

CURRENCY ASPECTS OF iSHARES ETFS

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This paper reviews the currency aspects of the range of iShares Exchange Traded Funds (ETFs) listed on the Australian Securities Exchange (ASX).

iShares ETFs provide investment exposure to both international equity markets and foreign currencies. The Australian Dollar (AUD) price of an iShares ETF therefore reflects both the Net Asset Value of the underlying securities (denominated in their local currency) and the exchange rate between the AUD and the foreign currency.

Investors wishing to gain exposure purely to equity returns may wish to neutralise the foreign currency returns within their international investments by implementing a currency hedging strategy. Several important factors must be taken into account when deciding whether to hedge (and if so, how much?) international currency exposure within a portfolio. Hedge ratios will be lower when:

- Total portfolio allocation to international assets is lower
- Time horizon of the investment strategy is longer
- Currency hedging costs are higher
- The investors risk tolerance is higher
- Tax consequences of a hedging strategy are unfavourable

The decision of how much to hedge and the implementation of a hedging strategy should be made from the perspective of the overall portfolio, rather than considering each individual international investment in isolation.

CURRENCY ASPECTS OF iSHARES ETFS

The range of iShares ETFs listed on the ASX provide investors with investment exposure to both international equity markets and foreign currency fluctuations. The Australian dollar price of a share in an iShares ETF traded on the ASX, determined by market participants, reflects two major components:

1. The Net Asset Value (NAV) of the underlying securities denominated in their local currency.
2. The Australian dollar/foreign currency exchange rate.

Returns to Australian investors will benefit from increases in the NAV of the underlying basket of securities measured in their local currencies and also by a weakening of the Australian dollar relative to these local currencies. The reverse is also the case: returns will be reduced by falls in the NAV of the underlying basket of securities measured in their local currencies and by a strengthening in the Australian dollar relative to those local currencies. When one component is positive and the other is negative, the net impact on overall returns is uncertain.

Hence, while market prices of iShares and the returns they produce are determined by market participants, all investors should be aware of the two major components that will affect returns:

1. Movements in asset prices

Each iShares ETF is comprised of a basket of underlying securities representing a particular index whose market prices measured in their local currencies fluctuate daily. The aggregate of these price movements measured in their local currency is one component of returns.

2. Fluctuations in the Australian dollar versus foreign currency

An investment in an iShares ETF will also be impacted by relative currency movements between the Australian dollar and the local currency (or currencies) of the underlying securities during the period of investment. These relative movements may enhance or diminish returns measured in Australian dollars.

For example, let's look at an investment in iShares MSCI Japan (ASX: IJP). The Australian dollar price of the iShares MSCI Japan as determined on the ASX will reflect the Yen NAV per unit and the current Australian dollar/Yen exchange rate. As the Australian dollar strengthens relative to the Yen, the NAV in Yen will represent fewer Australian dollars and the market price on the ASX is likely to fall. The reverse is also true – a weakening Australian dollar relative to the Yen will mean that the underlying NAV denominated in Yen will represent more Australian dollars, tending to increase the market price on the ASX, enhancing returns.

This relationship is straight-forward when considering a single country ETF, or an ETF for which all the underlying securities are denominated in a single currency, since there is one single exchange rate to factor. The situation becomes more complex when an iShares ETF (eg. iShares MSCI Emerging Markets) has holdings that are denominated in multiple currencies. This is the case for a number of regional and global iShares ETFs that represent index benchmarks which encompass multiple jurisdictions. The currency impact then includes multiple exchange rates simultaneously.

CURRENCY HEDGING

International equity investments tend to be made for two reasons:

1. To achieve diversification of risk within a portfolio.

If most of an investor's assets and their portfolio investments are located in Australia and denominated in Australian dollars, investing in international assets provides some exposure to international markets and international currencies. These investments will be most useful when Australian investments perform poorly or when the Australian dollar depreciates. The investor's Australian assets will fall in value at the same time as Australian imports of goods and services from overseas become more expensive. Holding international investments whose performance is not directly linked to that of the Australian market and that benefit from a decline in the Australian dollar exchange rate is a hedge against this risk.

2. To search for higher returns through active management of international market exposures and/or currency fluctuations.

It is possible to gain exposure to international markets without the currency exposure, through a currency hedged international investment. Equally, it is possible to gain exposure to currency fluctuations without international market exposure, through a pure currency investment. These are active management decisions and are not easily implemented using iShares alone, which provide both international market and currency exposures.

Hedging Australian dollar exposures against movements in the underlying foreign exchange rate neutralises currency returns, thereby allowing the investor to remain exposed to pure equity returns. Currency hedging can be implemented using a variety of standardised (e.g. currency futures) or customised (e.g. currency forward) contracts. These contracts are a commitment to purchase or sell a specified currency on a specified future date for a predetermined amount. However, currency hedging is not without cost or implementation challenges.

