Is It Prudent to Invest Overseas without Any Currency Hedging?

By Robert Colehan and Edward Baker

Is it prudent to invest overseas without any currency hedging? The simple answer is, well, it depends, because every investor has a different location, base currency, investment objective, risk profile, strategy, view, asset mix, etc.

Colehan and Baker (2011) discussed how globalization of the financial markets has brought about opportunities for wider asset diversification and greater potential returns through international investment. They highlighted that 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 investment returns. Colehan and Baker (2013) discussed the use of currency overlay management.

For U.S. investors in particular, currency hedging is a relevant topic because of significant changes in the value of the U.S. dollar compared to other currencies. For the past 30 years the U.S. dollar generally has been falling (see figure 1); it bottomed out some time in 2008 but then turned a corner in mid-2014 and is now up by about 25 percent in mid-2015.

Expected tightening from the U.S Federal Reserve, stronger relative growth of the U.S. economy versus its peers, increasing energy independence for the United States, and other well-documented factors help explain why the U.S. currency is rising in relative value. In fact, the consensus among commentators appears to be that we have entered a multi-year U.S. dollar (USD) bull market.

Why is this important to a U.S.-based investor? Historically, USD bull markets have lasted for multiple years; the two most recent were 1995–2002 and 1979–1985. History may not repeat itself, but we may well be in for four or five years of further significant USD appreciation.

Prior to this turning point, the hedging of offshore assets into USD has provided a significant negative impact because the hedges generated losses, partially offsetting capital gains from overseas investments (depending on the hedge ratio). However, it is important to note that when fully hedged, any gain (or loss) in a portfolio’s underlying currency exposures is fully offset by a corresponding matching loss (or gain) in the hedge position. As a consequence, fully hedged portfolios effectively have no foreign currency exposure. It is in the context of a dollar rally that this article will attempt to answer the question of whether it is prudent to hedge overseas investments. The article covers the following questions:

1. What are the benefits of investing overseas?
2. What is currency hedging?
3. Why do some investors hedge?
4. Why do some investors decline to hedge?

What Are the Benefits of Investing Overseas?

Investment portfolios often are characterized by a significant and rising exposure to foreign assets, thus portfolio managers are confronted with increased currency risk. But why is this?

A typical investment fund holds around 40–60 percent in equities, and approximately half of that will be invested in overseas equities. Fixed-income holdings also will have a sizeable proportion allocated overseas.
The strategic decision to allocate a high percentage of the portfolio to international assets is probably not based upon the view that the local currency will appreciate or depreciate against other currencies. This decision is most likely based on the need to diversify the portfolio to reduce risk, or to pursue higher returns than those available domestically.

**What is Currency Hedging?**

Currency hedging is any risk-management technique that seeks to reduce foreign-currency exposures and lower a portfolio’s risk due to currency fluctuations. Most investors dread losses from unfavorable currency movements more than they relish gains from beneficial ones.

An investor that purchases unhedged overseas assets effectively is holding assets denominated in the foreign currency. As a result, the value of these assets in USD may be affected by changes in the value of the USD relative to the value of the foreign currency.

For example, if the USD declines against the Japanese yen and asset prices remain unchanged, a yen-based asset rises in USD terms. Conversely, if the USD strengthens and asset prices remain the same, the investment falls in value.

From an investor’s perspective, currency hedging enables the USD value of offshore investments to be protected from exchange-rate changes.

Protection strategies, such as passive and dynamic hedging, are forms of currency hedging that reduce the risk of currency exposure. Managers may choose to fully hedge currency exposure, removing any impact from currency fluctuations; or they may partially hedge in order to achieve a result somewhere between that of a fully hedged portfolio and an unhedged portfolio. The main instrument used in most hedging strategies, and the one used for examples in this article, are forward foreign-exchange contracts. A common expiration period for a forward contract is 90 days, though longer and shorter time periods are also available.

Investor regret is an important factor when considering a possible foreign-currency hedging strategy. If the foreign currency risk is ignored, investors are likely to suffer regret when the local currency strengthens. On the other hand, if they fully hedge they will face regret when the local currency weakens.

It's almost impossible to estimate the amount of risk attributable to currencies in an international portfolio because the major asset classes all have different characteristics and the mix of assets within these portfolios also have different characteristics. For example, the amount of risk due to currency fluctuations for an emerging-market corporate bond is likely to be quite different from that for a developed-market sovereign bond.

The relative asset class volatilities are an important consideration when making a decision about hedging. The relative volatility of foreign exchange compared to that of the underlying overseas asset class needs to be considered, because it may be that left unhedged, return volatility in an overseas asset is mainly dictated by the foreign-exchange risk. In this case, it may be optimal to increase hedging to reduce the overall volatility. Thus, in general, a lower volatility asset class, such as fixed income, tends toward being fully hedged and a higher volatility asset class such as equities tends to be only partially hedged (emerging-market equities often are left unhedged, for reasons we will discuss later). With this in mind, currency fluctuations can account for as much as two-thirds of the volatility of the total return of international bonds, making them act more like stocks. Therefore, keeping currency fluctuations to a minimum via hedging can provide international bond investors with the benefits of diversification over the long term because interest-rate and inflation patterns in other countries’ bond markets differ from those in the United States. These differences cause non-U.S. bond markets to behave differently than the U.S. bond market. As a consequence, an unhedged international bond investment might actually increase the risk of a portfolio, because an investment portfolio of unhedged international fixed-income securities is basically a basket of currencies offering uncompensated risk.

