Hedged share classes explained

Columbia Threadneedle Investments offers currency hedged share classes within its range of Luxembourg-domiciled Société d'Investissement à Capital Variable (SICAV).

Hedged share classes aim to provide investors with a return more closely correlated to the base currency performance of the fund, by reducing, but not completely eliminating, the effect of exchange rate fluctuations between the hedged currency and the base currency.

Why use hedged share classes?

For investors holding assets in currencies other than their own, currency fluctuations can be a significant contributor to or detractor from returns, and are therefore an additional source of risk.

For example, an investor in Asia holding US dollars, may wish to invest in a Japanese equity fund without being exposed to the fluctuations between the Japanese yen and the US dollar. In this instance, a USD hedged share class would aim to provide a return as close as possible to that of the underlying Japanese yen assets, although there can be no guarantee that the hedge will perform perfectly.

EXAMPLE:

A client in Asia invests $10,000 in an unhedged share class of a Japanese equity fund. At the time of purchase, the yen is 150 to the dollar and the investor's subscription is worth ¥1,500,000. Assuming the fund returns 10% over the next year, the value of the investment then goes up to ¥1,650,000. The investor decides to sell the investment, however the yen has weakened and is now worth 160 to the dollar. The investor therefore receives $10,313 for the sale, representing a return of around 3%.

Had the investor purchased hedged shares, the effect of the weakening yen would have been reduced and the return experienced would have been closer to that of the fund in yen terms.

Conversely, had the yen strengthened against the dollar, an investor in an unhedged share class would have received a greater return than that of the fund's returns in yen. Assuming the yen is now 140 to the dollar, the investor will receive $11,786 for the sale, generating a return of close to 18%. In this scenario, an unhedged share class would have produced a superior return to its hedged equivalent.

How does the hedge work?

An investor's subscription is made in the currency of the share class. This is converted into the base currency of the fund at the prevailing spot rate. At the same time, the resulting exposure to the base currency is hedged at the forward foreign exchange rate. The hedging transaction is 'rolled' on at least a monthly basis, which crystallises any loss or gain on the hedge.

Gains or losses on hedges are included in the daily NAV for the relevant share class only, and such gains and losses are borne only by the shareholders of such classes, as are any expenses related to the hedging process.

How do hedged share classes perform relative to base currency classes?

Although the intention for hedged share classes is to remove the effect of exchange rate movements and offer shareholders the return of the underlying portfolio, there are a number of factors that can contribute to a divergence between the performance of hedged classes and the corresponding base currency classes:

- **Interest rate differential:** Any difference in interest rates between the base currency and the hedged currency will lead to a divergence in performance. The hedged class may outperform or underperform depending on the nature of the differential. The example below outlines a scenario where the hedged class outperforms the base currency class, due to a positive interest rate differential:

Example: USD hedged shares on JPY base currency	
JPY-based return	**10.0%**
JPY interest rate	0.0%
USD interest rate	5.0%
Interest rate differential	**+5.0%**
USD-hedged total return	15.0%

For illustrative purposes only. Interest rates may fluctuate and are likely to change.

Where the interest rate differential is negative, the hedged class would be expected to underperform the base currency class.

This is because the pricing of the currency forwards used for hedging takes into account the different interest rates that investors would earn holding different currencies. These relationships are governed by an economic concept known as interest rate parity, which broadly holds in most market environments.

- **Unrealised profit or loss:** Over the period of the forward currency contract, unrealised gains or losses are included in the NAV of the share class, but are uninvested in the assets of the fund and will not therefore participate in the performance of those assets. This can lead to a dilutive effect on the hedged classes versus the unhedged classes.
- **Hedging expenses:** Any expenses relating to the management of the currency hedge are accrued only against the hedged share classes.

Important information

For use by Professional and/or Qualified Investors only (not to be used with or passed on to retail clients).

This material is intended for informational purposes only and should not be considered representative of any particular investment. This should not be considered an offer or solicitation to buy or sell any securities or other financial instruments, or to provide investment advice or services. **Investing involves risk including the risk of loss of principal. Your capital is at risk.** Market risk may affect a single issuer, sector of the economy, industry or the market as a whole. The value of investments is not guaranteed, and therefore an investor may not get back the amount invested. **International investing** involves certain risks and volatility due to potential political, economic or currency fluctuations and different financial and accounting standards. **The securities included herein are for illustrative purposes only, subject to change and should not be construed as a recommendation to buy or sell. Securities discussed may or may not prove profitable.** The views expressed are as of the date given, may change as market or other conditions change and may differ from views expressed by other Columbia Threadneedle Investments (Columbia Threadneedle) associates or affiliates. Actual investments or investment decisions made by Columbia Threadneedle and its affiliates, whether for its own account or on behalf of clients, may not necessarily reflect the views expressed. This information is not intended to provide investment advice and does not take into consideration individual investor circumstances. Investment decisions should always be made based on an investor's specific financial needs, objectives, goals, time horizon and risk tolerance. Asset classes described may not be suitable for all investors. **Past performance does not guarantee future results, and no forecast should be considered a guarantee either.** Information and opinions provided by third parties have been obtained from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. This material and its contents have not been reviewed by any regulatory authority.

In Australia: Issued by Threadneedle Investments Singapore (Pte.) Limited ["TIS"], ARBN 600 027 414. TIS is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth) and relies on Class Order 03/1102 in respect of the financial services it provides to wholesale clients in Australia. This material should only be distributed in Australia to "wholesale clients" as defined in Section 761G of the Corporations Act. TIS is regulated in Singapore (Registration number: 201101559W) by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289), which differ from Australian laws.

In Singapore: Issued by Threadneedle Investments Singapore (Pte.) Limited, 3 Killiney Road, #07-07, Winsland House 1, Singapore 239519, which is regulated in Singapore by the Monetary Authority of Singapore under the Securities and Futures Act (Chapter 289). Registration number: 201101559W. This advertisement has not been reviewed by the Monetary Authority of Singapore.

In Hong Kong: Issued by Threadneedle Portfolio Services Hong Kong Limited 天利投資管理香港有限公司. Unit 3004, Two Exchange Square, 8 Connaught Place, Hong Kong, which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 regulated activities (CE:AQA779). Registered in Hong Kong under the Companies Ordinance (Chapter 622), No. 1173058.

Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies.