Managing Currency Risk with FTSE WPU

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The Poisoned Chalice: Quantitative Easing hurts investors

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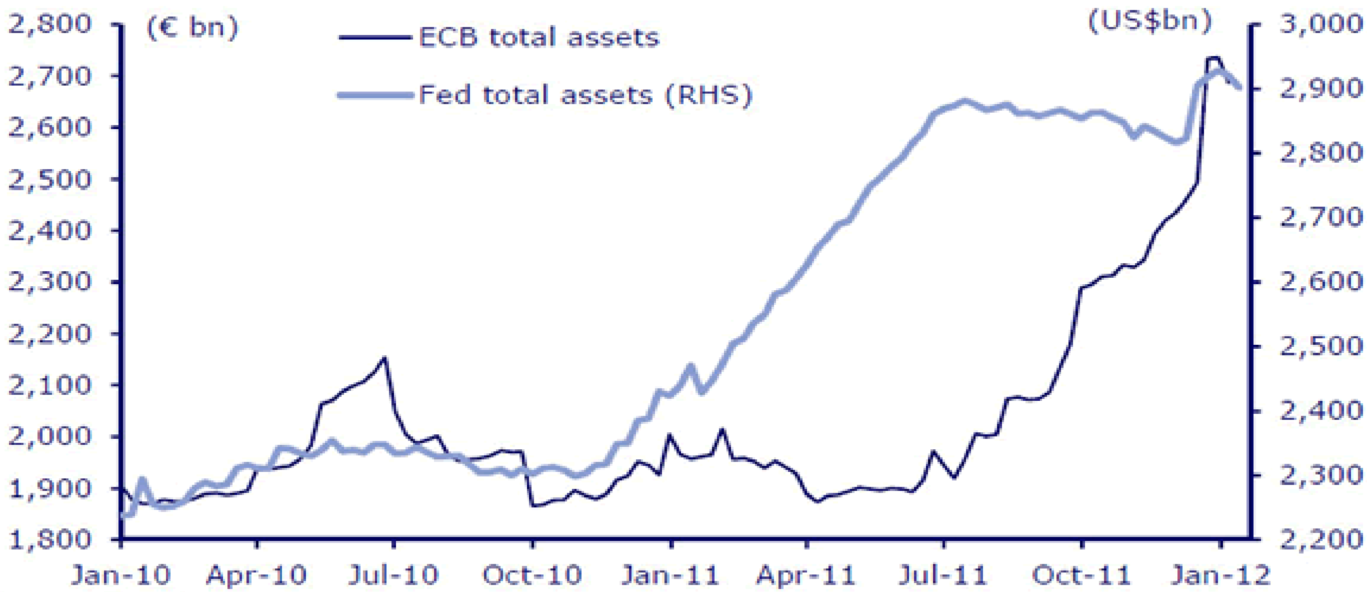
There are huge public and private debts in the US and Europe.
The Fed, ECB and BOE are bailing out debtors by quantitative easing.
This undermines the value of these currencies for investors.

Figure 2
ECB total assets and Fed total assets



Source: Bloomberg

The Poisoned Chalice: Quantitative Easing

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Quantitative easing creates short run growth gains from competitive currency devaluation.
This forced up the Yen to a severely overvalued level, causing losses for Japanese investors.

Quantitative easing reduces the burden for debtors, as it is a tax on investors:

1. **Devaluation: Taxing investors by currency devaluation**
2. **Inflation: Taxing investors by negative real return**

The challenge for Japanese Investors:

The Yen is severely overvalued
Japanese investors need to invest overseas to get higher returns
Japanese debt refinancing will become an acute problem

This may lead to forced quantitative easing in Japan and a falling global value of the Yen.

