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The recent rapid appreciation of the New Zealand dollar (NZD) has left many local investment managers on the back foot. The NZD/US dollar exchange rate hit a 10-month high of \$0.6725 on 5 August 2009, up 36% from a low of \$0.4940 on 9 March 2009.

NZD/US DOLLAR EXCHANGE RATE



Source: Bloomberg.

A recent survey by National Australia Bank and Bank of New Zealand titled 'Superannuation FX Survey 2009' showed that many New Zealand investment managers have been reducing the level of hedging used for international shares from 54% to 49% over the survey period 2005 to 2009. The same managers that were surveyed had also reduced the level of hedging on international fixed income investments from 88% to 85%. A reduction in the level of hedging – at a time when the NZD is appreciating – reduces the value of investors' international assets.

The survey identified that 42% of investment managers had changed their levels of currency hedging. Of those who had changed during the period 2005 to 2009, 46% cited a change in the value of the currency as a reason for adjusting their level of hedging.

Michael Lang, Chief Investment Officer at New Zealand Funds Management Limited (NZ Funds), called the results of the survey "a depressing indictment on the New Zealand investment industry". "Unlike companies that regularly trade with international partners (and therefore have to consider the implications of an openly-traded, volatile currency), investment managers, brokers and private investors are not wise to the dangers of owning offshore investments without a currency hedging strategy," says Lang.

Dave Wilson, Investment Strategist and Principal at NZ Funds, agrees and believes that the New Zealand investment industry's approach is inadequate and needs to change. "The majority of local investment managers have a passive index-orientated approach to managing currency. The problem is that there is no 'benchmark' against which to manage currency. As a result, investment managers tend to hedge approximately half investors' international investments and leave the other half exposed to fluctuations in the currency." This means that investors are exposed to adverse currency movements.

Lang says that NZ Funds adopted an alternative approach to currency management in response to NZD volatility in 2008 and that clients are now reaping the rewards. "We believe that currency is as important an asset class as shares or government bonds. As such, we have put the same energy and intensity into protecting against losses and generating gains out of the NZD as we do with clients' other assets." NZ Funds uses a range of investment tools, including valuation models and momentum indicators, to help with the daily currency management.

Lang says that sometimes this means clients are fully hedged against a rise in the NZD, as has been the case since 5 May 2009 when NZ Funds hedged clients against any appreciation of the NZD above \$0.5770. And while he believes that the currency has now become overvalued, he will not be removing the hedges just yet. "We believe the NZD has become slightly overvalued, but we expect the current momentum to last a little longer. The ability to remove our hedges at a moment's notice – when signalled by our models – gives us the confidence to outstay our welcome," says Lang.

Both Lang and Wilson are adamant that the passive approach to currency management, as practised by the New Zealand investment industry, is no longer an option. To date, losses generated by passive currency allocations have been concealed by rising global share prices. However, there is no guarantee this will continue. "When investors wise up to the losses being generated by passive currency management, there will be some very uncomfortable client conversations," Lang predicts.

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