This article by Will Thomson is excerpted from a letter of Massif Capital.

What follows is a brief review of how we at Massif Capital understand currencies and manage our currency exposure within a multi-currency portfolio. This paper arose out of conversations and questions asked by current investors regarding our lack of currency hedges.

At the current time, our portfolio is exposed to the US, Canadian and Singapore dollar as well as the Euro. Despite the diversity of currencies, we maintain no currency hedges and are unlikely to at any time soon. We have pursued this strategy for two reasons, one practical and demonstrated, the other philosophical.

Practical Reasoning

The first issue we consider when thinking about our foreign exchange (FX) exposure is what we would be looking to accomplish with an actively managed FX strategy. Specifically, are we looking to manage risk or are we looking to enhance portfolio returns? Differentiating between the two goals is important. From our perspective, a return enhancement strategy is an alpha-generating strategy, which means it is a strategy based on a differentiated outlook for how a currency will appreciate or depreciate relative to another currency. As our investment practice seeks capital appreciation through careful asset selection and participation in the equity market, we do not engage in currency trading to enhance returns.

With respect to risk management, a key concern of ours, there is ample empirical evidence to suggest that currency hedging strategies are of little value-add to portfolio returns. Take for example a 2010 study conducted by Vanguard which found that over a 22-year period from January 1988 to January 2010 the average hedge impact was not statistically different than zero for currency-hedged portfolio of the MSCI World Index. Similar results were documented in a paper by Kenneth Fisher and Meir Statement which found that the realized returns and risk for hedged and unhedged portfolios were virtually identical during the 1988 to 2002-time period.

These results are unsurprising. To hedge well requires one to have an idea about the direction of a currency in relation to another. Unfortunately, as a paper by Kenneth Rogoff and Richard Meese found, exchange rate models and most expert forecasts were no more accurate than a random walk would be in forecasting changes in currencies a year out. If our ability to forecast currency moves is that poor, hedges would seem as likely to hurt returns as they would to help.

One final practical issue worth considering is the cost associated with implementing an FX hedging strategy. Although rather small, any strategy can only be properly assessed within the context of the return on the cash deployed. Research by Stephen Nesbitt indicates that hedging costs (using forward contracts) for an international equity portfolio are well north of 0.25% per annum on average. Given that long run studies cited above find almost no

impact on returns for hedged vs. unhedged portfolios, even that small cost seems unwarranted.

Philosophical Reasoning

Our philosophical approach is consistent with the lack of demonstrated evidence that hedging currency risk is value added to a portfolio returns. Fiat money, as we know it, is not a commodity good, which means it has no scarcity, it is created at the whim of financial institutions and central banks. Fiat money is not tied the nature of the capital or assets it commands but instead to the abstract idea that the printer is credit worthy and/or a good steward of the yardstick by which we (society) have decided to judge value.

Given these realities, fiat money has significant limitations. When you measure the value of an asset in say US dollars, you are measuring its value in terms of US government liabilities. Decisions made in the future and promises made in the past by the government regarding spending will impact the money value of the asset being measured even if there has been no change to the true value of the asset. Fiat currencies are thus correctly understood as an investment in a government that can, at any given time, make decisions that impact the relative purchasing power over your wealth.

If a portfolio manager chooses to pursue an FX strategy to manage currency risk actively, they are implicitly consolidating all their risk in one currency and thus one government. Every currency has this risk, and so we choose to stay diversified in our currencies. As an investment in a country’s government, it seems prudent to have a portfolio of diversified assets in diversified currencies.