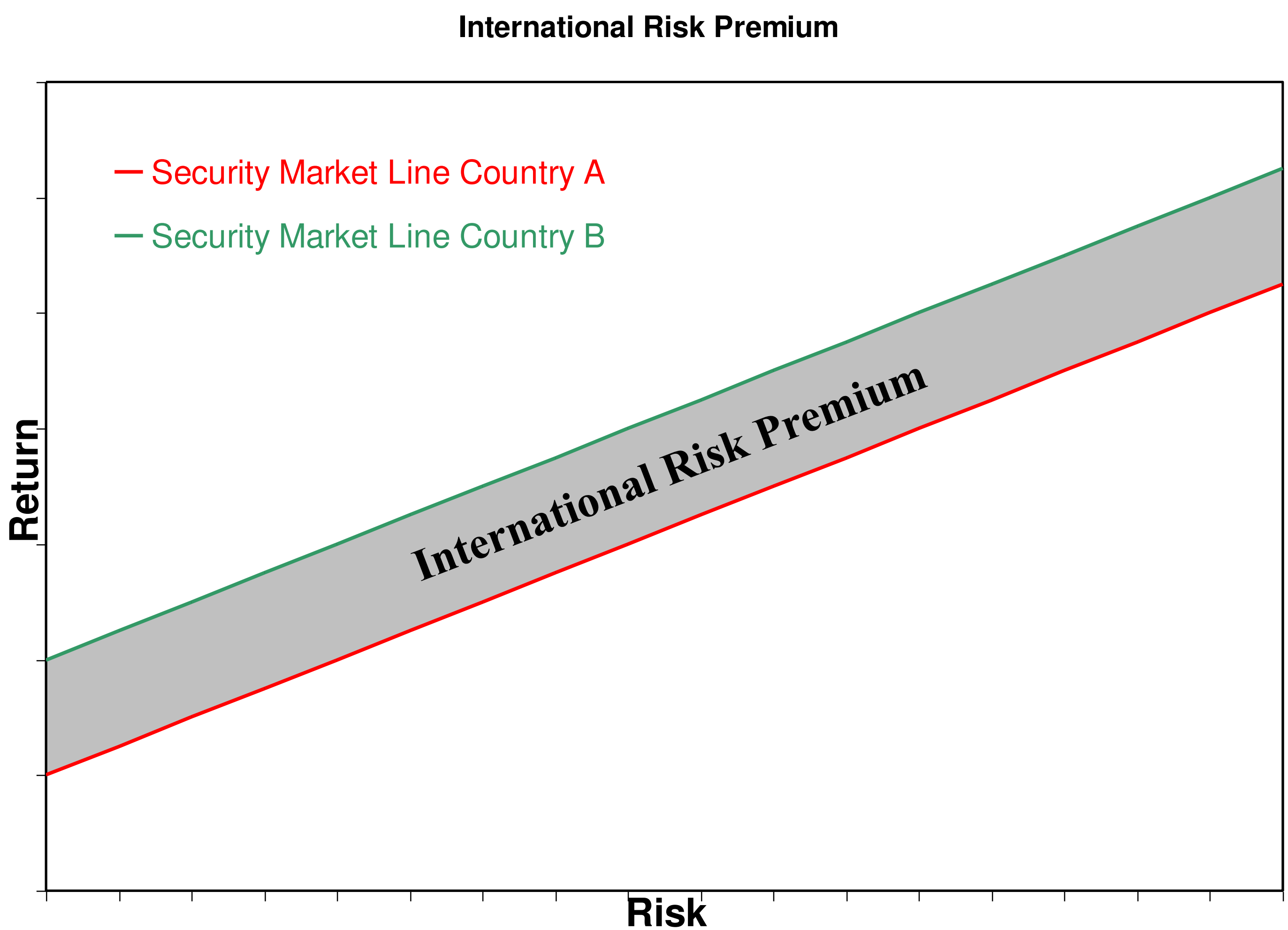
International Risk Premium is an Attractive Separate Asset Class

Adrian Lee & Partners

Forward Rate Bias in currency is an attractive risk premium and asset class

- Expected real return and risk relationships differ by country.
- These differences exist ex-ante to efficiently allocate capital globally and have been realised historically.
- We call these differences International Risk Premia and they are well proxied by nominal yield differences.
- Investing in International Risk Premia is easily achieved by buying higher-yielding currencies while selling lower-yielding currencies.
- These risk premia are attractive to investors as they are diversified across asset class, country and region.
- Inflation differences associated with nominal yield differences will be reflected ex-post in spot currency returns.

