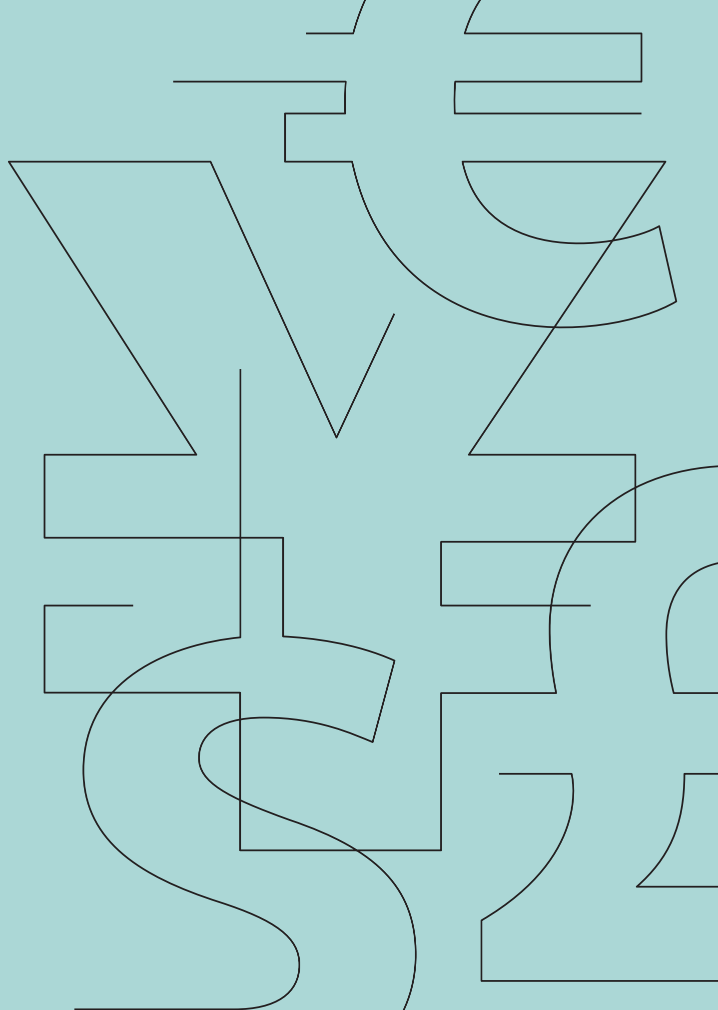

DYNAMIC STRATEGIC HEDGING

Customised currency exposure to reduce losses and improve excess return

STATE STREET GLOBAL ADVISORS®

Dynamically managing currency exposure customises the hedge ratio of each currency with the aim of reducing the size of currency losses while providing an added source of diversification in stressed market environments and adding potential excess returns.

HOW IT WORKS

Who It's For

Investors looking to improve their hedging risk reduction and returns by customizing hedge ratios for individual currencies over the valuation cycle.

Why Use It

- Innovative approach that can reduce currency losses.
- Can increase diversification and add excess return relative to a static hedging solution.

Dynamic Strategic Hedging (DSH) aims to add value relative to a passive hedge through both risk reduction and enhanced performance. The strategy begins with a passive hedging benchmark, often 50%, and then varies the hedge ratio for each currency separately between a client-specified minimum and maximum allowable hedge ratio (the hedge ratio band).

In our view, long-run valuation relative to a purchasing-power parity (PPP) equilibrium level provides the best anchor for active risk management.

Our DSH Strategy sets the hedge ratio for each currency pair individually to balance the level of mis-valuation versus our proprietary PPP estimates, the cost of hedging and currency volatility. For example, if relative to the euro the US dollar (USD) is 20% above fair value while the British pound (GBP) is 20% below fair value, a euro-based investor should hedge a greater proportion of the USD compared to GBP.

Another Layer of Diversification

The value focus of the DSH strategy can provide additional diversification benefits compared to a simple passive hedge. Unlike value investing in equity markets, value-based currency models have the potential to outperform during times of stress and illiquidity.

During such periods of uncertainty, investors find themselves forced to slash risk exposures and increase their preference for home-country assets. This results in currencies moving, often aggressively, back towards PPP equilibrium levels. A value-based hedge tends to improve performance relative to a static hedge exactly when USD-based investors are experiencing their largest losses on equities and credit.

Our DSH Solutions

DSH is highly customizable and can be applied to any set of international currency exposures across asset classes, provided those currencies are in the universe covered by our purchasing-power parity valuation model. This universe currently consists of the 13 developed market currencies in the MSCI World Index and 18 of the most liquid emerging markets currencies in the MSCI Emerging Markets Index.

HOW TO IMPLEMENT

Variable Total Hedge Ratio

Typically, implementing DSH involves choosing custom hedge ratios for each currency around a benchmark-passive hedge ratio.

To the extent that all currencies are expensive or cheap compared to the investor's home currency, DSH may suggest uniformly higher or lower hedge ratios across most currencies. This will result in a high/low total portfolio hedge ratio that will change over time, a variable total hedge ratio.

For example, an investor may approach us with a 50% benchmark hedge ratio and utilise DSH to vary the hedge ratio for each currency between 0% and 100%, the lower and upper hedge ratio bound.

The benchmark hedge ratio and upper and lower bounds are flexible and can be chosen to suit each investor's goals. A fixed income investor may want a higher average hedge ratio, say 90%, given the large impact of unhedged currency on global fixed income returns. In this case, the minimum allowable hedge ratio may be 80% and the maximum could be 100% for each currency.

Other investors, concerned about exposure to often undercompensated currency risk, may choose a benchmark 100% hedge ratio. In this case, DSH may be used to reduce the hedge to be less than 100% for one or more currencies, but would never increase the hedge above 100%.

Fixed Total Hedge Ratio

In some cases, investment policy guidelines or regulatory rules stipulate a fixed total portfolio hedge ratio.

However, those rules don't force the hedge ratio for each currency to be identical. For example, rules may force a 50% hedge but the investor is free to choose which currencies to hedge in order to achieve that hedge ratio.

In this case, DSH can guide the hedges towards expensive currencies while leaving undervalued currencies unhedged or under hedged. The result is a constant total portfolio hedge ratio while individual currency hedge ratios vary over time.

Absolute Return Implementation

Choosing a 0% benchmark and allowing the effective hedge ratio to be negative or positive isolates the active value added by DSH. This approach is particularly interesting for investors seeking to add alpha with low or negative correlation to risky assets.

DSH results in a value-tilted currency portfolio where the measure of value is always versus the investor's home currency.

On average, this will likely add return over a static hedging benchmark and that excess return will likely tend to have low or negative correlation to equities, credit and other risky assets.

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Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Currency Hedging involves taking offsetting positions intended to substantially offset currency losses on the hedged instrument. If the hedging position behaves differently than expected, the volatility of the strategy as a whole may increase and even exceed the volatility of the asset being hedged. There can be no assurance that hedging strategies will be effective.

Investing in futures is highly risky. Futures positions are considered highly leveraged because the initial margins are significantly smaller than the cash value of the contracts. The smaller the value of the margin in comparison to the cash value of the futures contract, the higher the leverage. There are a number of risks associated with futures investing including but not limited to counterparty credit risk, basis risk, currency risk, derivatives risk, foreign issuer exposure risk, sector concentration risk, leveraging and liquidity risks.

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ID13363 1979985.3.1.NA.RTL 0618 Exp. Date: 31 July 2019