FACTORS TO CONSIDER

Several factors must be taken into account by any investor deciding whether to hedge (and if so, how much?) international currency exposure within their portfolio. The most important of these are discussed below.

Total portfolio allocation to global securities

Intuitively, the impact of currency hedging on the risk and return of the overall portfolio will be less significant, the smaller the allocation to international assets in the portfolio. In the absence of active decisions on future currency fluctuations, a rough rule of thumb for institutional investors is to consider currency hedging when the level of international equity holdings exceed 10%–20% of the total portfolio.

Currency hedging should be considered at the total portfolio level, rather than for each specific international investment. Although it may not exactly provide the level of currency hedging against every foreign currency desired, it is often easier and simpler for an investor to leave some international equity investments unhedged, while fully hedging others. Hence an investor with 30% allocation to international investments that wishes to hedge one third of this exposure, might make a 20% allocation to an international investment on an unhedged basis and 10% on a hedged basis. Many global equity managed funds have both a fully unhedged and a fully hedged product available.

Time horizon

The longer the investment horizon, typically the lower the hedge ratio. This is due to the cyclical nature of currency returns, leading to a smoothing of currency impact over longer investment horizons.

To demonstrate the impact of hedging foreign currency exposure for Australian investors, *Figure 1* below compares historical returns for the hedged and unhedged MSCI World ex Australia Indices. We have included one year, five year and 10 year returns to both November 2000 and November 2007, to show the sensitivity of returns to currency exposure over different time periods.

It is interesting to observe above that the decision to hedge foreign currency exposure can have very different effects on portfolio returns, depending on the time period in question. Perhaps less surprising is that over longer time horizons, the impact of currency was less dramatic (although still not insignificant) than the short term impact. Portfolio volatility was similar for both hedged and unhedged indices for all of the time periods above, despite the differences in absolute returns.

Figure 1 – Historical returns of hedged and unhedged MSCI World ex Australia Indices*

1 year returns:	As at Nov 2000	As at Nov 2007
MSCI World ex Australia ^(SM) (unhedged in AUD, net dividends reinvested)	11.66%	0.01%
MSCI World ex Australia ^(SM) (hedged in AUD, net dividends reinvested)	-2.00%	9.56%
5 year returns:	As at Nov 2000	As at Nov 2007
MSCI World ex Australia ^(SM) (unhedged in AUD, net dividends reinvested)	20.61%	5.69%
MSCI World ex Australia ^(SM) (hedged in AUD, net dividends reinvested)	16.33%	15.59%
10 year returns:	As at Nov 2000	As at Nov 2007
MSCI World ex Australia ^(SM) (unhedged in AUD, net dividends reinvested)	16.47%	4.35%
MSCI World ex Australia ^(SM) (hedged in AUD, net dividends reinvested)	14.06%	7.38%

* The MSCI Index data is sourced from MSCI. Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability of fitness for a particular purpose with respect to any of such data. Without limiting any of the foregoing, in no event shall MSCI, or any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent. The MSCI data may only be used for your internal use and may not be used to create any financial instruments or products (including funds and derivative instruments) or any indices.

Risk tolerance

The more risk averse the investor, the more they will tend to hedge foreign currency exposure. As we stated earlier, hedging eliminates currency risk (but also returns) and is therefore more attractive to investors with a lower tolerance for volatility of portfolio returns.

Cost of hedging

The more expensive the cost of hedging, the less an investor will tend to hedge foreign currency exposure. This is intuitive, as the cost of hedging reduces one's total returns.

Tax consequences

The investor must also take into account the tax consequences of any gains or losses from the hedging instruments. This is a complex area and you should always seek professional taxation advice.

CONCLUSION

In summary, all investors holding international assets within their portfolio will be faced with the decision of whether or not to hedge the resulting foreign currency exposure resulting from holding international securities. As discussed above, optimal hedge ratios will be lower when:

- Total allocation to international assets within the overall portfolio is lower
- Time horizon of the investment strategy is longer
- The cost associated with implementing currency hedging is higher
- The investor has a higher level of risk tolerance
- Resulting tax consequences of the hedging strategy are less favourable

Finally, remember that the decision to hedge or not to hedge should be made from the perspective of the overall portfolio, rather than considering every individual international investment in isolation. Hedging can also be implemented at the portfolio level. For example, it is possible to achieve an overall hedge ratio, of say 30%, by investing 70% of the international portfolio in unhedged assets, whilst allocating the remainder to a fully hedged strategy.



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Important Information

Before investing in an iShares fund, you should carefully consider whether such products are appropriate for you, read the applicable Australian prospectus and consult an investment adviser.

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