International Risk Premium – an illustration

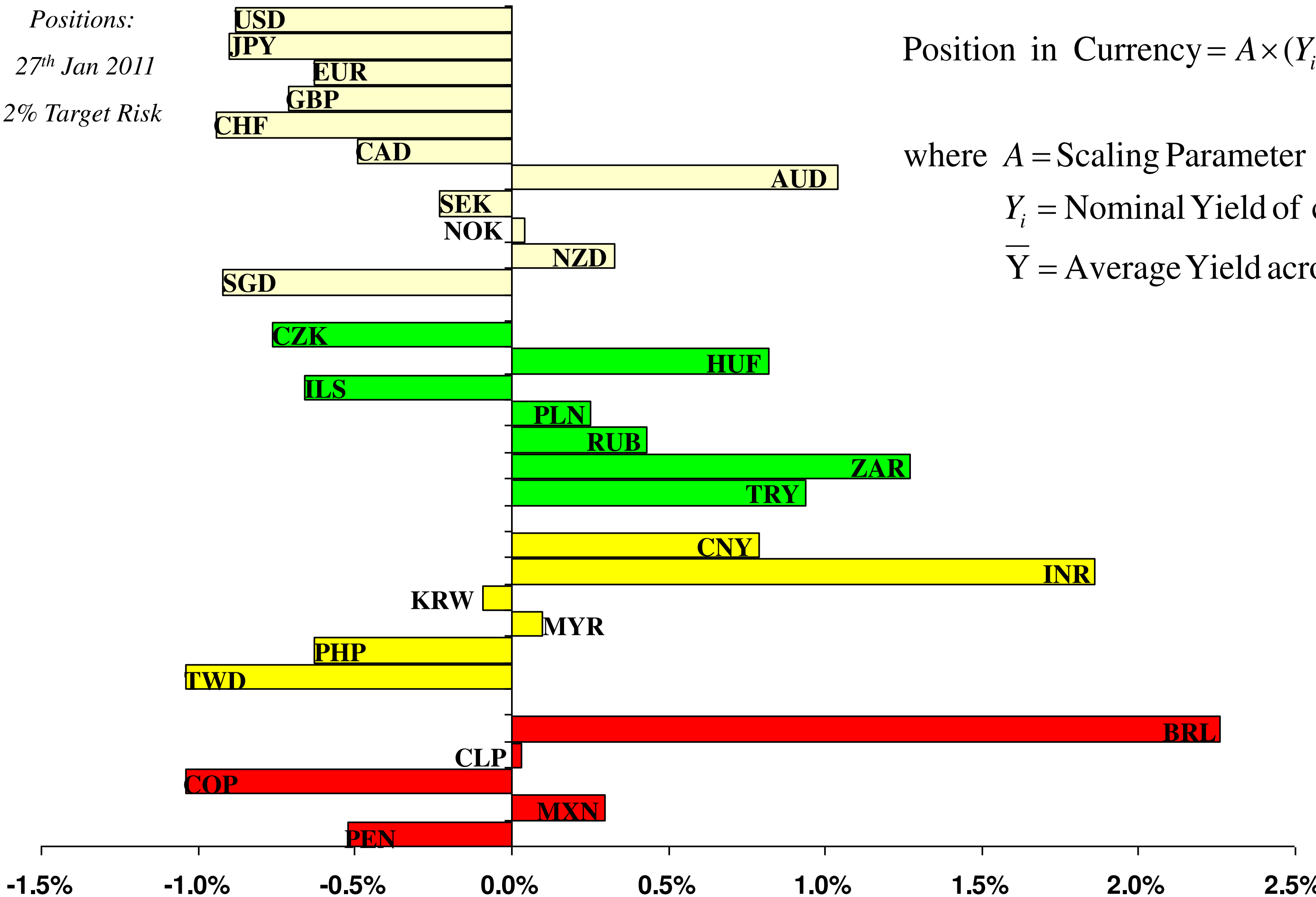


Investing in International Risk Premia

Positions:

27th Jan 2011

2% Target Risk



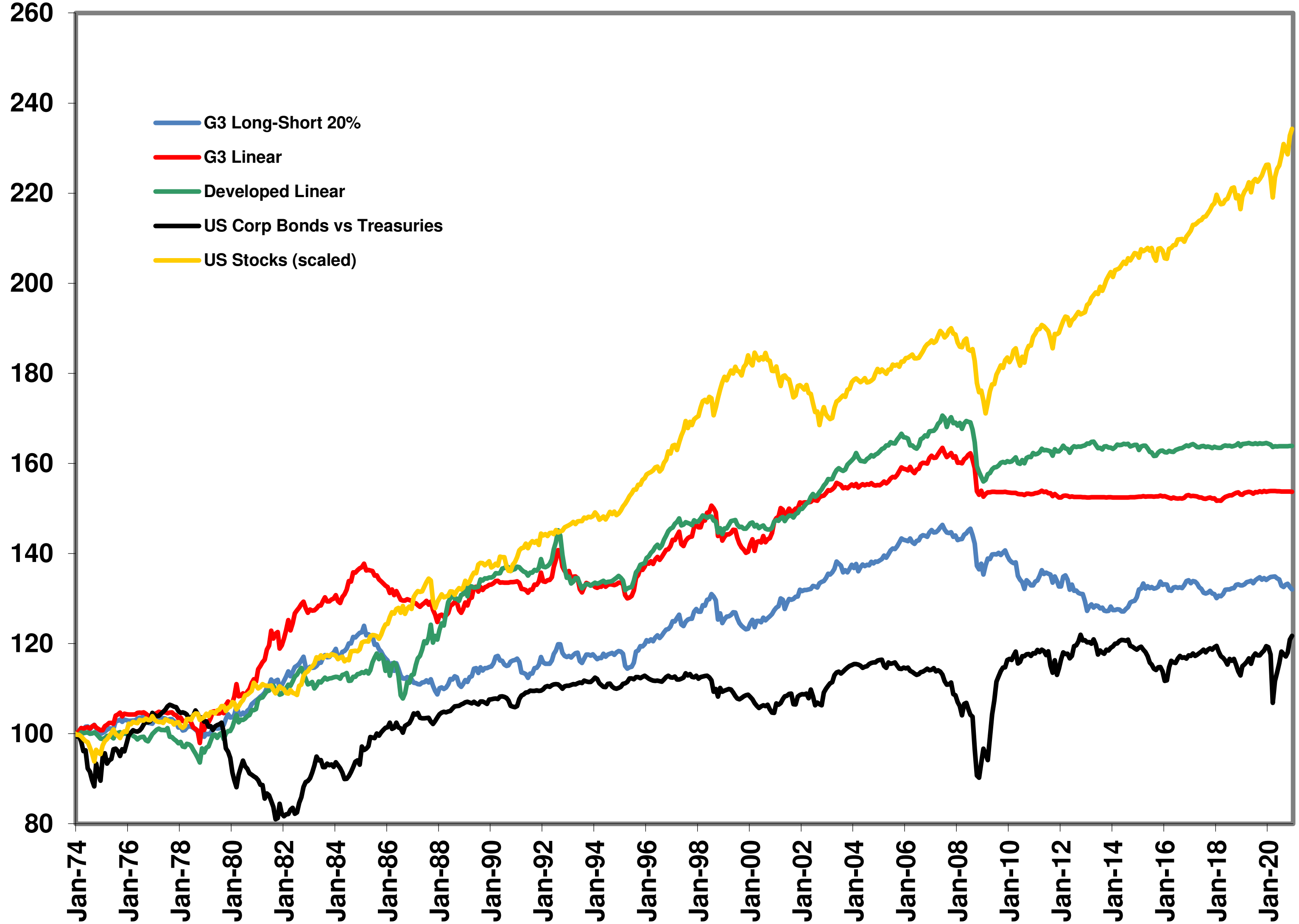
$$\text{Position in Currency} = A \times (Y_i - \overline{Y})$$

