Seed Weekly

25 September 2019

Is FX an Asset Class?

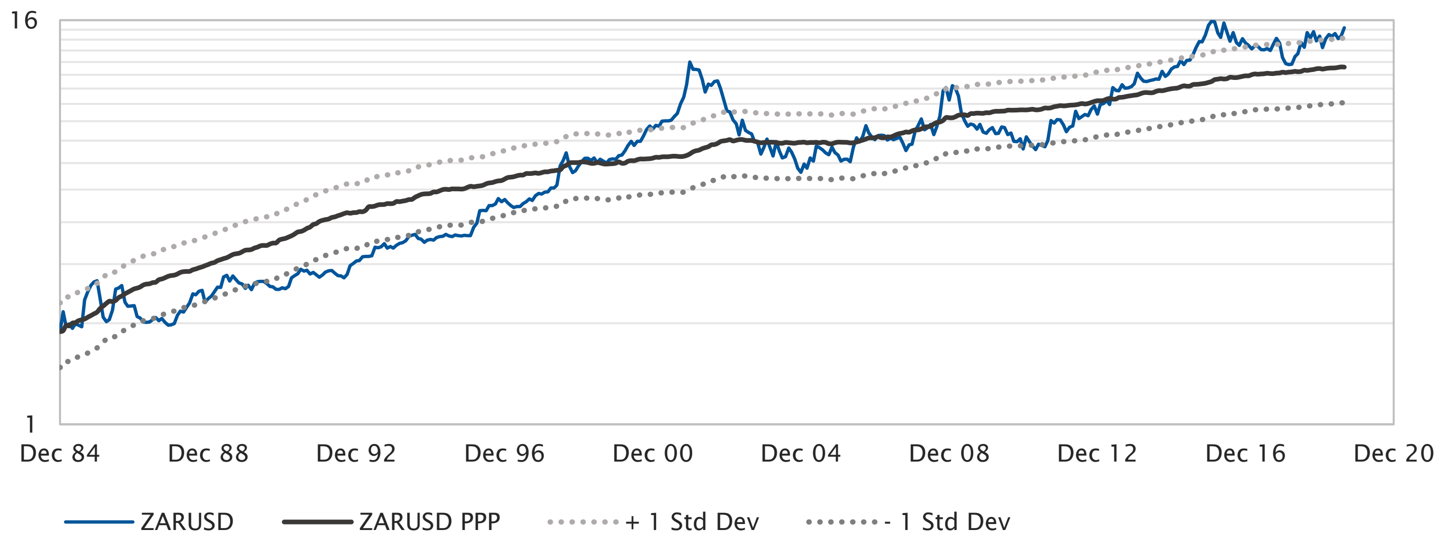
At Seed, our investment process is designed to ensure that we make decisions that are not only good for our investors, but that those decisions can be repeated through the cycle - AND cycle after cycle. A large portion of our time is therefore spent determining where asset classes are priced versus their fair value.

Some common questions that we receive are, ***"Are currencies/foreign exchange/FX asset classes?"*** and ***"Should we hedge the currency when investing abroad?"***

Unlike equities property or bonds, where investors receive a yield and prices can go up, essentially the FX market is a zero-sum game as FX is just a rate of exchange. One can only make an FX profit if the counterparty takes a loss. Strictly speaking, it therefore does not fit into the traditional definition of an asset class but, when investing globally, one needs to take into account any exchange rate movements, particularly when investing from a country like South Africa that has a volatile exchange rate. As such, we spend a fair amount of time determining what the fair value of any currency is in comparison to a range of other currencies.

When compared to the US dollar (USD), the South African rand (ZAR) is very volatile and is, in fact, nearly as volatile as an equity investment. Over the last 30 years the local equity market's annual volatility comes in at just under 18%, while the USD/ZAR exchange rate's volatility is slightly under 15% pa. Making a poor decision on your FX exposure can therefore wipe out a material component of any return you receive.

Purchasing Power Parity (PPP) is a widely accepted methodology, which uses the relative inflation rates of two countries to determine the fair value for the exchange rate. Given that South Africa has structurally higher inflation than the US, we would expect the ZAR to depreciate versus the USD over time. It therefore typically makes sense, from a return perspective, to retain as much USD exposure when investing globally (using the US as a proxy), but there will be times when the ZAR is so undervalued that it makes sense to hedge a component of your global exposure. The chart below maps how the ZAR/USD exchange rate has moved around its fair value (PPP).



Source: Seed Investments (31 August 2019)

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Since the end of 1984 (nearly 35 years ago), the ZAR has only rarely traded more than 1 standard deviation weaker than the USD:

- 1985 - Post the Rubicon Speech by PW Botha
- 2000/2001 - Currency crisis
- 2008 - Global Financial Crisis (GFC)
- 2015 - Nenegate

Post 2015 the ZAR has strengthened but has largely remained more than 1 standard deviation weaker than the USD. Our analysis shows that while PPP is not a great predictor of short-term currency movements, when a currency trades more than 1 standard deviation away from fair value, there is a good chance that over the next 12 – 24 months it will strengthen.

Based on this analysis, we have used bouts of currency weakness over the past 3.5 years or so to protect a component of our global allocations in our local Funds. This active decision (to retain global exposure but hedge out the FX risk) has not only contributed to our Fund returns, but also reduced the volatility of our Funds. While it is not a strategy that we will blanketly apply, given that we expect the ZAR to generally weaken over time, it is an arrow in our quiver when it comes to managing our Funds.

In short, the question of whether FX is an asset class is a moot one, as we realize that we need to have a proper understanding of how a currency is valued in order to optimally manage our client investments.

It definitely remains a building block when constructing a diversified, efficient, portfolio.

Take care,

Mike Browne *CFA*

Portfolio Manager

Is FX an Asset Class?

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