Currency

Understanding currency

Currency is a system of money used as a means of exchange, in a country or economic region. Examples of different currencies are the Australian Dollar, the US Dollar and the Euro.

As AustralianSuper buys or sells assets in different countries, the portfolio is exposed to different currencies. About 50% of the Fund's investments are now in international markets and are priced in foreign currencies. The value of AustralianSuper's portfolio can vary based on the exchange rate of foreign currencies compared to our own currency.

Monitoring the currency exposures of these investments is important to manage the risk of the portfolio and find opportunities to improve returns for members.

Currency markets and exchange rates

Currency markets include both spot and forward markets. A spot trade takes place when an investor buys or sells in a foreign currency at current prices for immediate delivery and settlement. Examples of this include the the trading of Australian dollars for a foreign currency, such as US dollars or Euro, on the spot value date, typically within two business days. Forward trades are when investors buy or sell goods, agreeing the terms on the current date but with delivery and payment at a future date. These types of trades are used for managing liquidity, hedging investment exposures, or taking a position in the future direction of a currency.

There are many factors that can influence the value and exchange rate of currencies. These include interest and inflation rates, economic conditions and market sentiment. Favourable conditions support the flow of foreign capital into a country which helps the value of that country's currency. Understanding how each of these factors will affect a currency's value can be used for investment strategies that may improve the return of a portfolio. These factors determine whether a currency appreciates (increases in value) or depreciates (decreases in value), compared to foreign currencies.

- The level of interest rates can influence the amount of foreign capital that will flow to a country. A country with a higher interest rate can attract additional capital flow and the increased demand would cause their currency to appreciate relative to other countries.
- Inflation can have the opposite effect, with higher inflation eroding an investor's return. A country with higher relative inflation may see their currency depreciate relative to other countries.
- The economic conditions in a country affect its GDP growth potential, employment levels, along with fiscal and monetary policies. These factors can also be interrelated with a country's current account, levels of government debt and terms of trade. A change in these factors affects the perceived health of a country's economy, affecting capital flows and resulting in adjustments to the exchange rates with other countries.
- Market sentiment and speculation can affect currency markets. Investor perceptions and expectations can lead to currencies appreciating or depreciating, which can increase the volatility of trading in currencies.

The table below shows how a change in key factors, can influence an exchange rate.

Factor	Change in factor	Effect on the domestic currency exchange rate
Interest rates	Increase	Currency appreciates
Inflation	Increase	Currency depreciates
GDP	Increase in growth	Currency appreciates
Unemployment	Decrease in unemployment	Currency appreciates
Current account	Deficit (more imports than exports)	Currency depreciates
Government debt	Increase	Currency depreciates
Political stability	Increase in political uncertainty	Currency depreciates
Speculation	Higher investor demand	Currency appreciates

We often think of currency and the impact of changing exchange rates when we're buying an item from overseas. For example, when we're thinking of buying a new mobile phone and there's an opportunity to buy a phone from the US for US$1,000. When converted to Australian dollars the price would be A$1,400, or about A$1.4 for every US$1. In waiting a few months to make the purchase, the price is still US$1,000, however it now costs A$1,300, or A$1.3 for every US$1. What happened during this time was a change in the exchange rate between the US and Australian dollars. An appreciation of the Australian dollar compared to the US dollar made the phone less expensive for a buyer in Australia. The opposite would happen if the Australian dollar depreciated against the US dollar. This is an example of a change in currency exchange rates that an investor may either seek to hedge against depreciation of a currency or invest in the appreciation of a currency.

Another factor to consider is how much your Australian dollar can buy in other countries for a similar item. This has been made famous by the Big Mac index where a similar item can be bought in different countries. A Big Mac in Australia may cost AUD6.48, while in Europe it could cost you €4.25, based on The Economist index as at 1 January 2021. (**economist.com/big-mac-index**) While the lower Euro figure may make the burger look cheaper in Europe, the exchange rate between the countries of about €0.63 to buy A$1 means that the burger is about the same cost for the Australian traveller. Comparing the purchasing power of a currency can provide opportunities for an investor to determine the relative value of two currencies and the future direction of exchange rates.