where $A = \text{Scaling Parameter}$

$Y_i = \text{Nominal Yield of currency i}$

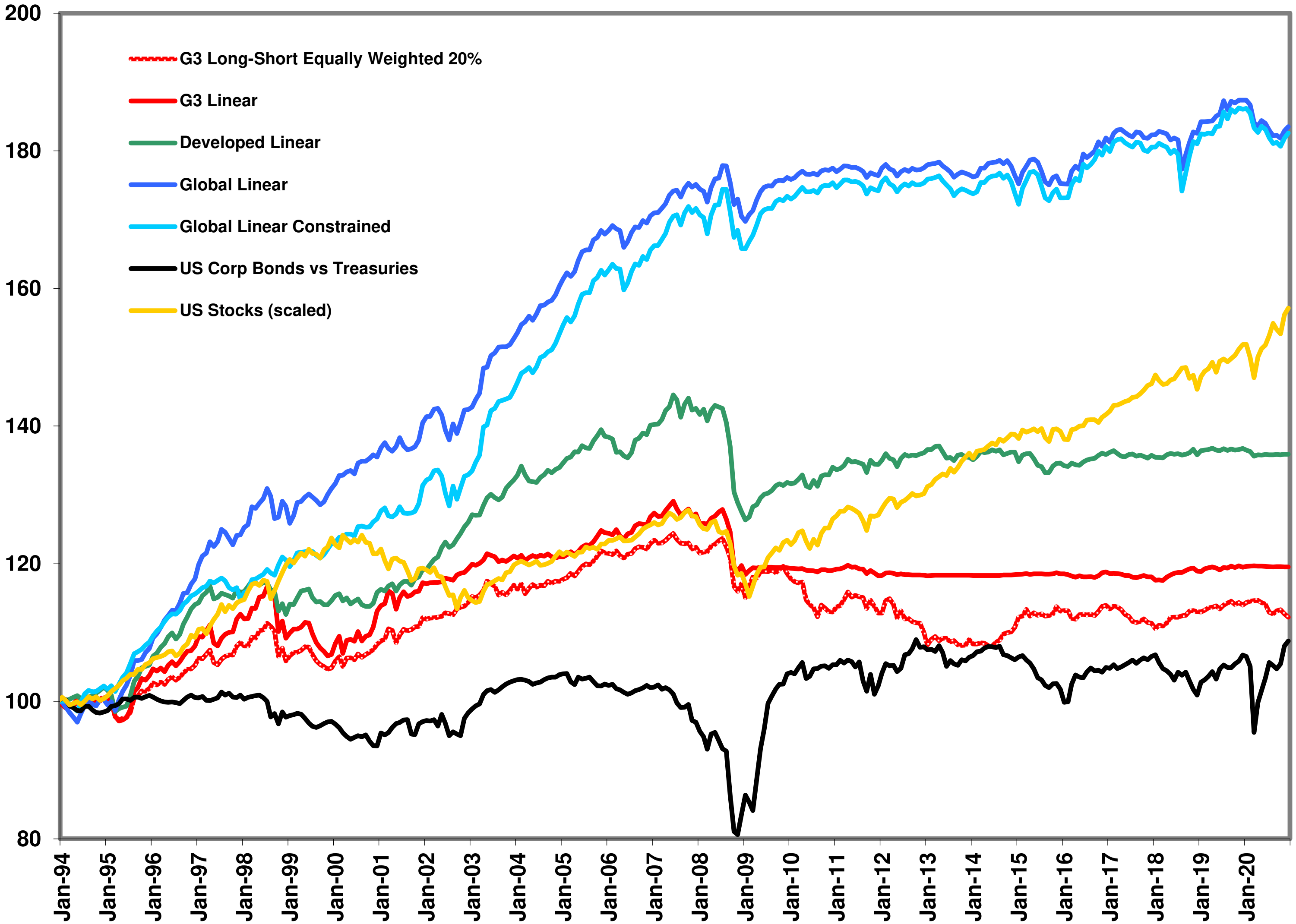
$\overline{\text{Y}} = \text{Average Yield across currencies}$

Cumulative Net Returns to International Risk Premia (1974 – 2020)



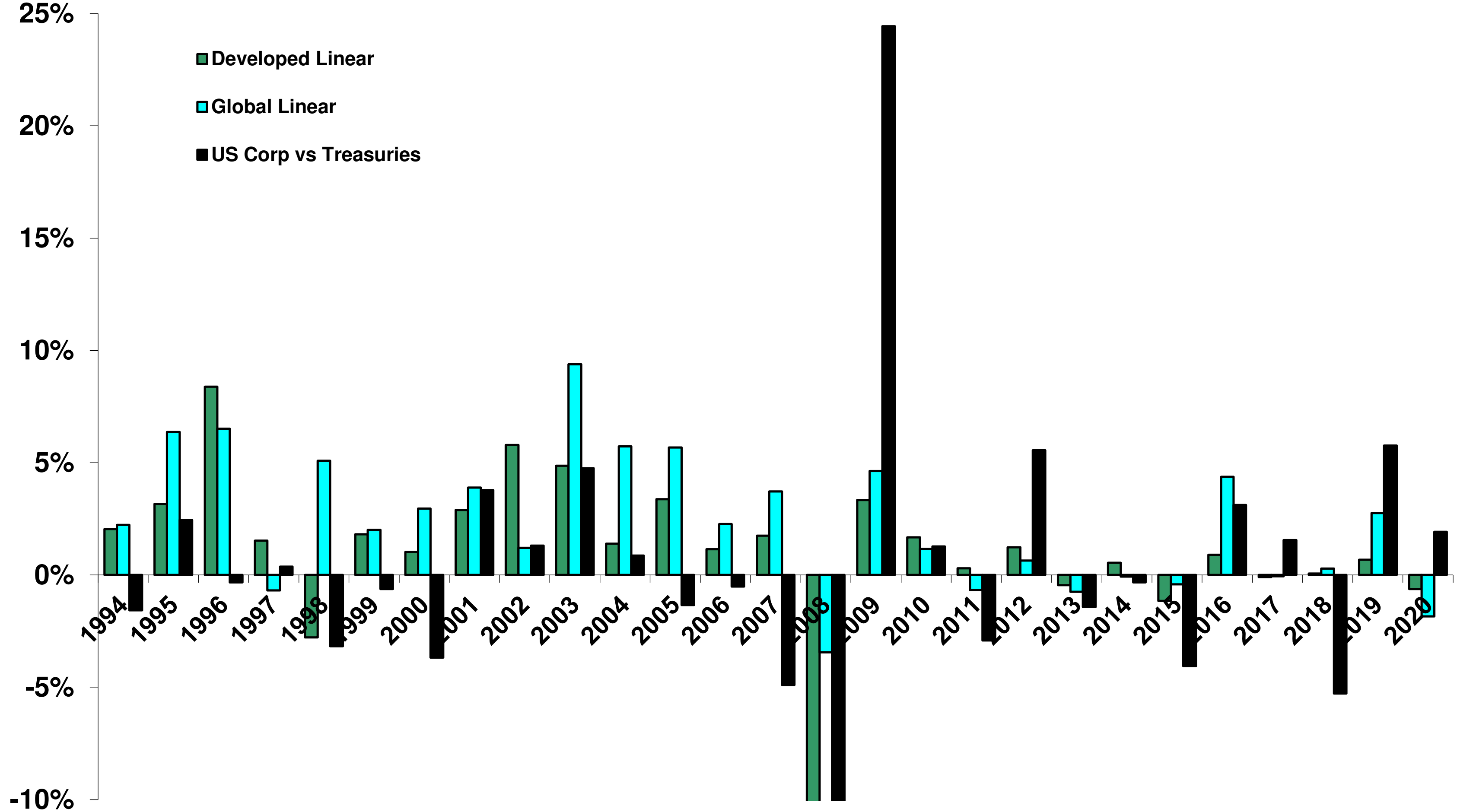
Return (% pa)	Risk (% pa)
1.84%	2.41%
1.08%	2.41%
0.94%	2.41%
0.62%	2.41%
0.51%	4.27%

