

Hedging the US-Can Exchange Rate

Roughly half of our funds are invested in funds denominated in US dollars. As a consequence, the most significant risk facing the Plan is the fluctuation in the value of the US\$ relative to the Can\$. If the value of the US\$ dollar appreciates, then our investment in a US\$ denominated fund increases its value in Canadian dollars even when the US fund itself shows zero return. Alternatively, if the Canadian \$ shows strength *vis a vis* its US counterpart, the value of our investment will deteriorate unless the US manager shows sufficient growth to compensate for the change in exchange rate in Canada's favor.

This valuation exercise is conducted on a monthly basis. If the Canadian dollar shows strength for an extended period, then the value of our portfolio may deteriorate significantly and compromise future investment opportunities.

In this context, it is thought sensible to hedge the value of the US\$ against its possible depreciation. One standard approach is to go the secondary market to purchase a futures contract that locks in an exchange value for the two currencies at the beginning of the month. In this way, a depreciation of the US\$ would be offset by a cash gain in the secondary market. The monthly return on our Canadian investment in a US manager would only be affected by the performance of the manager and not by an exchange rate movement.

As usual, there are two sides to every coin! In this case, the hedge could go the 'wrong way'; i.e., a value of the exchange rate would be locked in in order to guard against an appreciation of the Canadian dollar, the value of the US\$ in fact appreciates. We would be on the wrong side of the hedge and, as a result, would be forced pay the difference in cash at month's end. Since the amount hedged is large given the extent of our investment in US-denominated funds, the cash drawdown would be significant. Indeed, if the hedge were incorrect, a significant proportion of consecutive months, the cash hits could entail a liquidity crisis whereby some investments would need to be sold to meet these cash requirements—a dire eventuality

In sum, being hedged works best/badly against a weakening/strengthening US\$; the downside risk involves a capital drawdown. The downside of going naked or unhedged does not involve cash but may have valuation implications.

One way that pension funds have dealt with this dilemma is to embrace it by constantly being hedged at 50%. The underlying motivation is to minimize risk; in particular, to reduce the risk of extreme cash drawdowns.