5% and is nearly double the longer term average and three times the average of the first 16 years.

The increased volatility between the hedged and un-hedged portfolios is largely a result of the increasing volatility of commodities. Figure 3 illustrates how much more volatile commodities have become over the recent decade as volatility has doubled from around 10% to 20% (blue line). This spike in volatility coincides with the dramatic up and down swings in relative returns since 1986 versus the hedged and un-hedged returns for US equity (brown line).

A large contributor to this increase is the volatility of oil, which on an annualized basis has averaged about 32%, versus 15.5% for the un-hedged S&P 500 Index returns<sup>3</sup>. In addition, we have also seen a considerable rise in correlation of the relationship between the loonie and commodity prices. For instance, rolling three year correlations of the CAD/USD exchange rate and commodity prices were close to 0% in 2001, as of March 2009, the correlation reached nearly 80%<sup>4</sup>. This further highlights how closely linked the exchange rate has become to commodities as a whole.

While it is conceivable that volatility may subside from these extreme elevated levels, it is equally conceivable that it will remain above the previous lows which persisted for well over two decades. This will in turn continue to impact the Canadian economy as well as the CAD which have become closely associated to the movement of commodity prices<sup>5</sup>. These circumstances are likely to continue to cause wide dispersions between hedged and un-hedged returns of US equity going forward.

**Figure 3: Commodities Rolling Volatility**



<sup>3</sup> Source: Commodities Research Bureau (CRB). Annualized volatility measured in standard deviation for the S&P 500 Index and CRB Oil Index from Jan. 1980 – Mar. 2009.

<sup>4</sup> Source: CRB, FactSet, Russell Investments

<sup>5</sup> The shift in export composition offers further illustration of the dependence to commodities. Energy related exports represented about 14% of total exports as of the 3<sup>rd</sup> quarter 2004; by the 2<sup>nd</sup> quarter 2008, the share had jumped to 28% of total exports – a doubling in about four years. Over this same timeframe, automobiles share of total exports declined from 22% to 12%. Source: Statistics Canada.

---

## Hedging out the uncertainty

Prudent investment management requires positioning portfolios for the future. As such, Russell Investments has taken into consideration the volatility of returns resulting from uncontrollable currency movements of the US Dollar versus the Canadian Dollar and has decided to hedge the US equity exposure within our balanced funds. Since the US currency does not have the benefit of diversification similar to that of the basket of currencies within the EAFE region, it leaves the Canadian investor exposed to swings in returns resulting from exchange rate volatility which are not necessarily due to portfolio management decisions.

As global economies get on the path to recovery and demand for commodities likely resurges, the Canadian dollar should be a benefactor of this increased demand as our economy is heavily tied to the resource sectors. The main impact this can have for a Canadian investor is their direct exposure to US equities, which in some cases can equal that of their exposure to Canadian equities from a balanced investor perspective<sup>6</sup>. A depreciating US dollar in such a scenario would have an adverse impact on the returns of the un-hedged portfolio.

We feel having this flexibility to hedge the US currency exposure highlights our commitment to investors as we continue to seek ways to improve the risk adjusted experience for our clients.

## Important Information

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

Nothing in this publication is intended to constitute legal, tax securities or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. This is a publication of Russell Investments Canada Limited and has been prepared solely for information purposes. It is made available on an "as is" basis. Russell Investments Canada Limited does not make any warranty or representation regarding the information.

Russell Investments and the Russell Investments logo are registered trademarks of Frank Russell Company, used under license by Russell Investments Canada Limited.

Copyright © Russell Investments 2009. All rights reserved. This material is proprietary and may not be reproduced, transferred, or distributed in any form without prior written permission from Russell Investments.

---

<sup>6</sup> For illustration: Assuming 60% equities and 40% fixed income asset allocation. If equities exposure is equally divided by one-third US, Canada and EAFE regions, the exposure to USD can be as high as the exposure to the CAD. As mentioned, EAFE has the benefits of currency diversification from the basket of countries/currencies.

---

## **Disclaimer for DEX Indexes**

Source: PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. 2008. All rights reserved. The information contained herein may not be redistributed, sold or modified or used to create any derivative work without the prior written consent of TSX Inc.

THE USER AGREES THAT TSX INC. AND THE PARTIES FROM WHOM TSX INC. OBTAINS DATA DO NOT HAVE ANY LIABILITY FOR THE ACCURACY OR COMPLETENESS OF THE DATA PROVIDED OR FOR DELAYS, INTERRUPTIONS OR OMISSIONS THEREIN OR THE RESULTS TO BE OBTAINED THROUGH THE USE OF THIS DATA.

THE USER FURTHER AGREES THAT NEITHER TSX INC. NOR THE PARTIES FROM WHOM IT OBTAINS DATA MAKE ANY REPRESENTATION, WARRANTY OR CONDITION, EITHER EXPRESS OR IMPLIED, AS TO THE RESULTS TO BE OBTAINED FROM THE USE OF THE

DATA, OR AS TO THE MERCHANTABLE QUALITY OR FITNESS OF THE DATA FOR A PARTICULAR PURPOSE.

Date of first publication: 2009

