Maimon
Wealth Management

To Hedge, or Not to Hedge?

A Euro Case Study

December 2017

Many investors take a global perspective when building portfolios to achieve their investment goals. With the potential benefits of an expanded opportunity set comes exposure to foreign currencies. Currency returns can be volatile, creating winners and losers. While there is little evidence that currency movements can be predicted, investors still want to know about whether to hedge their currency exposure.

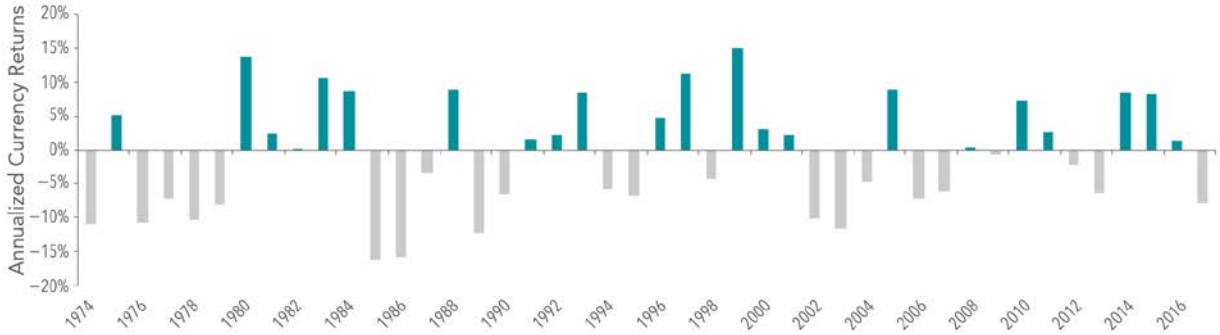
To answer this question, it is helpful to see whether exposure to currency returns is consistent with the investor's goal. Some investors may want to hedge currency exposure due to the volatility of currency returns and the impact on a portfolio. In global equities, currency hedging does not meaningfully reduce portfolio volatility, since equities are generally more volatile than currencies. For fixed income, currency hedging can be a useful tool to reduce portfolio return volatility.

This article looks at the impact of currency movements on global equity and fixed income portfolios from the perspective of a European investor as well as the merits of hedging.

CURRENCY RETURNS

For European investors with unhedged international investments, when the euro appreciates currency exposure has a negative impact on returns, and when the euro depreciates the impact is positive. **Exhibit 1** shows currency returns from the perspective of a European investor with exposure to a basket of developed market currencies.

Exhibit 1. **Currency Returns**
1974–2017



Currency returns are calculated for a basket of developed market currencies for the sample period January 1974–July 2017. Included countries; Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, UK and the US. Each currency is weighted by the market capitalisation of its country. Market capitalisation data is sourced from MSCI World Index. MSCI data © MSCI 2017, all rights reserved. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Past performance is not a guarantee of future results.

In 2017, the period ending 31 July, the euro had appreciated nearly 8% against a basket of developed market currencies. For example, the euro appreciated 9% against the US dollar and 7% against the Swiss franc. From an historical perspective, the recent movement of the euro is not unusual. From 1974–2017, currency returns relative to a basket of developed market currencies exceeded 8% in absolute value more than 40% of the time.

Currency returns have moved between positive and negative with about the same frequency, being positive nearly half the time (22 out of 48 years). In those years, currency hedging would have decreased returns to a European investor. Additionally, over the full sample, currency returns have not been reliably different from zero. The implication for investors is that although currency returns may be volatile at shorter time horizons, they are not expected to be a driver of expected return differences over longer time horizons.

DOES HEDGING REDUCE VOLATILITY?

