GSI PERSPECTIVE

Global investing and the effects of foreign currency exposure

If you're a UK investor with assets in funds venturing beyond the UK market, chances are that you'll have some degree of foreign currency exposure. The only situation when this isn't true is when your foreign exchange exposures are fully hedged back to Sterling. For equity investments this would be unusual.

Andrew Cain, CFA
Managing Partner, GSI

Published: JAN 2023

FOR PROFESSIONAL INVESTORS ONLY

What does it mean to have foreign currency exposure?

It's similar to the experience of going abroad and using the local currency to buy local goods. Mentally, we convert the local currency back to Sterling to work out how much it costs in our home currency.

Funds do the same thing. Consider a UK fund investing in global equities. At the end of each day the fund accountant collects the closing price for every company in the fund. Also recorded are the various foreign exchange rates, typically at a set time, such as 9pm. The local values of all the investments in all countries are calculated, converted into Sterling, and used to determine the UK fund's price each day. From this, it's clear that movements in both equity prices and foreign exchange rates will affect the price of the UK-based fund.

Generally, exposure to foreign currencies is considered to be secondary to the underlying equity exposure. Currencies are not the drivers of long-term growth. Over time foreign exchange rates' movements are determined by economic, political, and market forces. The result is a noisy, random pattern, which can occasionally drift in one direction or another for some time. These excursions can work in favour of UK investors if Sterling loses value against foreign currencies or, conversely, against UK investors when Sterling strengthens.

Both instances have happened recently.

The recent "mini-budget", released on the 22nd September 2022, resulted in a loss of confidence in the UK economy and a sharp fall in Sterling against all major currencies. At the time was a general sense of doom and gloom, inflation was up and, listening to the business news, markets around the world were down. However, because Sterling fell so sharply, dropping over 5% from $1.13 to $1.07 in a couple of days, weak returns from foreign markets were obscured.

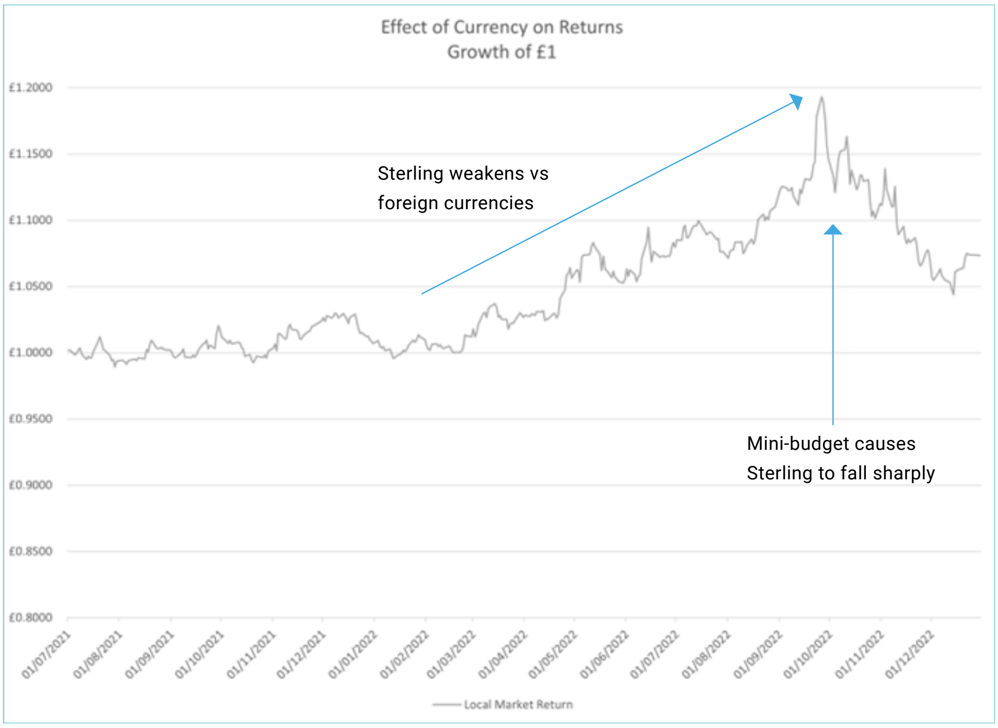
Recall the holiday currency example, because of a weak Sterling, foreign investments were more "expensive". For an investor in those foreign assets this was a good thing.