Cumulative Net Returns to International Risk Premia (1994 – 2020)



Return (% pa)	Risk (% pa)
2.28%	2.33%
2.26%	2.33%
1.70%	2.33%
1.16%	2.33%
0.69%	2.33%
0.45%	2.33%
0.41%	4.31%

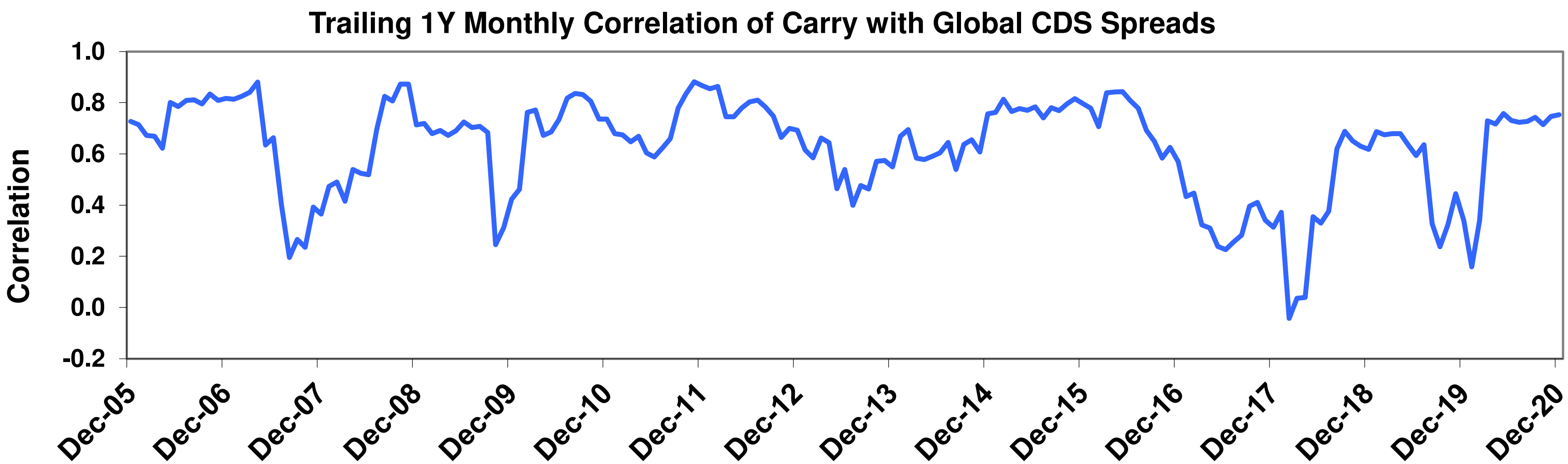
Annual Returns to International Risk Premia (1994 – 2020)



International Risk Premia are highly correlated with other risk premia

Correlations (Monthly 1997 – 2020)

	IRP
US Corporate Bonds over Treasuries	0.29
US Stocks	0.31
Japan Corporate Bonds over Treasuries	0.25
UK Corporate Bonds over Treasuries	0.25
Canada Corporate Bonds over Treasuries	0.29
Global Credit	0.28
Global CDS	0.61



Japanese, UK, Canadian, and Global Credit statistics calculated from 1997 – 2020. CDS statistics calculated from 2005 – 2020.

