

Q3 2017

To Hedge or Not to Hedge, That is the Question

The third quarter was another in a recent trend of subdued market volatility in the face of ongoing global political and economic news. Upheaval continued among the committee ranks of the Trump Presidency, and increasing signs of civil unrest surfaced during protests in Charlottesville, Virginia. A spate of natural disasters hit North America, spanning wildfires in Alberta and California, earthquakes in Mexico and hurricanes in the Caribbean and along the coast of Florida. Perhaps most alarmingly, military rhetoric and action from North Korea continued in a rapid drumbeat fashion.

Throughout all of this, equity markets have remained strikingly resilient. Revenue and earnings growth for large corporations in developed markets remained strong, and even showed some signs of accelerating. The price of economically-linked commodities rallied in step, with West Texas crude oil gaining 12% and copper rising 9%. In fact, domestic economic strength prompted the Bank of Canada (BOC) to increase their base rate, with the Bank of England now posturing a similar move as well.

Equity Markets

The third quarter saw steady gains in local currency terms across all major developed regions. The domestic TSX Composite price index managed to reverse its losses from the prior quarter, posting a total return of 3.7% due to strength in Energy, Materials and Financials sectors. Shaking off international and domestic political tensions, the U.S. markets managed to build further upon their eight year rally, with the S&P 500 total return index rising another 4.5% in U.S. dollar terms. Finally, European and Asian markets continued their strong ascent, with the MSCI EAFE posting a strong 5.4% total return in Q3 in U.S. dollar terms, bringing year-to-date return to an impressive 20.3%.

For Canadian investors, however, foreign returns were impinged upon by the notable strength in the Canadian dollar, as a gain of 4.0% versus its U.S. counterpart effectively erased the S&P 500 total returns in the quarter to just 0.5%, and MSCI EAFE total return performance to just 1.4%.

Fixed Income

The BOC introduced headwinds to the domestic fixed income market in the third quarter, raising their overnight policy rate by 0.25% on July 12th and again on September 6th. While at the time the rationale for raising the overnight lending rate from 0.50% to 1.00% was viewed skeptically, recent data points have suggested that the BOC's thesis that the Canadian economy could tolerate higher rates was correct.

The yield curve flattened fairly substantially, with bonds of short duration moving higher in yield while comparable longer dated bonds moving higher in price. The yield on the benchmark 2-year Canada bonds moved from 1.10% yield on June 30th to 1.52% on September 30th, while benchmark 5-year yields were offered at 1.75%, up from 1.39% to start the period; 10-year Canada bond yields widened by the close of the quarter to 2.10% from 1.76%.

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The Federal Reserve has begun their program of balance sheet reduction, a slow and steady process so as to not upend the continuing growth in the U.S. economy; they remain committed to normalizing interest rates, taking them higher as and when data suggests that the economy can support historically “normal” rates.

Commentary

Any Canadian investor that held foreign currency-denominated assets over the summer saw the impact that the sharp, Bank of Canada-induced appreciation of the Canadian dollar had on their portfolio’s bottom line. The 4.5% total return on the S&P 500 in Q3 in U.S. dollar terms ends up being just a 0.5% gain when translated back into loonies.

So even though the S&P 500 has outperformed the TSX’s 3.7% in local currency since the end of June, Canadian investors would have been better off just investing in the domestic market.

So that begs two questions.

First, because of the currency movements and their potentially adverse impacts, is it even worthwhile for Canadians to hold investments denominated in other currencies?

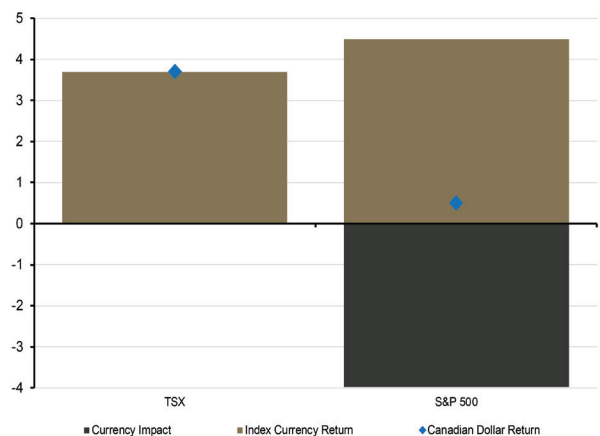
Second, if you do hold these foreign investments, should you hedge the currency exposure completely so that you can avoid the negative shocks from a strengthening domestic dollar?