Devaluation: Taxing investors by currency devaluation

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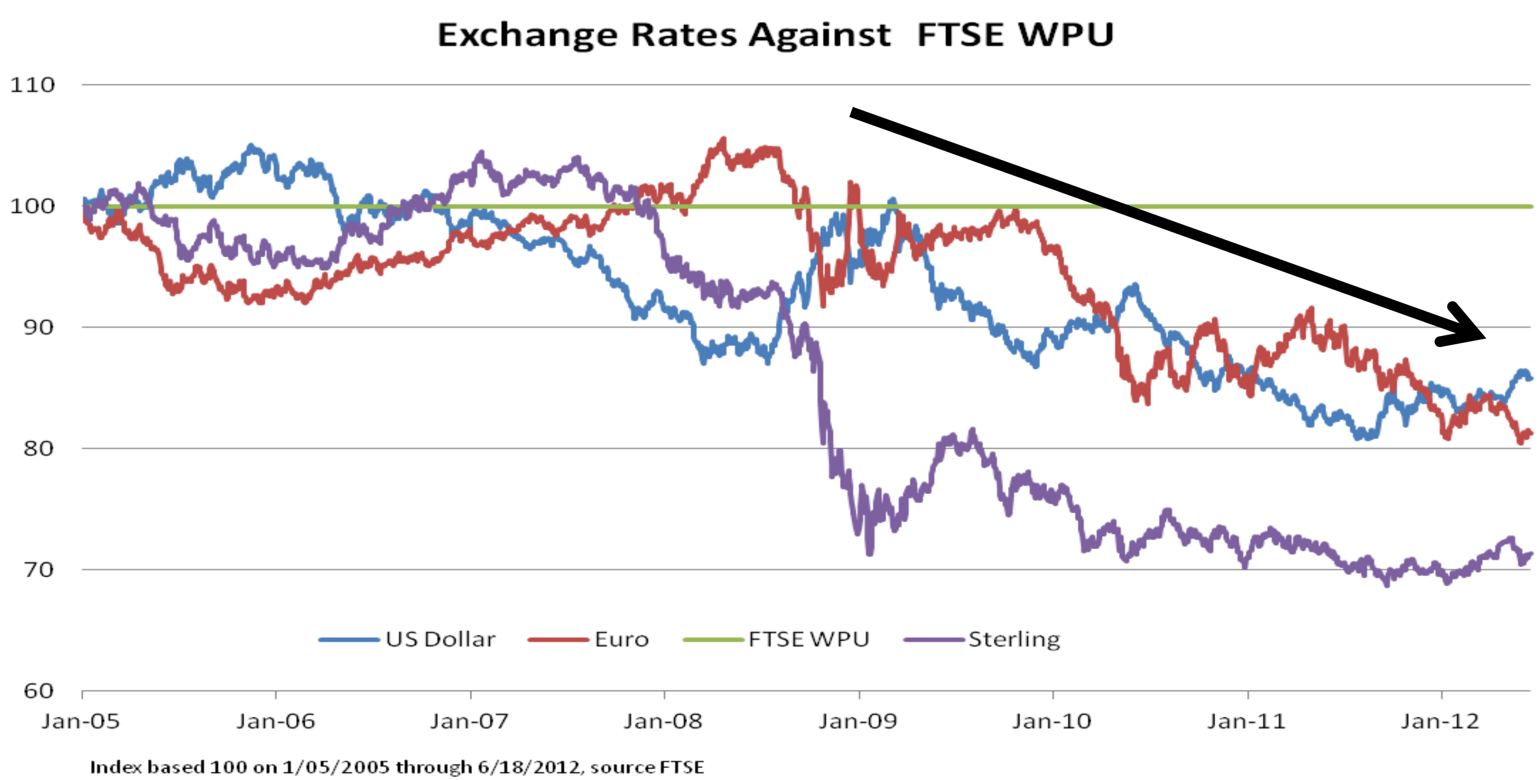
Quantitative easing is causing Sterling, Euro and US Dollar to decline.



