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*A reprinted article from November/December 2018*

## **PROS AND CONS**

### Currency Hedging Versus Not Hedging

*By Robert Colehan and Edward Baker*



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## PROS AND CONS

# Currency Hedging Versus Not Hedging

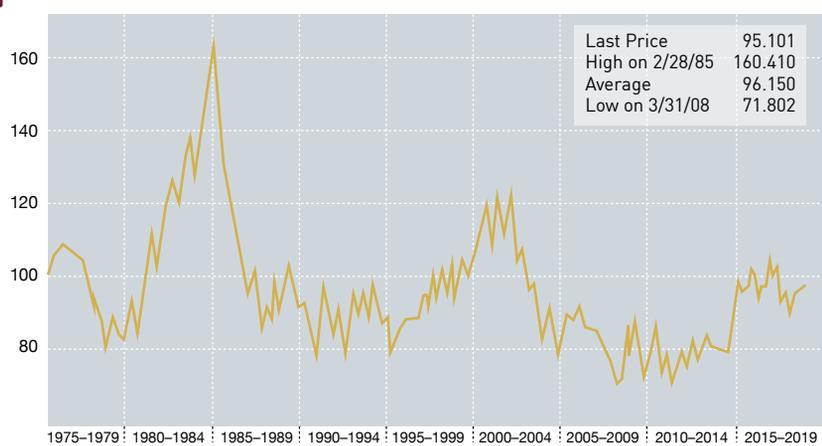
By Robert Colehan and Edward Baker

The globalization of financial markets has brought about opportunities for wider asset diversification and greater potential returns through international investment. Although investing across international markets does provide these benefits, it also introduces the unintended by-product of currency risk, which can have a significant impact on returns.

This article follows Colehan and Baker (2015), an article entitled “Is it Prudent to Invest Overseas without Any Currency Hedging?” The simple answer was, well it depends, because every investor has a different location, base currency, investment objective, risk profile, strategy, view, asset mix, and so on. This article does not explain how to hedge, beyond a brief description, but instead points out the advantages and disadvantages of hedging, principally from the point of view of a U.S. investor. Currency hedging is currently a relevant topic for U.S. investors, with the U.S. Dollar Index (DXY) having strengthened by more than 8 percent from 2018 lows at the time of writing. With the potential for global trade wars (the imposition of tariffs and barriers, allowing currencies to weaken as an offset), declines in emerging market equities, U.S. interest rates rising more quickly than in many other nations (interest-rate differentials are a major driver of currency prices), and several other potential drivers, it is likely that we will see further significant upside in the DXY over the coming quarters.

Figure 1

### U.S. DOLLAR INDEX (DXY) 1975–2018



Source: Bloomberg

### HISTORY OF U.S. DOLLAR MOVEMENT

If we look at the performance of the DXY since 1975, as presented in figure 1, we will note the DXY is currently at, roughly, the same level as at the beginning of the period in 1975. However, it has been fairly volatile over the period, with several sustained periods of strengthening and weakening. In particular, the DXY experienced a period of rapid weakening beginning in March 2002, reached a bottom in March 2008, and began a strengthening trend in mid-2014.

Is this recent strength part of a multi-year U.S. Dollar (USD) bull market and, if so, how far can it go? The two notable multi-year USD bull markets since the end of the fixed exchange-rate regime under the Bretton Woods system were 1979–1985, with an approximately

40-percent rally; and 1995–2002, with an approximately 60-percent increase in value (see figure 1).

### HOW U.S.-DOLLAR STRENGTH WILL IMPACT U.S.-BASED INVESTORS

The dollar must rally a long way before its impact is really felt at home by the average American. This is because compared to the eurozone, Canada, Australia, and other developed economies, the U.S. economy is relatively closed. The heart of U.S. economic activity is based on gains in household spending and stronger business investment and not from international trade.<sup>1</sup> Consequently a strong dollar has less impact on domestic growth than other countries' currencies have on their growth. Additionally, as the dollar rises, it could act as a magnet for foreign

direct investment flows, further benefiting the U.S. economy, which could result in a virtuous cycle. However, for U.S.-based investors investing outside the United States, any USD strength can have an immediate negative impact on performance.

Over the past decade or so, the non-home-country exposure of pension funds in many countries has expanded as these funds continue to broaden their investment universes.<sup>2</sup> Sensible as this may be for diversification purposes, it also has incrementally increased the funds' currency-risk exposures (whether by accident or design).

Foreign investing introduces the additional dimension of currency risk into the return equation. For a U.S. investor, the return on any investment in a foreign market is equal to the return on the investment in local currency plus the return of the foreign currency relative to the USD. When the dollar is strong relative to the foreign currency this can hurt total return, because the local currency translates into fewer dollars.

