



Diversified

Diversified's View

The Fallacy of Swapping a diversity of offshore Currencies for solely New Zealand Dollar Risk Punished some Investors in 2008

Abstract

Kiwi investors are generally over-exposed to NZ\$ by dint of lifestyle assets, future earnings and entitlement to the universal pension. Curiously, some fund managers customarily further undo important diversification of investment portfolio wealth, through 'hedging' investor's offshore currencies back into New Zealand Dollars. The effect is to abrogate important diversification, and to concentrate currency risk in a small, volatile unit. The practice has most recently robbed Kiwi investors of a very useful cushion amidst the global financial crisis of 2008, and retarded portfolio investor's returns longer-term. Investors subjected to hedging to NZ\$ have not been well served.

Global currencies only move relative to one another, with an equal number of gainers and losers, with no change in the aggregate. Single currency risk is therefore completely diversifiable. A basket of unhedged currencies is the least risky approach, and concentrating in any single currency is to introduce currency risk. Undoing a sound spread of diverse currencies to favour the home currency is a bet that should only be considered on a tactical basis where immense conviction is held of imminent gains.

The record of the NZ dollar's exchange rate is one of very high volatility in a generally downward trajectory spanning 40 years. Higher interest rates on offer in NZ over time, reflect greater risks in NZ's small and trade-dependent economy, and hence the currency that it supports.

That foreign lenders to NZ often demand hedging from the NZ\$ risk to invest their funds, (forming a convenient pairing for institutions able to match this derivative trade), is no justification for Kiwi portfolio owners to be subjected to the less desirable side. Investors who have shunned the product-providers fashion of swapping a natural basket of offshore currencies into the NZ Dollar have prospered most.

Fortunately, Kiwi residents are mostly unfettered in being able to diversify sovereign, currency, industry and geographic risks in well-managed portfolios, via a wide range of listed or unlisted funds in NZ, Australia, the UK or USA.

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What is Currency?

Our Kiwi dollar, in common with most all other currencies, is 'fiat money'. Fiat money has no intrinsic value and can not be redeemed for specie nor for any commodity. The kiwi is legal tender in NZ and a few islands by government decree, with value arising solely from the strength of our country's economy, and government's ability to tax that wealth.

NZ's relative economic growth rate, productivity gains and inflation rates have for many years lagged that of most of our trading partners, and especially the high-growth area of Asia, while the tax burden is relatively fuller. The backing to our kiwi dollar has therefore increased at a lesser rate, than the backing to most other fiat currencies.

The economic backing for NZ's fiat currency is comparatively diminishing suggesting depreciation being the logical trend for the NZ\$ over time.

Factors Influencing Exchange Rates

Exchange Rate appreciation, or depreciation, is influenced by relative differences in:

- national economic growth rates per capita;
- perceived political stability;
- current account balances;
- rate of inflation, and;
- interest rate on offer.

The New Zealand economy has slipped down the OECD rankings progressively over recent decades, while growth outside the whole OECD has been higher than within.

Mixed Member Proportional parliamentary representation has increased uncertainty at the margin, and relative to countries persisting with established FPP systems.

New Zealand's Current Account is persistently in deep Deficit. The traditional remedy to address CAD's, is to foster exports whilst curtailing imports. NZ's Current Account Deficit augurs for a lower currency.

New Zealand's Official Cash Rate was until recently the highest in the OECD, serving both to combat relatively higher national inflation, as well as to attract funding to cover our CAD. Less attractive economic fundamentals signal the New Zealand dollar is most likely to depreciate over time.

Diversification - the lowest-risk option

Diversification is the sole recognized defense against unknowable risk. Currency movements can only be relative to one another. e.g Yen rising or falling against US\$, Euro, Pound Sterling or Chinese Renminbi – but completely countered with matching rises or falls elsewhere and no aggregate change possible.

An index of all currencies would therefore diversify completely all currency movement. Currency movement is the classic diversifiable risk.



Diversified

For portfolio investors, a diverse basket of currencies represents the least risk course. Concentration in a single currency introduces currency risk.

NZ Risk

NZ is a small and remote trading nation heavily dependent on agricultural exports. Changing markets (food miles?), or potential disease (foot and mouth) are enormous risks to economic well-being.

Larger economies are intrinsically more diversified.