Inflation: Taxing investors by negative real return

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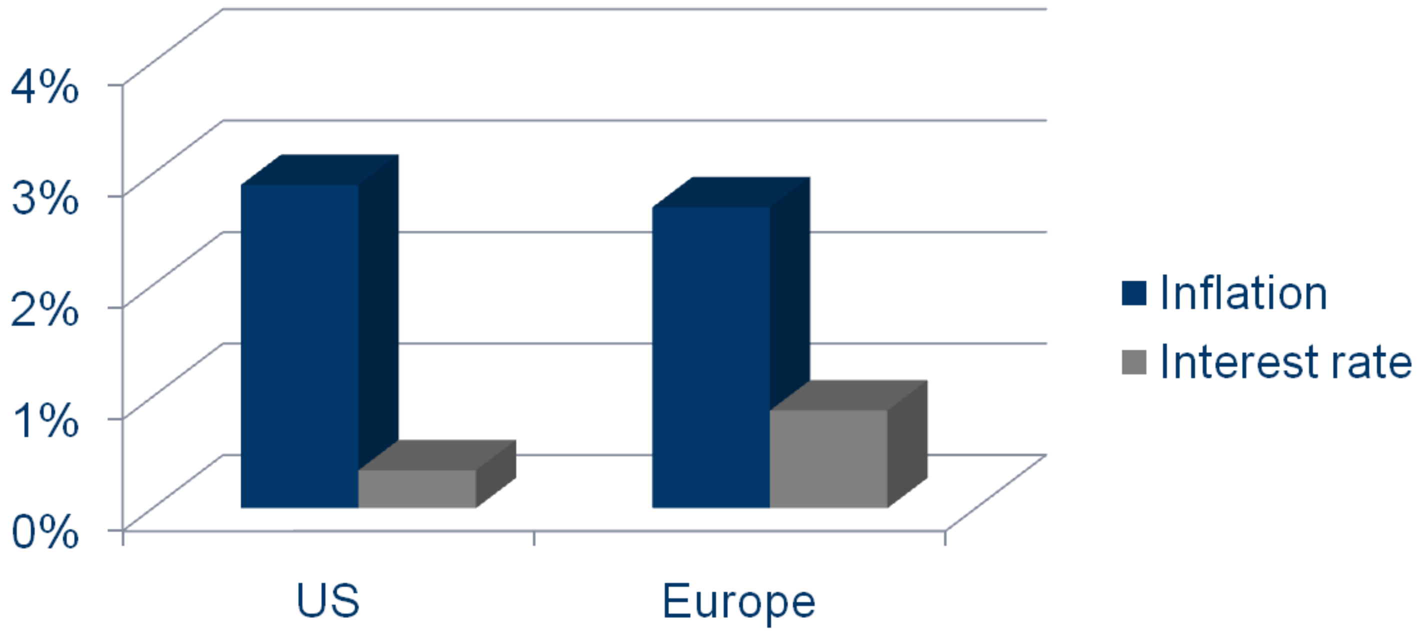
Investors are losing over 2.5% per annum if their wealth is in US Dollars or Euros. If this continues, over 10 years this is a loss of 22% of total wealth.



Data sources: US Bureau of Labor Statistics, European Statistics Office, Reuters as of June 2012.

The Currency Risk in International Equity Investing

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Developed equity markets provide two sources of return

Return on Developed Equity Markets ex Japan

Unhedged yen return: +1.8 % p.a.
Volatility: 21.1 % p.a.

1. Foreign Equity Investment

Equity return hedged into yen
Yen return +3.9 % p.a.
Volatility 14.7 % p.a.

2. Foreign Currency Exposure

Foreign currency return vs Yen
Yen return -2.1 % p.a.
Currency volatility 10.0 % p.a.

