

FEBRUARY 20, 2014

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To hedge or not to hedge

Examining the Loonie versus your investment portfolio

With the Canadian dollar at four-year lows, attention has turned to the economy and the impact of the loonie's devaluation on investors. Many economists are forecasting that the Canadian dollar will fall below the 89-cent (U.S.) level in 2014.

National Bank analysts believe that the large current account deficit, and hence the dependency on capital inflows, leaves the loonie vulnerable to further declines. However, they view this development as a net positive for the economy and for S&P/TSX earnings.

Canaccord Genuity North American Portfolio Strategist and Quantitative Analyst Martin Roberge observes that ever since the loonie rose above 90 cents in 2009, Canada has produced a chronic trade deficit. Roberge concludes that the weaker dollar is likely to prevail because a number of key drivers remain bearish, such as stronger U.S. retail sales, lagging commodity prices, and foreign outflows of Canadian bonds.

Such movements will impact investors with exposure to foreign currency. Given the outperformance of the American markets over the last few years, many investors have large holdings in U.S. investments. For those with unhedged investments, a falling loonie is a good thing because it enhances returns on the U.S. holdings. Conversely, investors holding hedged positions aren't necessarily in a difficult spot. They may

miss the added gains, but are protected should the loonie turn around.

There are many ways to invest in the falling loonie, with plenty of unhedged exchange-traded funds and mutual funds on the market. Investors can also look for individual companies that benefit from a weaker dollar.

An example would be a company whose costs are mostly in Canadian dollars, but with the majority of its sales in U.S. dollars. Companies who will be relatively unaffected are those with both costs and sales primarily in U.S. dollars or match to the local currency. Most susceptible are companies with costs in U.S. dollars but revenues in Canadian currency.

Some data indicate that trying to benefit from currency movements may not be worth the effort. RBC found that over periods of 15 years or longer, the impact of exchanges between the Canadian dollar and the U.S. dollar on investment returns gets closer and closer to zero.

Hedging can also lead to significant additional costs and act as a drag on total return over the long term. While less of a concern when hedging U.S. dollars, it becomes an issue when dealing with emerging markets and some of the more difficult markets to hedge.

Currency hedging

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It can be argued that hedging is unnecessary in a properly diversified global portfolio. Through diversification, a portfolio comprised of multiple different currencies will be subject to less foreign exchange risk. Ultimately the diversification acts as a natural hedge because a rise in one currency tends to cancel out another and vice versa.

Investors who wish to be cautious with their hedging could apply a hedging strategy to some of

the portfolio and leave the balance unhedged. This will furnish some protection in the event that the dollar rises, while also providing some upside should the loonie continue to weaken.

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