More recently we have seen the opposite effect. Sterling has begun to regain ground against other currencies. In our imaginary tourist's eyes, investments priced in those currencies have become "cheaper". The result for UK investors in those assets is that the rise in Sterling has reduced returns on their foreign investments.

The following graphs demonstrate the effect of the noisy currency movements for a UK investor over the period from 1 July 2021 to 31 December 2022.

Exhibit 1

This imagines that an investor converted £1 into a range of major currencies, in proportion to the equity market size of that country. For example, the amount converted to USD was around 68% as that was the size of the US equity market relative to the other markets in the portfolio. However, in this example, the investor did not invest in the local equity markets. All they did was hold the currency in proportion to the size of the local equity market. This graph highlights the raw effects of currency movements over the period.

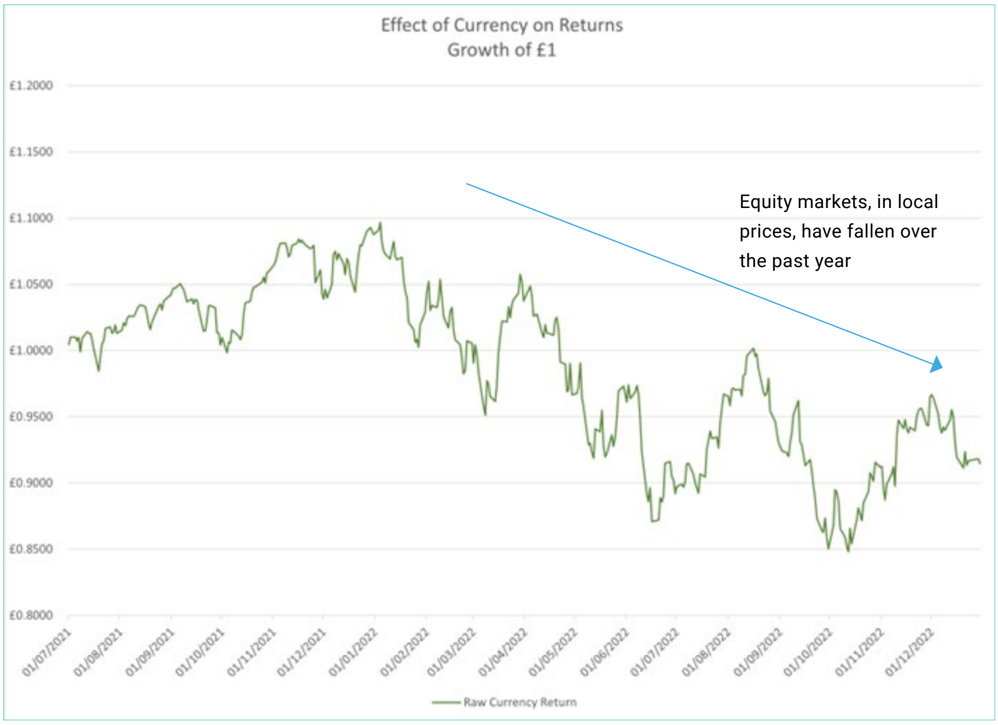


Data 1/1/2017 – 31/12/2022. Source: Global Systematic Investors LLP; Bloomberg; Yahoo Finance

When investing globally, UK investors are exposed to foreign currency risk, which means that changes in exchange rates can impact the value of their investments.