The foreign currency return is equal to the individual currency returns against Yen multiplied by the *equity capitalization weights.*

Datasource: FTSE KAIGAI equity index, hedged and unhedged monthly data from 9-30-2003 through 5-31-2012

The Foreign Currency Exposure Caused Large Losses

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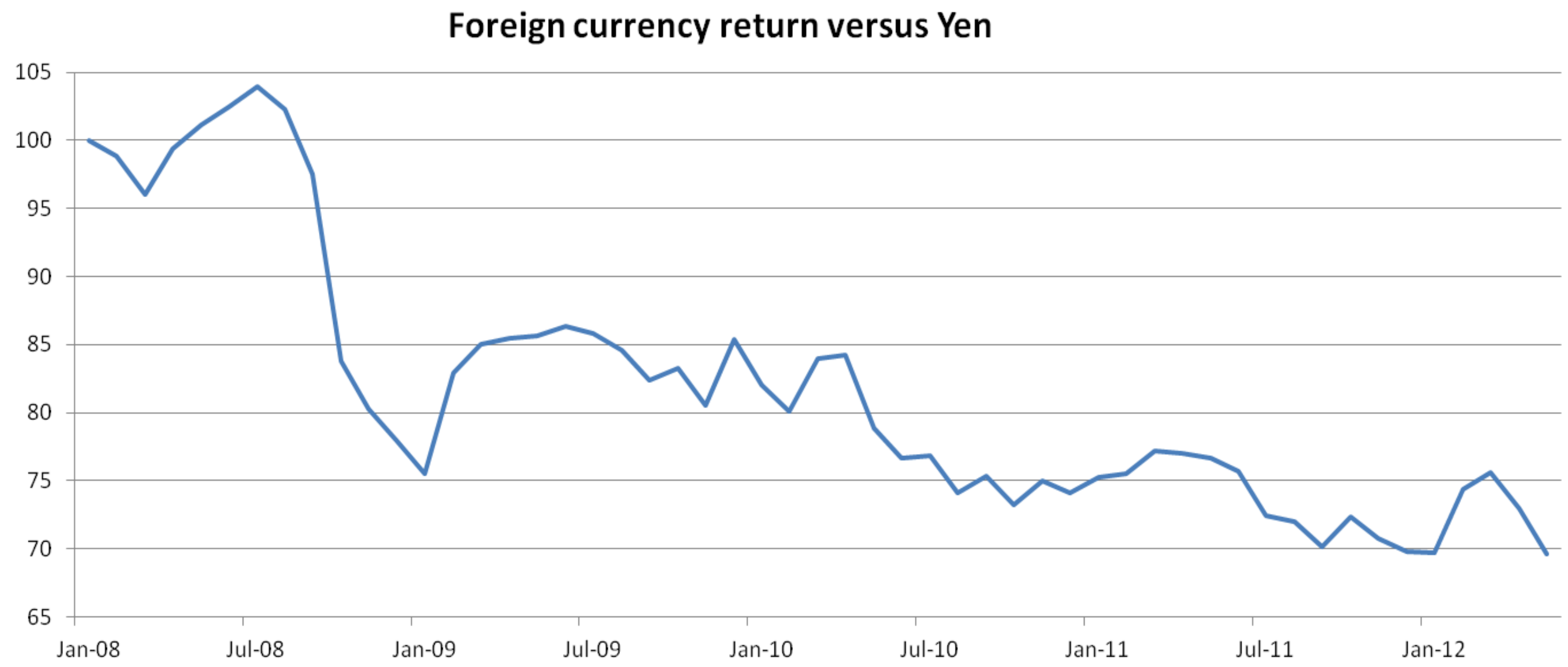
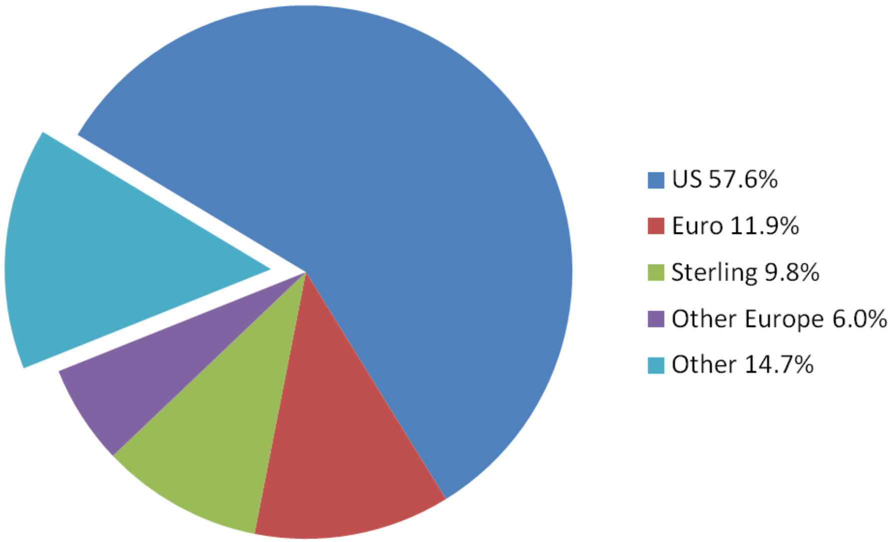