Source: Bank of America, CMA, Bloomberg, Thomson Reuters, Adrian Lee & Partners

International Risk Premia are an attractive separate asset class

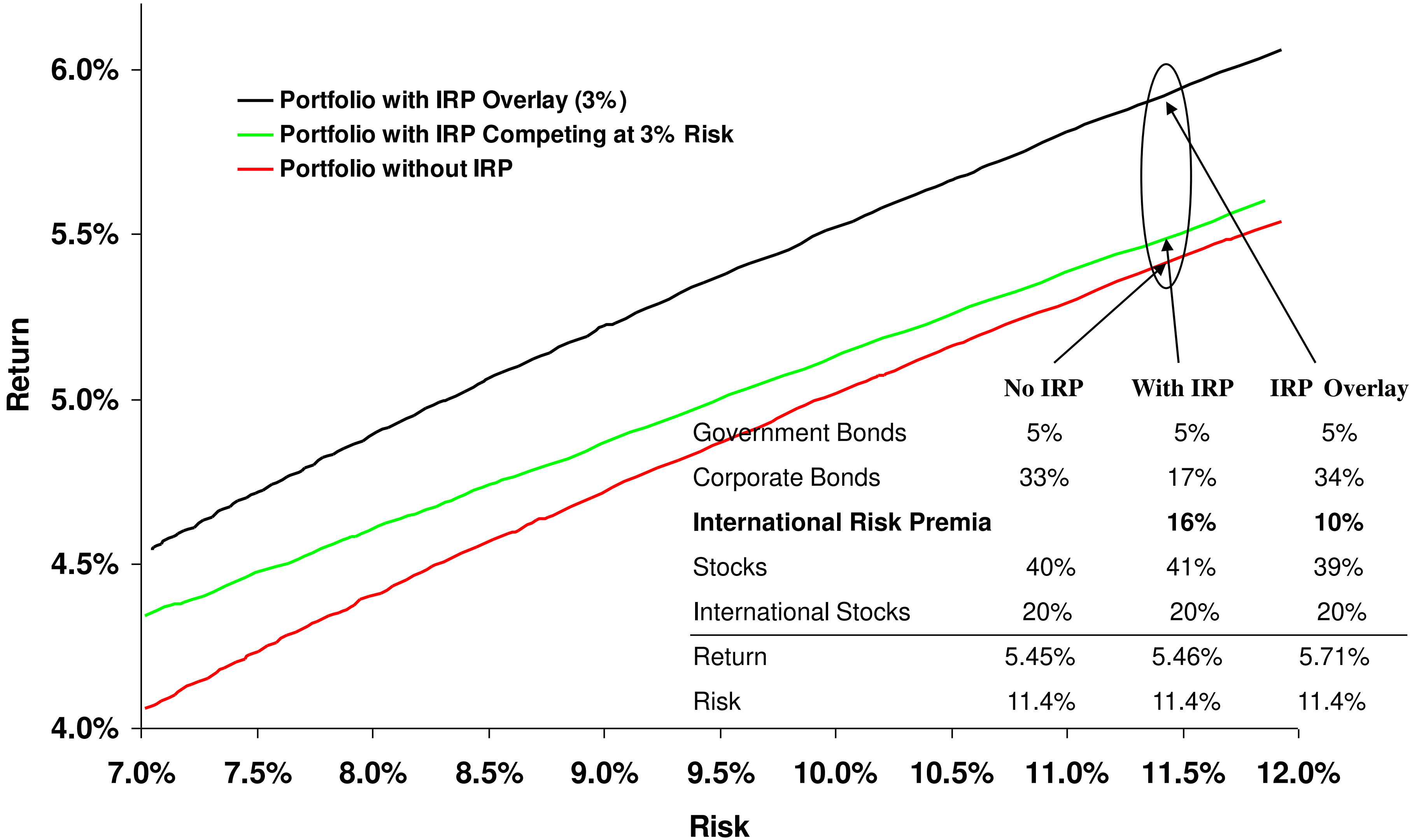
Asset allocation analysis – illustration:

