Investment Fund Matters

GBP hedged unit classes in the UK fund range

What are hedged unit classes?

The intention of Schroders' hedged unit classes is to remove the currency effects of investing overseas. A UK client may wish to invest in a Japanese equity fund, for example, without experiencing the effects of exchange rate movements between pound sterling and Japanese yen. Hedged unit classes aim to remove the effect of any exchange rate movements so that the investor experiences only the performance of the underlying portfolio, however there can be no guarantee that the hedge will perform perfectly (see below for details of factors that contribute to performance divergence).

What is the attraction of the hedged unit classes?

An investor may wish to remove the effects of exchange rate movements between sterling and the currency of the fund's investments. For example, a client may like to invest in Japanese companies, but have concerns that the Japanese yen may weaken versus the pound, thus eroding the value of the fund's holdings in sterling terms.

Example of currency rate movements on a foreign investment:

- On the day of investing, £1 buys ¥100
- An investment of £1,000 therefore buys ¥100,000 worth of holdings (shares in Japanese companies, for example) within the fund
- The performance of the fund is flat and the investor decides to redeem
- The yen has now weakened substantially, so that £1 = ¥200
- When the investor redeems, his ¥100,000 holding is now worth just £500

In order to mitigate this risk, the investor might choose to invest in the hedged unit class. By the same token, in the reverse scenario an investor in the hedged unit class would not benefit if the yen were to strengthen versus the pound.

How does the hedging programme work?

In the UK fund range, exposure is hedged at the portfolio level. That is to say, the proportionate exposure of the underlying holdings in foreign currencies is hedged back to sterling. If a European equity fund has 80% in euro-denominated holdings, 10% in Danish krona-denominated holdings and the remaining 10% in sterling cash, proportionate hedges will be taken out for the value of each currency within the hedged class, i.e. 80% against the euro and 10% against Danish krona. J.P. Morgan carries out the hedging programme on our behalf.

Daily hedging process:

- Net inflows to the unit class are received.
- Assuming net inflows exceed the minimum transaction size (as agreed between J.P. Morgan and Schroders), currency forward contracts are bought to match the exposure of the fund.
- Foreign currency movements between sterling and the currencies in the portfolio are reflected in the value of the forward currency contract, booked as an unrealised profit or loss until the contracts mature.
- Cash collateral is exchanged between the counterparty and the fund to cover any unrealised profit or losses above a certain threshold, in order to minimise counterparty risk.
- The effects of this hedging are reflected in the net asset value of the hedged unit class and therefore in its performance (although any profits or losses are only crystallised monthly).

How will the performance of a hedged class differ from the unhedged class?

In theory, the only difference in performance between a hedged and an unhedged class should be the movements in exchange rates between the currencies being hedged. In practice, however, other factors may contribute to a difference in performance between the classes.

What other factors may affect the performance of the hedged class?

It is important to note that in practice the hedge will never be perfect and there can be no assurances that the currency hedging employed will fully eliminate the unitholder's exposure to exchange rate fluctuations. Differences can arise due to:

- **How frequently the hedges are rolled:** The hedges are rolled on a monthly basis. They are only reset intra-month when certain tolerances are triggered, such as a minimum currency movement or transaction size. This is to avoid inefficient transaction costs of minor adjustments.

- **Interest rate differentials:** A difference in interest rates between sterling and the hedged currencies will lead to a divergence in performance. A positive or negative effect will depend on the prevailing interest rates.

- **Unrealised profit or loss:** Over the period of the forward currency contract, its value will include unrealised profits or losses arising from currency movements. Unrealised gains, for example, are not used to buy additional holdings in the fund portfolio and will not participate in any market movements as a result. This over or under investment creates a dilutive impact on the hedged unit class compared to the unhedged class.

- **Hedging expenses:** These will erode a portion of the overall return. The hedging expenses will accrue to unitholders in the hedged unit class only.

- **Timing differences** between the valuation point of the fund and the time at which the currency hedges are transacted.

How are the UK hedged classes different to the Lux programme?

All our UK funds have GBP as their base currency. We will only offer GBP-hedged classes, which hedge against the currency exposure of the underlying portfolio. In our Luxembourg ranges, however, we offer many different currencies hedged against the base currency of the fund. The aim of this is to allow investors in different countries to invest in their own currency without suffering the currency movements between theirs and the base currency of the fund.

The Luxembourg hedging programme is therefore based on a NAV-hedge. This means that 100% of the fund's base currency is hedged, rather than the currencies of the holdings within the fund.

Which funds are included in the programme?

We currently offer GBP hedged unit classes on the following funds in the UK:

- **Schroder European Alpha Plus Fund**
- **Schroder European Fund**
- **Schroder Japanese Alpha Plus Fund**
- **Schroder Tokyo Fund**