Since quantitative easing started, foreign currency losses for Japanese investors have average 8.0% per annum.

Datasource: FTSE KAIGAI equity index, monthly data index 100 at 1-30-2008 through 5-31-2012

The Foreign Currency Exposure in International Equities

Foreign Currency Exposure in developed market equities



International equities are *58%* exposed to US Dollar and 28% exposed to European currencies

No investor would consciously choose *equity weights* as a *currency* benchmark.

Investors need a better global currency benchmark.

Datasource: FTSE World equity index weights, 31/5/2012

Why not use the SDR as a currency benchmark?

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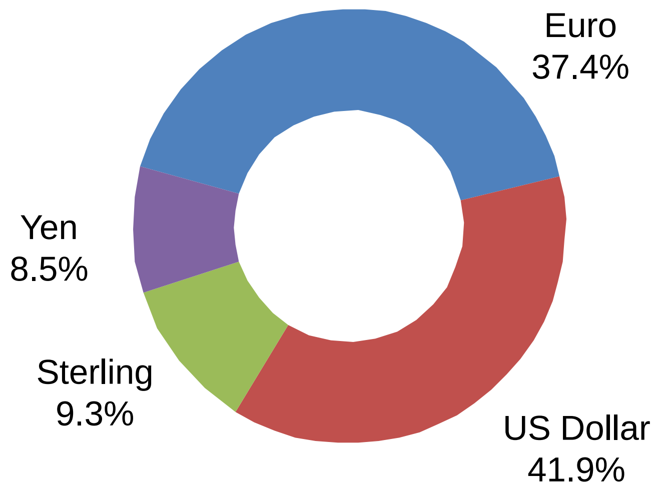
A basket of foreign currency exposures is less risky than one currency.
What is wrong with the SDR as a currency benchmark??



SDR was developed by the IMF as a *unit of account.*

**These are the four currencies with largest supply… and aggressive quantitative easing.
The SDR was not designed to preserve global wealth.**

Source: http://www.imf.org/external/np/tre/sdr/sdrbasket.htm.

FTSE WPU is Designed to Preserve Global Wealth

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FTSE WPU minimizes the two risks in fiat currencies

Risk #1 Devaluation

Seven major currencies — Diversifies ***Foreign currency risk***

Currencies weighted to minimize risk.
Euro has a weight of 10%.
US Dollar weight equals US share of global GDP: 23%.

Risk #2 Inflation

Developing Currencies: — BRIC Currencies - Hedges ***Buying power risk***

Developing countries are where goods are manufactured.
Developed currencies will have lower purchasing power in the future.

Storable Commodities: — Gold and Oil - Hedges ***Future inflation risk***

Unfunded deficits and loose monetary policy in the developed countries threaten the long term real value of these paper currencies.