For this reason, an international fixed-income portfolio typically has a higher hedge ratio than we observe with higher-volatility equities.

Investors may mitigate two kinds of risk with currency hedging: capital value risk and income/transaction risk. For a U.S.-based investor, capital value risk is the risk that the capital value of the investment will fluctuate as a result of movements in exchange rates as the value of foreign currency is converted into U.S. dollars. If a U.S.-based investor holds a yen investment and if the USD value rises relative to the yen, then measured in USD the yen investment is now worth less than before.

Income or transaction risk is the risk that arises when a payment is due in a foreign currency but then converted to USD. The risk is that by the time the investor receives the payment, the currency value of the income generated offshore will be reduced when it is converted back into USD due to a rise in the USD exchange rate.

Currency hedging is important for all asset classes such as equities, fixed income, and property. Fixed income and property generally are purchased for their defensive characteristics, because income rather than capital is the major driver of their expected returns. Because currency changes can increase portfolio volatility, it is common to fully hedge these two asset classes to remove exchange-rate risk. With equities, it is more common to partially rather than fully hedge the exposure. The decision to hedge or not to hedge can have a significant impact on a fund’s performance. Hedging enables a fund to offset the exposure on assets and also achieve relatively standardized performance across currency share classes.

To illustrate the impact of currency hedging, it is useful to compare hedged versus unhedged returns over the most recent USD bull and bear cycles and over the full term using the Dollar Index. These comparisons are shown in Table 1, which shows returns of the hedged and unhedged MSCI...
EAFE Index over the last full USD business cycle. We chose the MSCI EAFE Index because it is an equity index that captures large- and mid-cap representation across developed-market countries worldwide excluding the United States and Canada.

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 that currency hedging can be quite important. With the benefit of 20/20 hindsight, hedging overseas currency exposure in a cyclical USD bull market and remaining unhedged during periods of USD weakness is obviously the best possible strategy. A fully hedged strategy over the past full business cycle offered only marginally better risk-adjusted returns and no reduction in risk in this particular instance. Therefore, an investor could be forgiven for dismissing the need to hedge over a very-long-term horizon. We would counter that this is absolutely not expected to be the case. The above example uses a static hedge ratio but the ideal scenario would be to implement a dynamic/active hedging program that is able to assess when to hedge and when not to hedge. Furthermore, talking about long-term investment horizons is somewhat academic: Few investors can afford to wait out an entire investment cycle (in this case 13 years) to recoup large losses resulting from currency devaluations.

Even with the statistical benefits detailed above in mind, currency hedging is not suitable for every international investor.

Why Do Some Investors Hedge?
Recall that every investor is unique and has different reasons for deciding to hedge (or not). Either choice is an important strategic decision because currency can have a substantial impact on risk and return in global investment portfolios.

Currency hedging can be used to alter the risk profile of an international investment portfolio by allowing for the possibility of an increased allocation of the risk to more profitable asset classes. Most institutional investors have a specific risk budget for their investments. If the volatility from currencies can be removed, the risk budget can be re-allocated among those asset classes that fall under the core competency of fund managers. Most investment fund managers are chosen for their proven expertise in equity or fixed-income markets, not their currency management skills, so it might make sense to outsource the currency hedging to a specialist.

An investor’s outlook is important; if an investor believes that foreign currency will depreciate relative to the USD, then currency hedging may be seen as a viable solution to mitigate losses.

Consideration also must be given to the investment time horizon. Currencies are more prone to diverge from equilibrium in the short term than over the long term. Given the higher currency volatility over shorter or medium horizons, hedging may help to eliminate noise. Hedging currency exposures may allow investors to attain their goals if they value stability and are seeking to reduce short-term downside risk.

With regard to cost, on the whole, currency forwards are very liquid and therefore are a relatively inexpensive way to hedge.

Pension funds hold a specific set of assets to match liabilities. Almost all pension liabilities are defined in local currency. Investment in cross-border assets represents a mismatch between assets and liabilities of a pension fund, and hedging this currency risk may reduce the impact of this mismatch.

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 you are getting an asset with almost zero expected return and lots of volatility.

The decrease in fixed-income returns and the recent equity market turmoil justify a strong interest in the protection of asset returns, and this is where hedging can be useful.

Why Do Some Investors Decline to Hedge?
Like most things in life, the decision about whether to hedge has a flip side, too.