With respect to the first question, it is absolutely worthwhile to invest outside Canada’s borders. Having a well-diversified portfolio means not just being spread out across asset classes (stocks and bonds) and sectors (the industry sectors of the stock market; government and corporate bonds) but also geographically diversified as well.

Canada’s stock market accounts for just 3% of global equity market capitalization and is heavily concentrated in just three sectors — Financials, Energy and Materials alone represent half of the TSX. Expanding investment into other markets allows for a better balance of risk exposures that can complement domestic holdings.

In terms of the second question, while recent experience show the short term pitfalls of unhedged positions, what is important for investors to remember is that currencies may fluctuate in the short-term, but over longer periods they have been shown to be considerably more stable.

Total Return, Q3
(percent)



Source: Bloomberg, Guardian Capital

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For example, if we look at the last 25 years there has been absolutely no currency impact on overall performance. If, as a Canadian investor, you invested in American stocks, you experienced better overall portfolio performance than if you were just holding the Canadian stocks, with zero adverse impact from converting those returns back into Canadian dollars.

With that in mind, it is also important to recognize that currency hedging is not free. In order to take out the protection against currency movements, you have to pay additional fees which will erode returns.

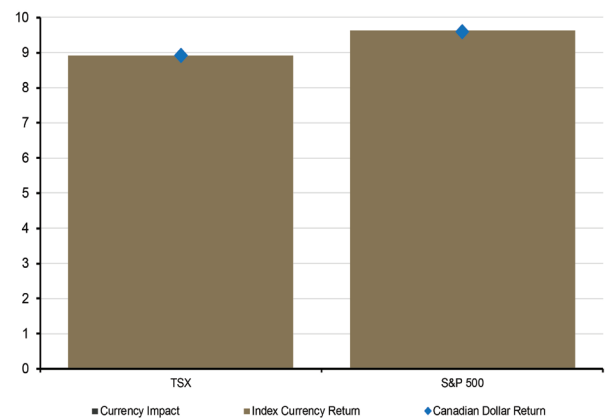
Let's not forget that effective hedging requires two correct decisions — when to put it on and when to take it off. A tall task.

A final thing to consider is that not only would a Canadian investor's portfolio see the diversification benefits from holding American stocks, not hedging the currency actually has the effect of reducing the overall volatility of those U.S. dollar returns. The exchange rate itself, since it is not perfectly correlated with the U.S. stock market, plays a role in dampening the overall volatility of total returns.

So, by maintaining the currency exposure over the last quarter century, investors would have reaped the performance benefits while also seeing lower volatility.

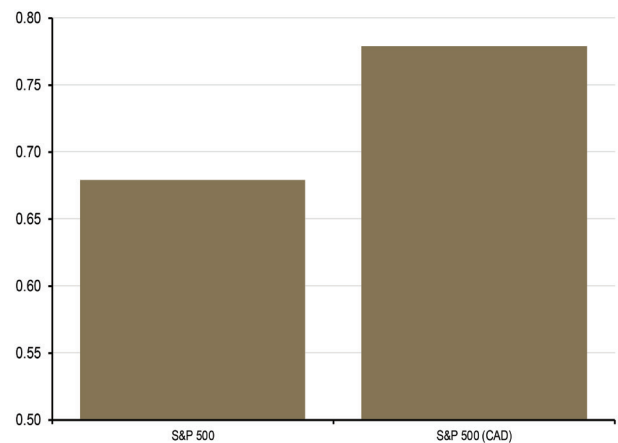
In other words, not hedging has resulted in better risk-adjusted returns over time, and in the end that is the ultimate goal of investing.

Total Return Over the Last 25 Years
(annualized percent)



Source: Bloomberg, Guardian Capital

Risk Adjusted Return, Last 25 Years
(ratio)



Source: Bloomberg, Guardian Capital

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