Datasource: FTSE WPU Ground rules www.ftse.com/.../FTSE.../FTSE_World_Parity_Unit_Ground_Rules.pdf

FTSE WPU is Designed to Preserve Global Wealth

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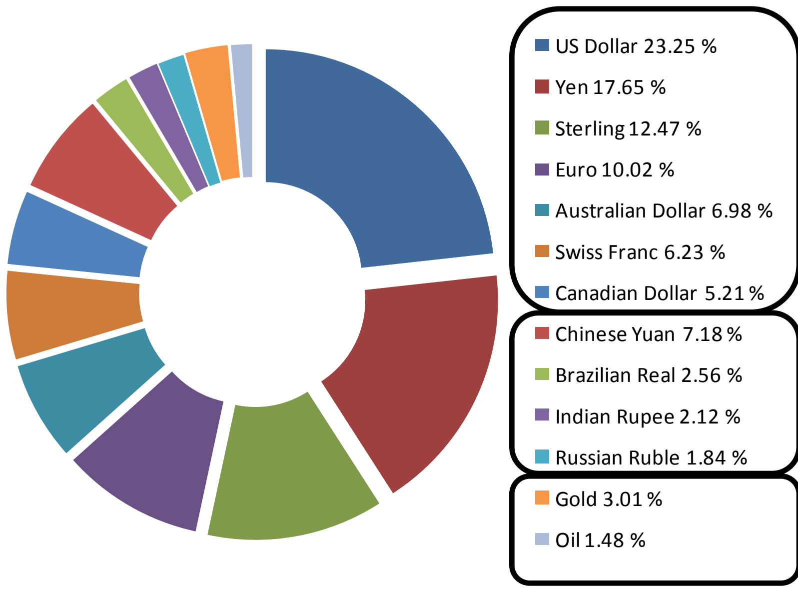
Components in FTSE WPU



Risk #1 Devaluation

Diversifies ***foreign currency risk***

Risk #2 Inflation

BRIC Currencies - Hedges ***buying power risk***

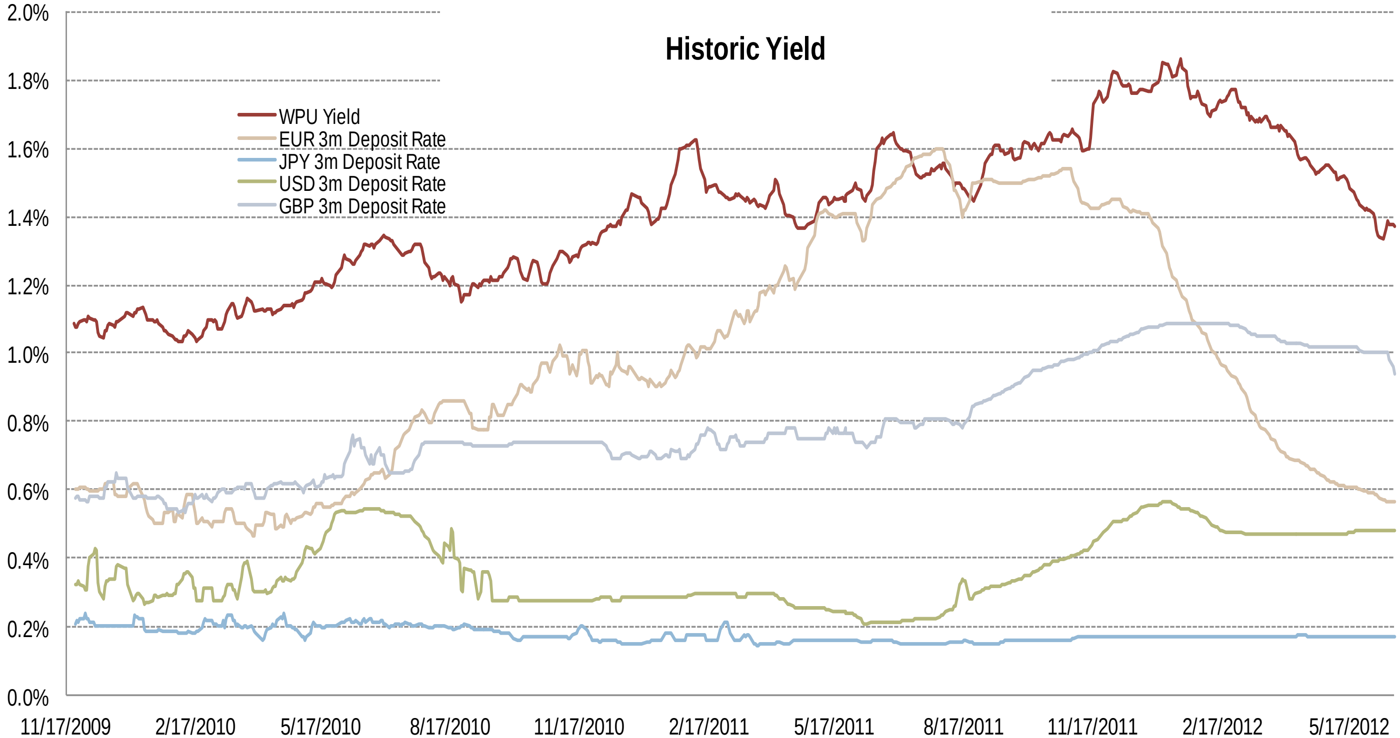
Gold and Oil - Hedges ***future inflation risk***