So, why not hedge all equity investments? Perhaps the exact currency exposure of the underlying investment is hard to determine. For example, many large international companies in which a fund might invest are not pure plays on the country in which they’re listed but international in their own right. Hedging such holdings isn’t necessarily straightforward.

Or a fund may be invested in emerging markets because the investor wanted some currency exposure in the first place (though

| Table 1: Comparison of Hedged vs. Unhedged MSCI EAFE Index Returns |
|----------------------------------------|-------|-------|
| **Previous 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  |
| **Last 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  |
with the recent large flows into emerging markets some funds have begun to hedge these exposures, because investments in developing economies now account for a greater proportion of their portfolios. But generally speaking, international investors expect emerging-market currencies to strengthen as the stature of these economies improves. For that reason, they’re less inclined to hedge such positions.

Sometimes those currency fluctuations can be beneficial to investors. In such cases, currency hedging would counteract any profits due to favorable movements in the exchange rate.

If an investor believes that a foreign currency will appreciate relative to the USD, then investing in unhedged securities is probably more suitable. In this case, if the outlook proved to be correct, the investor would receive returns on the underlying security and gains on the currency.

Other reasons for not hedging currency exposures may include lack of knowledge or expertise. Investors may be unaware that the risk exists, or they may know that it exists but believe it is trivial.

Investors may believe that currency hedging costs too much. On the whole, currency forwards are very liquid and offer a relatively inexpensive way to hedge. However, for underlying currencies that are less liquid, such as those for emerging markets, hedging foreign-exchange exposure may be more costly and less efficient. These higher costs have the potential to diminish returns over time. Costs associated with hedging currency may include bid/ask spreads, carrying costs, and margin. Investors should evaluate whether the cost of a hedge outweighs the currency’s potential downside risk.

Cash-flow mismatches are also a potential downside of hedging. Currency hedges may produce cash flows independent of the assets being hedged. The change in value of hedged assets attributable to exchange rates should approximately offset the change in the value of the hedge itself, but the hedge position may create interim negative (or positive) cash flow needs as the forward currency positions are rolled forward. The situation becomes somewhat more risky for portfolios holding illiquid hedged assets. In such a case, a losing hedge position will produce negative cash flows that may not be recoverable immediately in terms of realizable value of the hedged assets. Cash flow implications for the portfolio might be one reason that some pension funds do not hedge currency investments. The forward contract would be in favor of the investor if the local currency depreciates with respect to the foreign currency, and vice versa if it appreciates. If there is a negative cash flow effect from the forward contract, underlying investments might need to be sold or extra cash may need to be paid to settle losses. However, an outflow of cash is merely the response to an unrealized currency gain in the portfolio.

Whether currency hedging is a zero-sum game is a continuous debate that entertains the questions of whether one participant’s currency gain is another’s loss and whether transaction costs make it a negative-sum game.

One argument holds that the impact of currency exposure is a wash over the long term as currencies go through offsetting weakening and strengthening cycles. This may be correct over a very long period, say 10 years or more, but investment horizons are normally much shorter, and therefore the impact of currency fluctuations should not be ignored. Few pension funds are likely to be willing to ride out a large short-term currency move resulting in a significant loss. Such large devaluations/revaluations can sometimes lead to very-long-term unrecoverable losses.

There are many types of participants in the currency markets and they have different views on how gains and losses are defined. For example, one participant may define returns relative to a benchmark, another may judge returns as a total return percentage, another as cash profits and losses, and others may have completely different investment time horizons or measure returns after adjusting for risk. Some seek nonmonetary gains (e.g., central banks or corporate transfers), and others seek a return independent of the currency transaction (e.g., mergers and acquisitions). The fact that participants have these often conflicting objectives (e.g., nonprofit-motivated investors create profit opportunities for profit-motivated investors) may not result in a zero-sum return for a trade in the currency, and it therefore can be argued that it is possible to generate positive returns from currency trading.

Other reasons not to hedge include the risk that the valuations for the hedging instruments may not accurately reflect the valuations for the physical securities on which the hedge is based, due to timing or pricing variations. The volatile nature of foreign-exchange markets may create slippage between the losses (or gains) on a foreign-exchange hedge and those from the foreign-exchange-related gains (or losses) on the underlying physical securities.

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
IS IT PRUDENT TO INVEST OVERSEAS — Continued from page 29

decision to hedge or not to hedge often depends on the characteristics of the asset class of the investment and the risk and return objectives of the particular investor.

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.

So, is currency hedging prudent? To answer this question, consider whether the risks of international investing are fully understood. If not, prudence suggests taking out an insurance policy, in this case currency hedging. High risk aversion normally leads to hedging; however, are the costs, including cash flow-related costs, worth the risk reduction?

Regret enters the framework. If we don’t hedge and don’t have a view, how much regret will we suffer? We want to minimize regret.

This would suggest an active hedging policy. Gardner and Wuilloud (1995) proposed that a 50-percent fixed hedge is in some sense the hedge of least regret. Active hedging should reduce regret even further, in part due to the delegation effect.

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