Global Gross Domestic Products, (derived by Purchasing Power Parity)

Area/ Country	Economy size GDP (PPP)	Rank
World	\$65.00 Trillion	
USA	\$13.80 trillion	1st
Euro Area	\$10.40 trillion	2nd
China	\$7.10 trillion	3rd
Japan	\$4.30 trillion	4th
Australia	\$0.70 trillion	18th
New Zealand	\$0.01 trillion	57th

Source: World Bank July 2008 data, PPP data 2007

In the absence of strong conviction and compelling data, it is riskier to exchange a basket of diverse currencies backed by the world's largest and most diverse economies, to instead concentrate all currency exposure to the 57th largest economy, backed only by 1/6500th of global economic activity.

Income versus Return

We are adherents to the Efficient Market Hypotheses: 'Yield is related to Risk'.

New Zealand has persistently offered investors higher yields on Cash, and also on 10-year Gov't Bonds, than are on offer in most larger, more dynamic or more diverse economies. Even at its peak of 8.25% last year, NZ's OCR remained below that of Brazil, Iceland or South Africa, where risks may be presumed to be higher.

The EMH suggests NZ's yield premia is necessary to offset perceived additional risks including currency risk, inflation risk and sovereign risk.

History suggests NZ's higher yields have been inadequate to cover currency depreciation over the nearly 42 years since the NZ\$ was created on 10 July, 1967.

Key Changes in NZ\$ Exchange rate since Decimal Currency (1967)

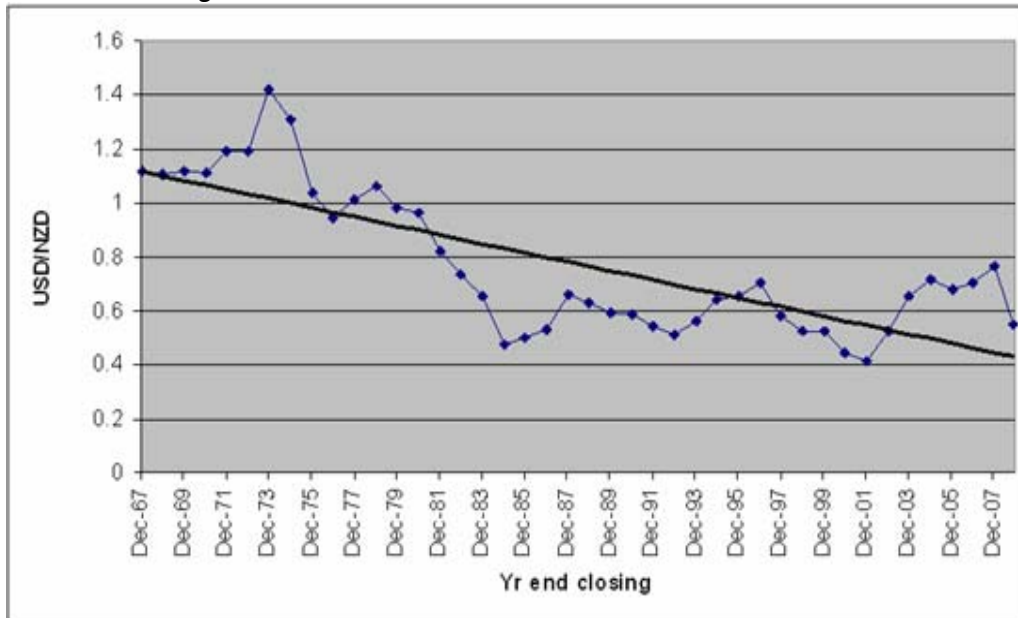
NZ\$ value in	1967	31/03/09	NZ\$ depreciation %
US dollar	US\$1.39	US\$0.562	-59.6%
Singapore	S\$4.30	S\$0.86	-74.4%
Great Britain Pound	£0.50	£0.39	-22.0%

Source: Diversified research.



The NZ dollar's high volatility against the global reserve currency, the US\$, is depicted below. (Note NZ\$ had already been devalued from US\$1.39 at launch, to US\$1.12 by December of 1967).