The weights in FTSE WPU are set to minimize devaluation and inflation risks

Datasource: FTSE WPU Ground rules www.ftse.com/.../FTSE.../FTSE_World_Parity_Unit_Ground_Rules.pdf

The yield on FTSE WPU reduces the hedging cost

Hedging into Yen is more expensive than hedging into FTSE WPU as the Yen has a lower yield and thus higher forward exchange rate.



Source: UBS, Bloomberg, data from 17/Nov/2009, when BRL deposit rate becomes available, to 01/May/2012.

FTSE WPU - a Better Currency Benchmark

Developed Equity Markets ex Japan

Capital Invested in 24
Developed Equity Markets

~~Implicit Currency Exposure~~

Currency hedging
program

FTSE WPU
Currency Benchmark

FTSE WPU is a superior currency benchmark

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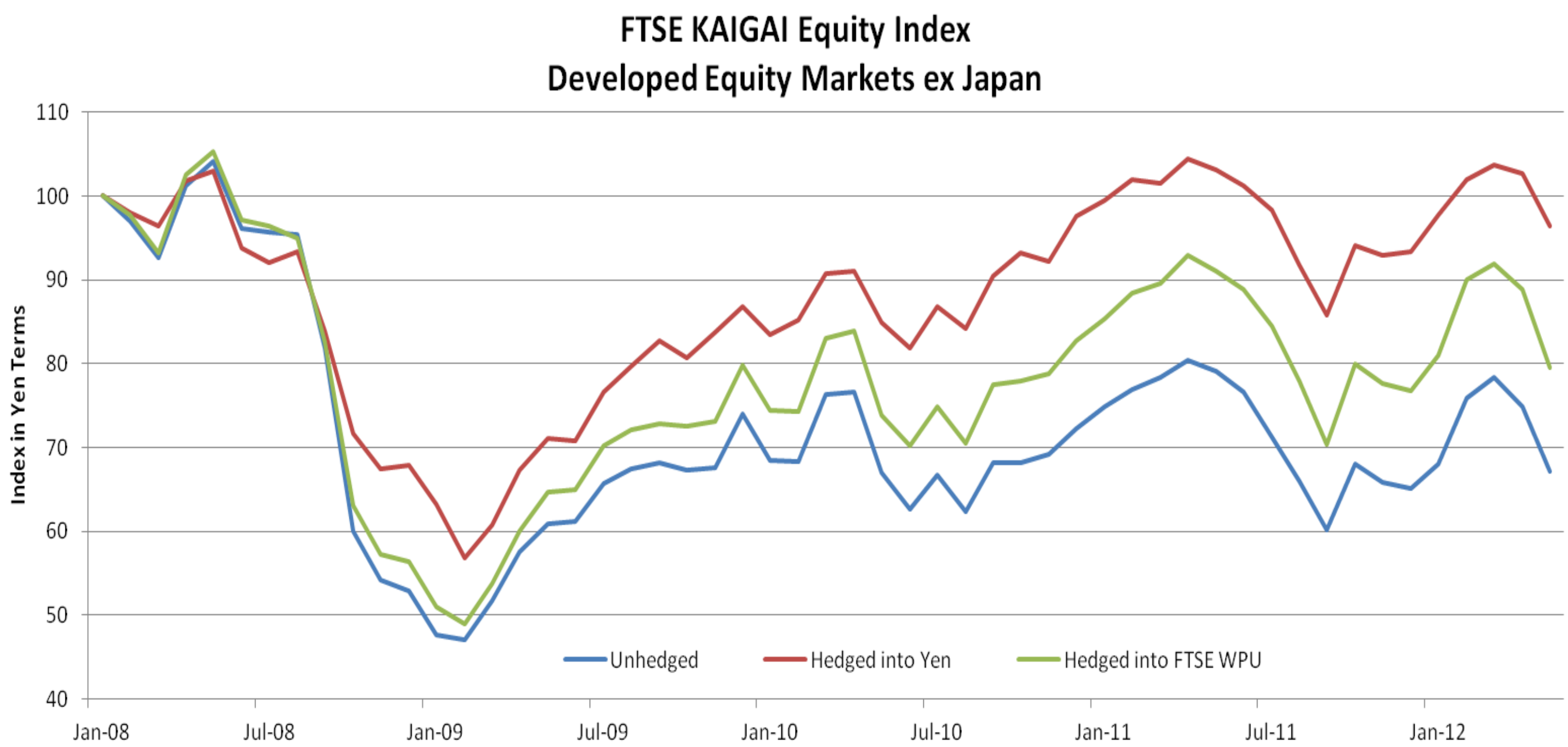

Datasource: FTSE Developed Market ex Japan equity index, base 100, monthly from January-2008 through May-2012, MPG and UBS data.

Investment uses of FTSE WPU

There are three major investment applications:

1. FTSE WPU Hedging overlay
   Hedging the currency risk in international investments, e.g. International equities, investments concentrated in one country, e.g. the US or Europe.

2. Global cash
   Hedging Yen cash into FTSE WPU to provide Japanese investors with a higher than Yen yield and a global store of value.

3. Hedging Funds into FTSE WPU.
   Existing investment funds can be offered together with hedges into FTSE WPU.
   Once a fund is hedged into FTSE WPU, it can then be sold to investors in any country.

Implementing hedges into FTSE WPU

The foreign currency exposure is measured based on the monthly custodian report.
This foreign currency exposure is hedged into FTSE WPU by:

1.Hedging the foreign currencies in the international investments into US Dollars and then:

2.Either
a) Buying the individual twelve non Yen components of FTSE WPU.
These are currency forwards, NDFs and Futures (or swaps).
or
b) Buying a derivative contract from a bank to convert US Dollars into FTSE WPU eg an NDF or Swap

Typically the size of the FTSE WPU hedge is adjusted based on monthly valuation of assets.

Note: the currency trades in the two stages can be netted into one set of transactions.

Conclusion

Quantitative easing is undermining the value of the major currencies

Foreign currency is causing large losses for Japanese investors

The existing foreign currency exposure is highly unattractive

FTSE WPU is designed to preserve global value

FTSE WPU is a better currency benchmark *and* hedges against future Yen decline

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