	Expected Return	(Premium)	Expected Risk
Cash	1.0%	-	3.0%
Government Bonds	2.3%	(1.3%)	5.5%
Corporate Bonds	3.1%	(0.8%)	5.6%
International Risk Premia	**3.0%**	**(2.0%)**	**3.0%**
Stocks	7.0%	(6.0%)	18.0%
International Stocks	7.5%	(0.5%)	20.0%

Historical monthly return correlations (1997 – 2020)

Cash	1.00					
Government Bonds	0.19	1.00				
Corporate Bonds	0.17	0.91	1.00			
International Risk Premia	**0.08**	**-0.24**	**-0.11**	**1.00**		
Stocks	-0.05	-0.28	-0.03	**0.31**	1.00	
International Stocks	-0.05	-0.26	0.01	**0.30**	0.86	1.00

International Risk Premia (IRP) significantly improves investor opportunity set



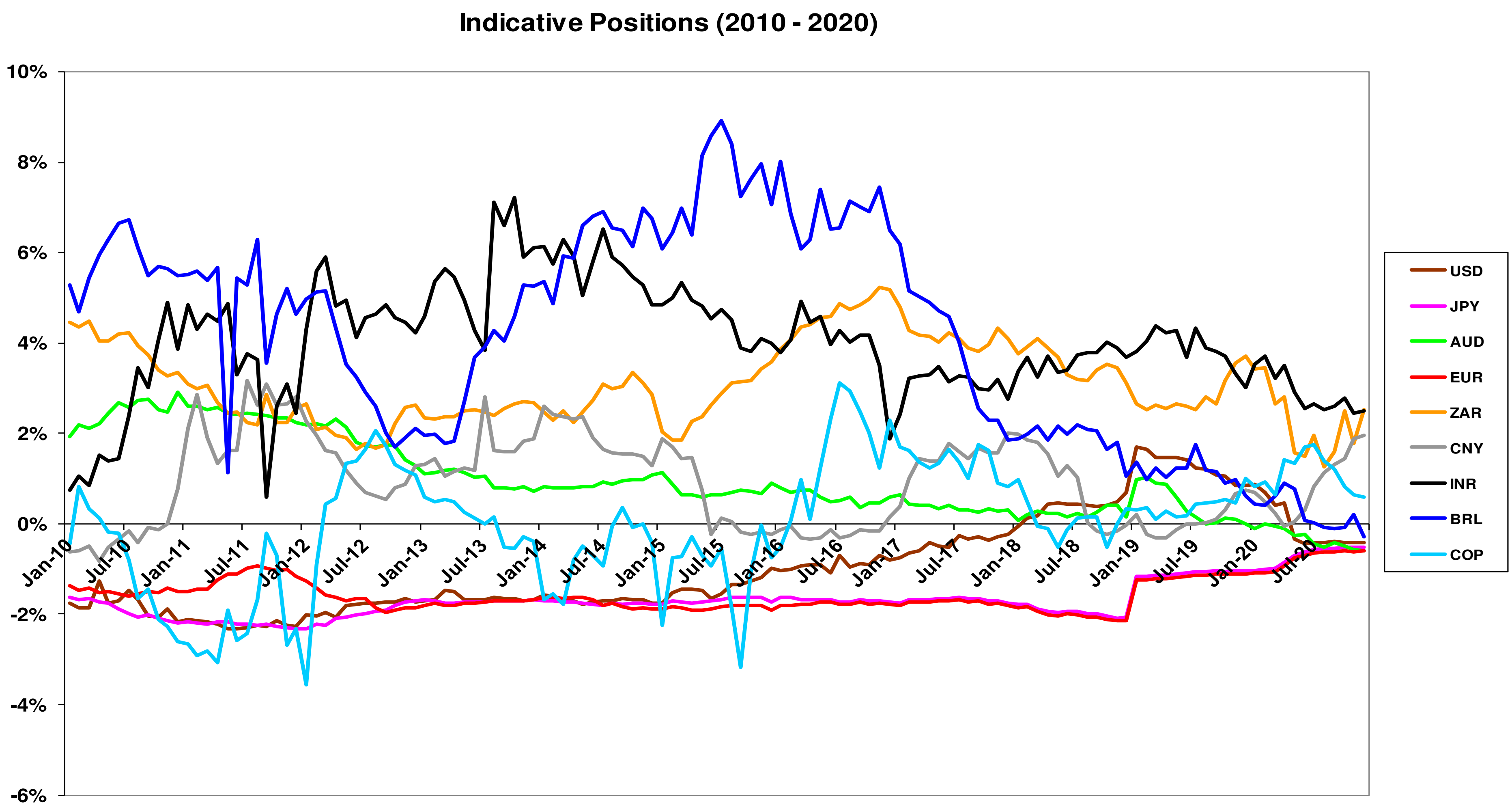
	No IRP	With IRP	IRP Overlay
Government Bonds	5%	5%	5%
Corporate Bonds	33%	17%	34%
International Risk Premia		**16%**	**10%**
Stocks	40%	41%	39%
International Stocks	20%	20%	20%
Return	5.45%	5.46%	5.71%
Risk	11.4%	11.4%	11.4%

