Trade Idea – Foreign Exchange

Brexit - Hedging risk ahead of the referendum.

27th May 2016

Vote imminent

- Three months after the date was announced, the EU referendum is finally around the corner. Political campaigning and media coverage of the event is reaching a highpoint as both “Leave” and “Remain” camps make a final attempt to sway the voting public in their favour. Like the 2015 general election and Scottish referendum before that, the uncertainty linked to the outcome of the June 23rd vote is being played out on the global currency market. The Sterling has tumbled 8%* (on a trade weighted basis) in the past six months as an increasing number of economic reports have highlighted the potential downside risks to the UK economy from a “Brexit” scenario. For foreign investors, managing Sterling exposure from UK holdings will be a key consideration in the build up to the vote, as growing tensions and uncertainties continue to ripple through the currency market.

Why currency hedge?

- When investing in foreign assets, investors, often unwittingly, acquire currency risk. An asset denominated in a different currency than that of the investor always involves taking a currency position where exchange rate movements form a part of investment returns. Historically, this factor has often been overlooked, but in the current environment of record central bank activism and political uncertainty, it has never been more crucial. Globally, FX market volatility has risen to multi year highs and the trend appears unlikely to relent.

- For non-Sterling investors with UK holdings, the referendum poses a significant currency risk. According to the latest analysis by the UK Treasury, the Sterling could be subject to as much as a 12%* fall should the vote result in a “Brexit”. While polls are showing a growing likelihood of a “Remain” outcome, option prices reveal that uneasy investors have purchased record levels of downside protection against the Sterling.

- Currency hedging is a strategy of actively offsetting all or a portion of currency risk in an international portfolio. Doing so offers some degree of protection for offshore investments against currency fluctuations in either direction. Hedges can either be implemented indefinitely or tactically depending on the individual investor objectives. In this case, investors have the opportunity to mitigate impending Sterling volatility in order to insulate their holdings from referendum induced fluctuations.

*All figures quoted are sourced from Bloomberg unless stated otherwise.
Using FX ETCs

- Hedging currency risk has typically involved the use of complex derivatives instruments such as FX forwards, futures or options. But the emergence of currency exchange traded products (ETPs) means this is no longer necessary. Currency ETPs offer transparent exposure to an underlying currency pair within a familiar exchange traded format, opening the door to more comprehensive risk management.

- The chart above compares EUR and GBP returns of a FTSE 100 position over the past 18 months. It highlights that a European investor with currency unhedged FTSE 100 exposure would have experienced daily returns that were 26% more volatile than that of an equivalent UK investor, all as a result of oscillations in the EUR/GBP exchange rate. Using an ETC to implement a monthly rebalanced currency hedge (going short GBP long EUR), an investor would have been able to effectively mitigate these fluctuations (see Figure 1).

Considerations

- Currency hedging strategies can be diverse in nature and depend on the objectives of an underlying investor. For those that wish to hedge currency exposure in the longer term, a more sophisticated approach needs to be taken. The longer the horizon, more thought needs to be devoted towards minimising transaction costs while maximising the accuracy of the currency hedge. The more frequently a currency hedge is rebalanced the more accurate it will be, but it comes at the price of higher transaction costs.

- In the case of the upcoming referendum, more investors are likely to prefer a more tactical, short term strategy, driven by the need to hedge the event risk of a “Brexit”. Leveraged currency ETPs can be useful instruments for this purpose as they require considerably less capital and in the short term will have little need for rebalancing.

Conclusion

- As the referendum approaches, investors with UK holdings will need to assess their currency exposure and make a decision of whether to hedge this risk. In the current financial environment, currency movements are becoming more pronounced and events like the EU referendum have potential to prompt considerable volatility in investor portfolios. Currency ETPs are an effective alternative to derivatives, simplifying the process of alleviating exchange rate risk and making the option to hedge “Brexit” tail risks more readily available.

Investors wishing to express the investment views outlined above may consider using the following ETF Securities ETPs:

**Currency ETPs**

**GBP Base**
- ETFS Long EUR Short GBP (GBUR)
- ETFS Short EUR Long GBP (URGB)
- ETFS Long USD Short GBP (GBUS)
- ETFS Short USD Long GBP (USGB)

**USD Base**
- ETFS Long GBP Short USD (LGBP)
- ETFS Short GBP Long USD (SGBP)

**3x**
- ETFS 3x Long GBP Short EUR (EGB3)
- ETFS 3x Short GBP Long EUR (GBE3)
- ETFS 3x Long GBP Short USD (LGBP)
- ETFS 3x Short GBP Long USD (SGBP)
- ETFS 3x Long USD Short GBP (USP3)
- ETFS 3x Short USD Long GBP (PUS3)
- ETFS 3x Long EUR Short GBP (EUP3)
- ETFS 3x Short EUR Long GBP (SUP3)
ETF Securities

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5x

- ETF 5x Long GBP Short EUR (EGB5)
- ETF 5x Short GBP Long EUR (GBE5)

Basket

- ETF Bullish GBP vs G10 Currency Basket Securities (LGBB)
- ETF Bearish GBP vs G10 Currency Basket Securities (SGBB)

The complete ETF Securities product list can be found here.
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