How AustralianSuper manages currency

Currency management contributes to member returns and helps the Fund to manage portfolio risks. This is why AustralianSuper now manages currency in-house.

To deliver member returns, the investment team looks for opportunities to adjust the currency exposures in the portfolio based on our market outlook.

To manage risk, the team monitor currency exposures using a 'One-Portfolio approach'. This takes into account the interactions between assets and risk profiles across the whole portfolio. Each investment option has a target foreign currency exposure and excess currency exposures are hedged. Hedging is done by selling unwanted foreign currency exposures in the portfolio. AustralianSuper's internalisation of managing currency provides additional efficiencies by helping the Fund to co-ordinate all foreign exchange activity in the portfolio. This means the investment team can efficiently manage the operational implementation of currency positions, portfolio liquidity and trade execution, thereby reducing management costs for members.

Our internal currency management approach consolidates currency management activities to provide additional oversight for currency transactions. Our process enables effective and efficient implementation of investment decisions while incorporating appropriate controls to manage operational risks. Key advantages include reduction in trade volumes through the netting of trades and coordinating foreign exchange activity across the Fund. The process also improves the management of liquidity to ensure sufficient access to cash is available when needed throughout the portfolio.

Currency risks

Currency trading has a number of risks that are monitored when managing currency exposure. These risks include market risk and counterparty risk.

- Market risk – Currency exchange rates can be volatile and adjust quickly to valuation factors, especially when there are changes to the levels of interest rates or economic factors. Significant examples include the strong appreciation of the US dollar compared to other currencies during the Global Financial Crisis in 2008 and during the COVID downturn in 2020. During times of market stress, investors often seek out safe haven currencies like the US dollar, Japanese yen and Swiss franc, as these currencies often retain their valued during volatile or uncertain markets.
- Counterparty risk – A counterparty that is not able to pay at settlement of a transaction's cashflows. Transacting with high quality counterparties and setting limits on counterparty exposure enables an investor to limit counterparty risk.

AustralianSuper has risk governance and operational processes in place to monitor and manage currency risks. These include monitoring currency and counterparty exposures to ensure that trades are implemented in a risk-controlled way to support the investment objectives of the Fund.

Our investment team consider the impact of exchange rate changes in the portfolio and targets a level of foreign currency exposure in the PreMixed options to meet the portfolio's investment objectives.

Australian Dollar appreciates

▲	In USD	In AUD	AUD/USD exchange rate
Purchase price	$100	$143	0.70
Current price	$125	$162	0.77
Return	25%	14%	10%

Australian Dollar depreciates

▼	In USD	In AUD	AUD/USD exchange rate
Purchase price	$100	$143	0.70
Current price	$125	$198	0.63
Return	25%	39%	-10%

Impact of currency on returns

Changes in currency exchange rates can have a big impact on the returns of international assets. The change in the exchange rate can increase or lower the return of an asset. This is a result of the difference in the pricing of the asset in its local currency and its value when converted to Australian dollars.

Think about an investment in a US stock where it is purchased for $100 and is currently worth $125. While it in US terms the stock returned 25%, an Australian investor would receive a different return based on the appreciation or depreciation of the Australian dollar over the period. If the Australian dollar appreciates by 10%, the return of the US asset would be lower (14%), while if the Australian dollar depreciates by 10%, the return of the US asset would be higher (39%).

Delivering long-term returns for members

Managing currency exposures is very important when investing globally. Our investment approach incorporates managing the level of currency exposures while looking for opportunities to add value by adjusting currency positions. This helps the Fund to have oversight on the risks of currency in the portfolio and establish processes to manage these risks. AustralianSuper's holistic One-Portfolio approach to managing currency balances the return and risk characteristics of currency exposures to deliver long-term returns for members.

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An Industry SuperFund

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