### WHAT IS CURRENCY HEDGING?

Currency hedging is a strategy that allows an investor in international assets to mitigate the foreign-exchange risks involved in investing overseas. This strategy aims to insulate investors from any loss in the value of the foreign currency exposures in the investment portfolio. It provides a payoff that is dependent on whether currencies rise or fall. Like any other type of risk mitigation approach, hedging has its pros and cons. As an investor, you need to decide whether the benefits of any such investment strategy outweigh the disadvantages.

There are several ways to hedge; the most common are:

- in-house,
- as part of a custodial agreement, and
- outsourcing to a specialist currency manager.

Each of these ways of hedging can use a number of different instruments, from the very simple forward hedge to very complex derivatives. The instruments typically used are foreign-exchange

forward contracts, currency swaps, and options. Forward contracts are agreements to lock in a specific exchange rate at a future date. Currency swaps involve the exchange of principal and interest in one currency for the same in another currency. Options provide a set rate at which the investor may choose to exchange currencies for a set period of time. Options require up-front premium payments; forward contracts do not. With swaps each party pays interest in the same currency as that of the principal received. All instruments also incur transaction costs.

Here is a very simple example of a forward hedge: Consider a U.S.-based investor with holdings in the Japanese Nikkei Index. Over the next year should the Nikkei appreciate 10 percent the U.S. investor is not assured of a 10-percent return in USD terms. If the USD appreciates by 10 percent, the investor would in fact net zero return, unless of course the investor hedged out yen exposure by selling the currency one year forward and repatriating that back into USD on expiry. A hedger always will buy the base currency (in this case the USD) and sell the currency of the country invested in overseas.

### TO HEDGE OR NOT TO HEDGE

Some argue that returns from currencies are a wash in the long run and that investing in currencies is a zero-sum game—so why bother hedging? If this were true and if investors have very long time horizons, managing currency exposures simply would result in uncompensated costs. This may be true in the extreme long term (20-plus years), but few investors are likely to be willing to ride out the impact of large shorter-term currency movements. Also, this argument doesn't take into account that large devaluations and revaluations potentially can lead to very long-term unrecoverable losses after moving from levels that are unlikely ever to be seen again. The fact is that currency risk changes the overall risk profile of a portfolio and thus directly impacts portfolio returns

Table  
1

### COMPARISON OF HEDGED VS. UNHEDGED MSCI EAFE INDEX RETURNS

USD Bull Market		
April 1995–February 2002	Hedged	Unhedged
Annualized Return	7.87%	0.11%
Standard Deviation	14.75%	14.75%
Information Ratio	0.53	0.01
USD Bear Market		
March 2002–March 2008	Hedged	Unhedged
Annualized Return	2.86%	10.53%
Standard Deviation	13.66%	13.24%
Information Ratio	0.21	0.80
Full Cycle		
April 1995–March 2008	Hedged	Unhedged
Annualized Return	5.51%	4.93%
Standard Deviation	14.22%	14.14%
Information Ratio	0.39	0.35

*Note: Past returns are not necessarily indicative of future returns. Future returns may materially differ from those shown above.*

*Source: Colehan and Baker (2015)*

and volatility. These impacts are most noticeable in the shorter term (0-10 years) and few investors can afford to wait out a whole investment cycle especially in the case of pension funds, when they have to manage declining funding ratios and increasing liability risks.

There is no consensus on the proportion of risk attributable to foreign currencies in a portfolio. However, a reasonable approximation for the longer-term relationship would be that 90 percent of the risk (i.e., volatility of returns) in international bond portfolio returns (perceived as a low-volatility asset) and 20 to 30 percent of the risk in international equity portfolios (perceived as a higher-volatility asset) is attributable to currency (Middleton 2009). These estimates depend on the sample period, asset mix, and base currency, but they provide some perspective on the potential impact that foreign-exchange fluctuations can have on the risk-return profile of international investments. Table 1 shows returns of the hedged and unhedged MSCI EAFE<sup>3</sup> Index over the most recent full USD business cycle to illustrate the impact of currency movements on a U.S.-based investor.

The numbers speak for themselves; the stark difference in risk-adjusted returns for a U.S.-based asset manager, depending on the prevailing foreign-exchange environment, shows just how important a component a hedging strategy can be. Based on the data, hedging out the non-USD currency exposure in secular USD bull markets and remaining unhedged during periods of secular USD weakness was the most optimal strategy over the time period. However, a fully hedged strategy over the full cycle shown in table 1 offered only marginally better risk-adjusted returns and no reduction in risk in this particular instance. An investor could, therefore, be forgiven for dismissing the need to hedge over a long time horizon in the spirit of the “it’s a wash” argument. However, we would counter that this is not the case. The ideal alternative would be a

dynamic hedging program that is able to assess when to hedge and when not to hedge. The increased role foreign asset holdings now play in the portfolios of U.S.-based investors means that the management of their foreign-exchange exposures is now crucial.