Conclusions

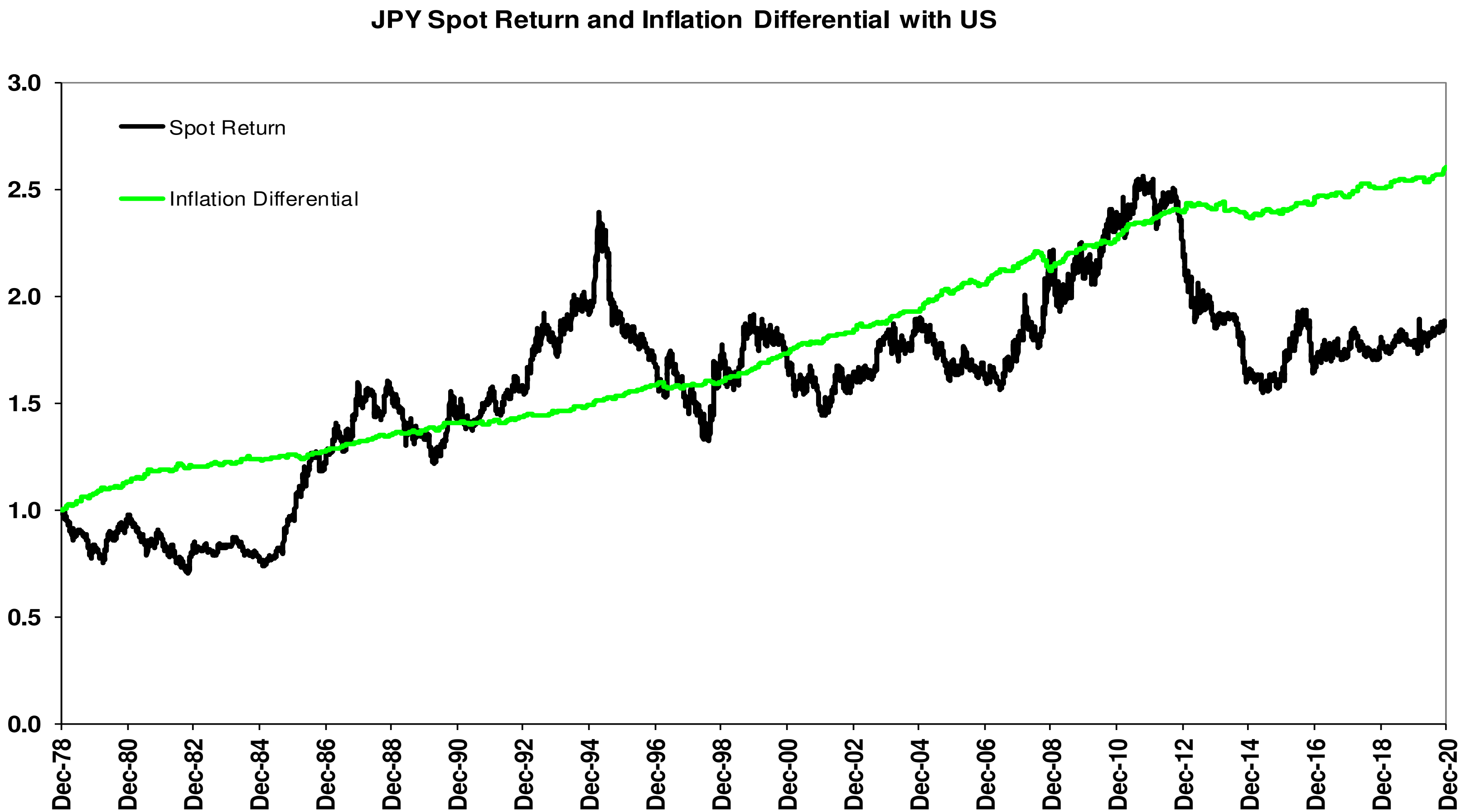
- International Risk Premia are a logical and attractive source of long term expected returns.
- These premia are highly diversified by asset class, country and region.
- They should form a significant part of an investor’s strategic asset allocation.
- They represent a natural extension to a global investment strategy.
- They can be accessed with zero additional capital.

Appendix

Illustrative Historical Positions for International Risk Premia – Global Constrained



International Risk Premia are left over after inflation



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