INVESTMENT BRIEF

Q1 2015

Strategic Investment Group®

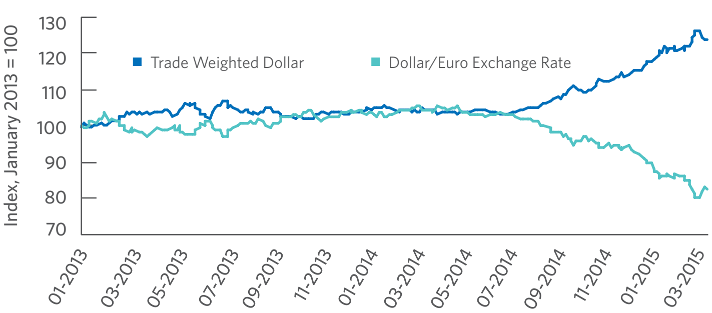
Dollar as a Pillar of Strength

The U.S. dollar's recent sharp rise against most currencies, and especially the euro, has brought currency risk to the fore among investor concerns. Since the latter half of 2014, currency markets have been at the epicenter of a reversion of asset price volatility from very low to more normal levels. The dollar, in particular, has surged against most currencies.

These movements largely reflect expectations for growing divergence in central bank policies. Over the last several months, there has been a flurry of easing by advanced and emerging central banks just as speculation in the U.S. has focused on the timing of the Fed's first rate hike. The ECB surprised markets by the magnitude of its asset purchase program, and the policy rates of the ECB and the central banks of Denmark, Sweden, and Switzerland were all reduced to below zero. Emerging markets also joined in, with notable easing moves by the central banks of India and China.

Exhibit 1: Dollar strength, euro weakness

Source: Federal Reserve Board



This policy divergence and related U.S. dollar strength is a natural reaction to relative economic growth prospects. Like the dollar, the U.S. economy is emerging as a pillar of strength. A strong dollar may well help sustain the global recovery by facilitating the adjustment of the euro area and allowing the Fed room for a deliberate pace of interest rate normalization. While arguably good for the global economy, dollar strength has hurt the return on non-U.S. assets held by U.S. dollar-based investors.

Our approach to currency risk management

Strategic's approach to currency exposure starts from the perspective of the role of each asset class in the total portfolio, with a focus on how currency movements affect the risk, return, and correlation characteristics of each asset class. We typically do not hedge the currency exposure of international equities, and the related benchmarks are unhedged. We believe that the combined impact of currency and equity market exposure provides an acceptable risk and return profile, and is consistent with the role of international equities as a relatively high return, high risk element of the total portfolio. Moreover, leaving currency exposure unhedged may add to the diversification benefits of such investments. In the case of emerging equities, some of the factors that make emerging markets attractive — rapid growth, capital deepening, improving economic management and market regulation — also tend to promote currency appreciation, making an unhedged position potentially even more attractive.

Our approach to currency management for international bonds differs from the one we use for international equities. In the case of international bonds, we typically adopt a hedged benchmark. Our strategy is consistent with the role of international bonds as a low volatility asset in the total portfolio. Currency volatility is typically a major element of international bonds' total volatility, and bond managers are more inclined to and experienced at active currency management than equity managers. This prepares them to manage to a hedged benchmark, but to take currency positions selectively, where they expect to be rewarded.

Tactical considerations

Our usual strategy for managing the currency exposure of international investments is overridden from time to time by tactical considerations. For example, our recent decision to overweight European equities was implemented on a currency hedged basis, as the same monetary support likely to buoy European stocks also seemed likely to trigger a depreciation of the euro. Here we departed from our typical approach and hedged the incremental currency exposure. In another recent example, we allowed an international bond manager to make limited use of long/short pairs to actively manage currency exposure. This was not a tactical, but rather a strategic move, giving the manager more scope to add value to a hedged international bond benchmark.

The dollar's recent rapid rise has spurred investors to reconsider how they manage currency risk. We continue to favor an approach grounded in the role of each asset class in the total portfolio. This viewpoint typically leads us to leave equity-related currency exposure unhedged, but to hedge international bonds. Combining this strategic posture with occasional tactical adjustments seems to us to strike the right risk and return balance for broadly diversified portfolios.

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