If one doesn’t hedge and doesn’t have a view, how much regret will be suffered? Hedging can minimize regret.

- It doesn’t have to be a fixed hedge ratio. Over the past few years the different types of hedging solutions available have grown significantly. In

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### WHAT ARE THE ADVANTAGES AND DISADVANTAGES OF CURRENCY HEDGING?

In this section, we present the arguments for and against currency hedging as well as several points related to currency hedging implementation. These points apply to any international investor and not just one based in the United States.

First, the pros:

- Currency hedging can provide both risk reduction and a greater certainty of portfolio returns.
- Peer comparisons can be improved with an efficient hedging program. This could lead to positive knock-on benefits for marketing and raising assets. However, it is equally true that poor currency management can adversely impact a portfolio’s performance.
- Currency hedging enables the foreign value of offshore investments to remain closely approximated to the base currency. In this case, a million dollars is still a million dollars regardless of the relative movements of the underlying currencies.
- Removal of stress and regret. Most investors dread losses from unfavorable currency movements more than they relish gains from beneficial ones.

addition to traditional passive hedging with a fixed hedge ratio, there are also dynamic and active overlays where overall or individual currency hedge ratios can change, and there are other strategies available from the very simple to the incredibly complex.

- Hedging doesn’t have to be expensive in terms of transaction costs. Currency forwards are very liquid and a relatively inexpensive way to hedge.
- Hedging doesn’t necessarily require costly fees. Most outsourced overlay mandates are relatively cheap in terms of fees. Management fees should not be considered in isolation but in comparison to what a hedging policy can do to reduce currency risk and add to returns. Investors should evaluate their investment objectives when determining a low-cost passive hedge or a more expensive (and flexible) active hedge. With the free-of-charge offer that often comes with custodian-bundled packages, investors need to be aware that the fiduciary responsibility found in other elements of the custodial contract does not always apply to the currency trading part because the clients’ and the custodians’ interests are not aligned when it comes to execution; thus clients should expect increased transaction costs relative to alternative implementation options.

- For a defined benefit pension fund, properly managed currency exposures may make the difference in achieving funding levels through making more efficient use of risk budgets. These potential additional returns and risk rationalizations come at a relatively low cost and can be gained without impacting the underlying asset allocation.
- Defined benefit pension funds hold a specific set of assets to match liabilities. Almost all pension liabilities are defined in terms of the pension fund's home currency. Investment in cross-border assets represents a potential mismatch between assets and liabilities of the pension fund, and hedging this currency risk may reduce the impact of the mismatch.
- A successful currency manager can design a bespoke hedging program. The hedging strategy can exclude investments that are less impacted by currency movements and make the hedge more efficient, limits can be placed on the range of the hedge ratio, and a whole host of other variables can be altered to suit the investor's individual requirements.
- It makes good sense to hire an investment manager with a core competence in currency management to oversee the foreign currency hedge. Most investment fund managers are chosen for their proven expertise in equity or fixed-income markets, not their currency-management skills. Outsourcing can compensate for this lack of knowledge and improve the management and awareness of currency risk in a portfolio. It is very difficult to accurately predict currency swings and because money managers put most of their efforts into evaluating the securities owned, their funds' performances should be driven by their asset selection ability rather than positive or negative currency movements. Investors who do not have the time to monitor and check their hedges also can benefit from outsourcing.
- Risk-management tools used in other asset classes are not always applicable

to foreign exchange due to the differences in the character of the underlying distributions. An expert currency manager is aware of this.

- At a time of virtually zero returns from fixed income, an unhedged portfolio is basically a currency portfolio rather than a bond portfolio. In effect the investor gets an asset with almost zero expected returns and substantial volatility.
- Currency hedging offers the opportunity to lock in favorable currency moves.

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*Beliefs are crucial, if any are held. If the investor believes that a foreign currency will appreciate relative to the base currency, then investing in unhedged securities is probably more suitable.*

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Secondly, the cons:

- Currency hedging can remove some or all of the favorable movements in the exchange rate depending on the hedge ratio used.
- Beliefs are crucial, if any are held. If the investor believes that a foreign currency will appreciate relative to the base currency, then investing in unhedged securities is probably more suitable.
- It is almost impossible to estimate the implied risk attributable to currencies in an international portfolio. For example, many large international companies in which a fund might invest are not pure plays on the country in which they are listed but may be international in their own right and have multi-currency flows and engage in their own hedging strategies. Hedging such holdings isn't necessarily straightforward.
- Returns from currency trading can be more difficult to quantify than returns

on other assets, such as equities or bonds, because there are always two moving parts as well as relative interest rates, the impact of margin, and the cost of capital.