NZ\$ - US\$ exchange rate 1967 to 2008



Source: *Whither the New Zealand Dollar*, Dr Shamin Shakur, Massey Univ, Nov, 2008

NZ\$ Currency Outlook

NZ's Trade Weighted Index (TWI) has undergone various methodology changes, but commenced in 1979 with a base of 100. TWI is currently (31/03/09) at 57.06. Our very own Reserve Bank of New Zealand forecasts continuing depreciation.

Forecast of NZ TWI, 90-day rate, CPI & 'Real Yield' (March year)

	2009	2010	2011	2012
TWI (yr average)	61.7	49.1	48.0	50.0
90-Day Rate	6.7%	3.1%	3.8%	5.2%
CPI	3.1%	1.6%	2.2%	2.1%
Real yield	3.6%	1.5%	1.6%	3.1%

Source: Data from RNNZ MPS of March 2009

Subtracting CPI Inflation from 90-yield [the 'Real Yield'], shows Hedging to NZ Dollar currently stands to gather a maximum 1.6% real yield pick-up, before tax (less whatever may be achievable in foreign fund accounts), whilst incurring greater volatility and NZ\$ currency risk.



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Empirical Damage to Investments

Example a)

When ING trapped investors in its DYFund in March 2008, the unit price was NZ0.83c, and investments were primarily in USA structured fixed interest instruments. The exchange rate at end march was 1NZ\$ = 0.7895 US\$. The exchange rate 31/03/09 is 0.5620 – i.e. a 28.8% drop.

Had ING not hedged that NZ\$83c/unit, it would have grown to NZ\$1.06 simply by currency gains.

Example b)

The depreciating NZ dollar greatly cushioned portfolio investors in 2008, largely keeping funds intact to participate in eventual recovery.

Effect of NZ\$ on Market returns - 1-yr to 28th Feb, 2008

Market	Index	Currency	Loss to NZ\$-hedged investor	Currency Diversified investor
FTSE 100 UK	-35.8%	-13.3%	-35.8%	-22.5%
DJIA	-42.2%	-36.8%	-42.2%	-5.4%
Nikkei	-46.6%	-40.4%	-46.6%	-6.2%
MSCI Cap	-48.4%	-29% (TWI)	-48.4%	-19.4%
Gold	-2.7% (US\$)	n.a.	-2.7%	+54%
Global Bonds	+7.95%	+36.8%	+7.95%	+44.75%

Source: *Diversified Research.*

Clearly an investor hedged to NZ\$ in 2008 was severely punished, while a similar investor in those markets but with currency diversification escaped with little or no loss (depending on the Bond / Equity mix).

Conclusion:

Beyond gold, international currencies are all fiat money, backed only by the promise of respective economies. NZ's economy has been a relative laggard in recent decades, against developed countries, and especially against Asian Tigers.

Economic fundamentals indicate the probable trend for the NZ dollar is continued weakening over the medium and longer term.

NZ's small, largely agrarian economy and remote location, subject it to greater risks than elsewhere. Sovereign currency is consequently likely to be more volatile than other currencies.

Higher yields on Cash & Bonds are the price the market asserts for greater risk in NZ, including currency risk. RBNZ also responds to NZ's higher inflation risks.

Currency is the one class where exchange rate movements can be entirely diversified away. A basket of currencies is less volatile than any single currency.



Diversified

A basket of international currencies serves as a good proxy for diversifying currency risk. Swapping an international basket of currencies for solely NZ\$ risk (i.e. hedging to the NZ\$), introduces excessive risk to portfolios.

Portfolio Investors who assumed excessive NZ\$ risk in 2008 suffered severe set-backs to their wealth, suffering the full brunt of tumbling markets. Currency diversified investors were cushioned by offsetting currency gains when reported in depreciated NZ\$.

The practice of hedging offshore assets to NZ\$ destroyed wealth and increased volatility over 2008, and also over the last 40 years.

Diversified continues to advocate to Private Client investors, and through its *Diversified* Wealth Management's Balanced Fund, that neither International Fixed Interest nor Internationally diversified Equity holdings should be hedged to NZ\$ as a neutral position. A diverse currency basket as a consequence of leading asset allocation, shunning the use of derivatives, is a superior and safer course.

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***Diversified* Investment Strategies Limited**

Advisor and Company Disclosure Statements are available at no cost by contacting us, or alternatively you may access these via our web site www.diversified.co.nz.