Exhibit 2

Here we show the foreign equity market returns without any currency exposure. This is calculated by recording movements in the local markets without converting those movements to Sterling and applying the changes to the £1 over time. Once again, the movements are weighted proportionally to the size of each country's equity market.

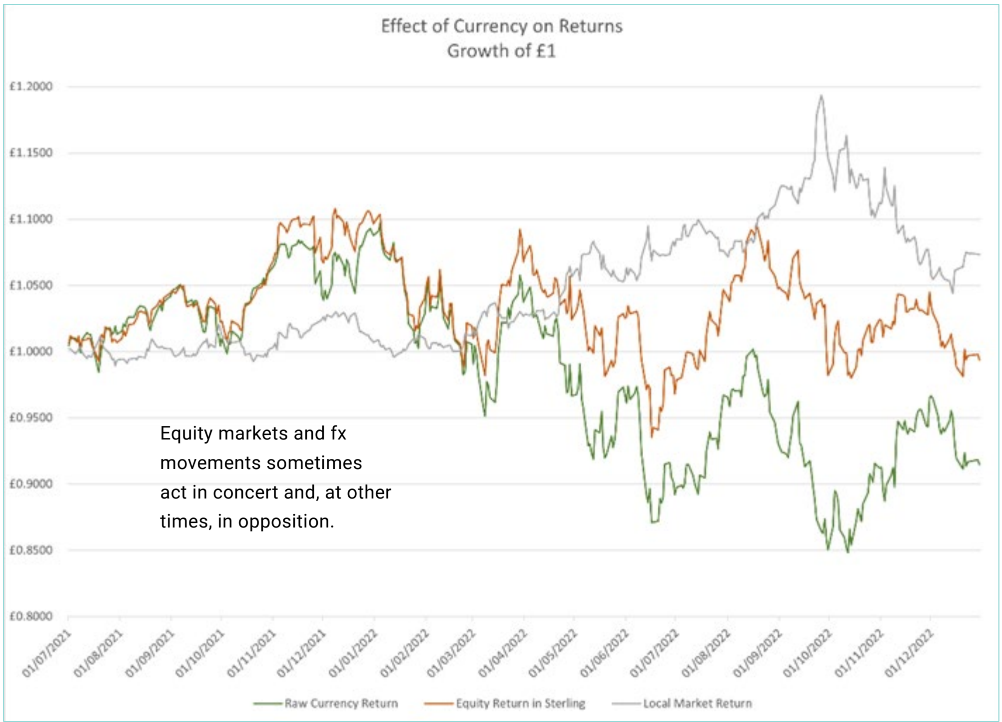


Data 1/1/2017 – 31/12/2022. Source: Global Systematic Investors LLP; Bloomberg; Yahoo Finance

The direction of returns on currency exposures may differ from the underlying equity returns. Sometimes they may add to the equity returns, while at other times they may detract.

Exhibit 3

The final exhibit shows the result of combining the foreign exchange movements and the underlying equity returns. This would be a fund's returns if it was invested in our hypothetical index.



Data 1/1/2017 – 31/12/2022. Source: Global Systematic Investors LLP; Bloomberg; Yahoo Finance

Investors in foreign equity funds will experience the returns of the local equity markets combined with the movement of Sterling against the foreign currencies

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Exhibit 3 shows how foreign exchange movements can mitigate poor underlying equity market returns, as happened in mid-September in the aftermath of the mini-budget. Poor local equity returns looked better when converted to Sterling.

However, the same movements may act in reverse, for example when Sterling strengthened against foreign currencies from late October. The rise in local equity markets was not experienced to the same extent in Sterling.

Investors in foreign equity funds will experience the returns of the local equity markets combined with the movement of Sterling against the foreign currencies. Sometimes the currency movements add to the returns, sometimes they do not.

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Global Systematic Investors LLP

75 King William Street, London EC4N 7BE

Tel. 020 7717 5578

www.gsillp.com

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