- Less-liquid currencies, namely those of emerging markets, are usually more costly in terms of transaction costs, negative carry, and, if applicable, margin.
- Cash-flow mismatches are also a potential downside of hedging. Currency hedging may produce positive or negative cash flows when the currency forwards mature depending on the performance of the hedge, which is typically independent of the cash flows from the assets being hedged. This situation becomes somewhat more risky for portfolios holding illiquid hedged assets because cash cannot easily be raised to pay for a losing hedge, so some cash may need to be kept uninvested (or invested in liquid assets that can be sold on short notice) if sufficient internal reserves or loan facilities are not available, and this has corresponding opportunity costs. With extreme movements in base currencies, these amounts can be significant.
- Longer-term tracking error. The valuation of hedging instruments may not accurately reflect the value of the underlying investments, particularly if the underlying assets are hard to value or only valued periodically. Periodic rebalancing between the hedge and the assets is necessary to avoid slippage because the local currency value of the assets changes but the hedge amount remains fixed.
- Shorter-term tracking error is typified by the divergence between the investor's theoretical hedged benchmark and the implemented portfolio's actual returns. This tracking error results from several factors; the most obvious of these results from active management decisions made by the currency manager. Short-term price movements also can lead to divergence, and tracking error usually occurs when movements lag between

underlying assets and the resulting foreign-exchange positions. For example, if equity trades are executed in the morning and the foreign-exchange trades aren't transacted until late afternoon, this time lag will result in differences between portfolio and benchmark performance.

- Determining the correct benchmark is not necessarily a simple task. The benchmark should be the standard against which active risk is taken and performance is assessed. Myriad published indexes are available for use as a benchmark and it is important to use an appropriate one. The default option is typically the MSCI World ex the home country, but customized benchmarks also can be used.<sup>4</sup>
- What is the correct hedge ratio? The most fundamental question that an international investor must address is whether to hedge currency exposure and, if so, by how much. This leads to the concept of a hedge ratio, which is defined as the portion of a position targeted for protection by a hedge versus the overall position. Hedge ratios will vary among investors and depend on their objectives, risk appetite, asset mix, and the underlying benchmarks.
- Should the hedge ratio be fixed or dynamic? Often the investor will specify a range for the hedge ratio, which will serve as a constraint when the hedge is actively managed. The default position is often a static 50-percent hedge ratio. Unlike the 100-percent or fully hedged position, a 50-percent hedge ratio allows the investor to benefit to some extent when foreign currencies appreciate relative to the base currency. Consequently, it is often referred to as the hedge of least regret. A static hedge ratio is aimed at reducing currency risk in a portfolio over the longer term. Hence, from an overall perspective it may be inappropriate in the shorter term, because in periods of high currency volatility a full hedge would be preferred, and when currencies deviate significantly from long-term fair

value an unhedged position may be more attractive.

- An investor's clients and other parties of interest may not like or understand hedging, and the benefits can be hard for them to see, particularly when the hedges are losing money.

## CONCLUSION

Currency management can play an important part in portfolio management, particularly as investors access a greater range of international investments. Hedging can help to lower risk in a portfolio and the decision to hedge or not to hedge depends on the characteristics of the asset class of the investment, the risk and return objectives of the investor, and how the investor views the pros and cons listed above.

Investors in international shares may be willing to accept some currency risk, and a higher level of portfolio volatility, in exchange for a greater potential return. For more defensive asset classes, such as property and fixed interest, however, hedging may be a better long-term portfolio management strategy.

With the current unsettled global environment, we see significant differences in outlook among regions and currencies. This suggests that the currency markets appear set to remain volatile. Given this, we expect to see increasing demand for more flexible approaches to currency exposure management than those that are now widely used. As a result, investors and consultants will most likely re-appraise their assessments of currency exposures and how they should be handled. ●

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## ENDNOTES

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2. "International Investment by Pension Funds Increases Globally but Is Still Restricted in Some Markets," press release, Association of the Luxembourg Fund Industry (September 16, 2015), <http://www.afli.lu/node/3019>.
3. The MSCI EAFE Index is an equity index that captures large and mid-cap representation across the developed market countries around the world, excluding the United States and Canada.
4. The MSCI World Index is a broad global equity index that represents large and mid-cap performance across 23 developed markets countries.

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