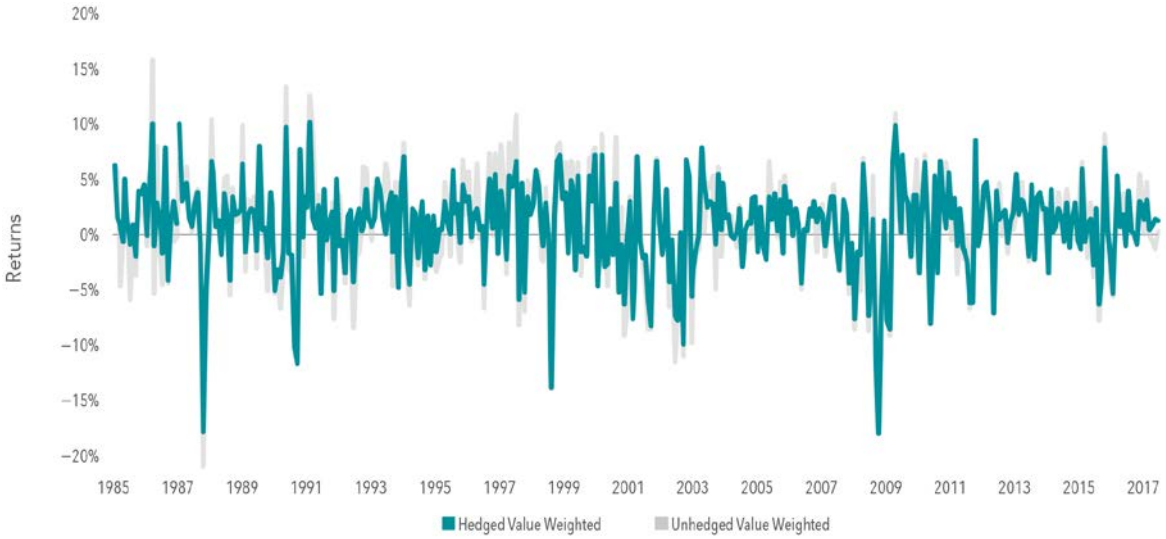
Equity

Some investors may want to hedge currencies with the goal of reducing the volatility of returns. For an investor with a global equity portfolio, hedging currencies tends not to reduce return volatility by a significant amount, as illustrated in **Exhibit 2**. Equities tend to be more volatile than currencies, so the volatility of an unhedged global equity portfolio is, on average, dominated by the volatility of the underlying equities, not the currency movements. As a result, unhedged and hedged equity portfolios tend to have similar standard deviations.

Fixed Income

In global fixed income, hedging currencies is an effective way to reduce return volatility because currency returns are more volatile than investment grade fixed income returns. If the currency exposure is unhedged, the currency will be mostly responsible for the volatility in a fixed income portfolio. As shown in **Exhibit 3**, the volatility of the hedged index (1.34%) is much less than the unhedged index (6.52%) despite having comparable annualized returns (2.93% vs. 2.97%).

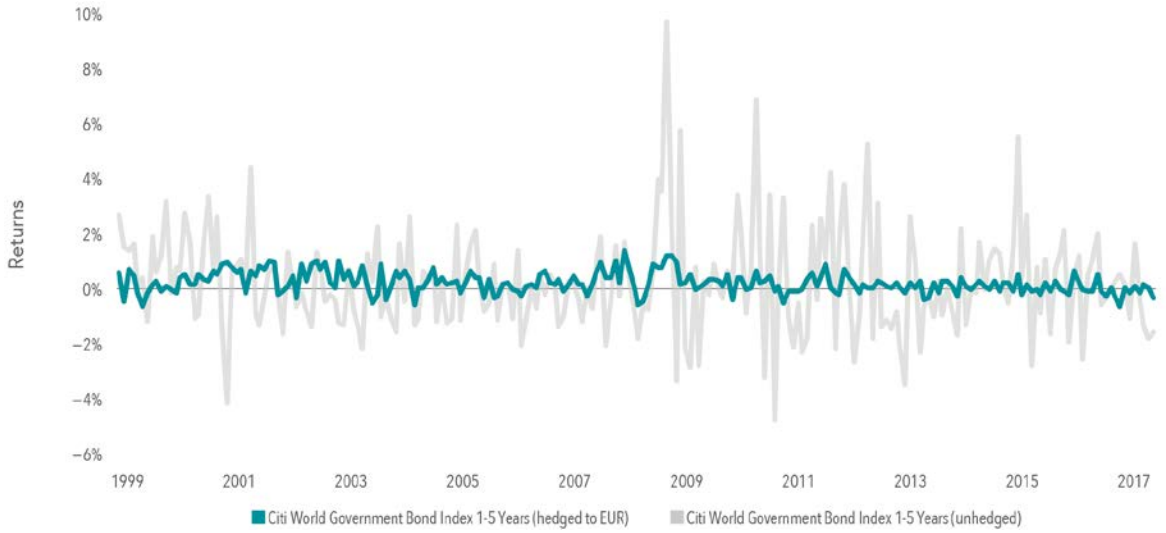
Exhibit 2. **Hedged vs. Unhedged International Equity Returns**
1985–2017



International equity returns are measured as a market capitalisation-weighted portfolio of the following MSCI country indices: Australia, Canada, Denmark, Germany, Japan, New Zealand, Norway, Singapore, Sweden, Switzerland, UK, and US. Hedged returns are calculated using the one-month forward contract. Currency and equity indices data is from MSCI. The sample period is January 1985–June 2017. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Past performance is not a guarantee of future results.

Exhibit 3. **Hedged vs. Unhedged International Government Bond Returns**
1999–2017



Unhedged bond returns are measured using the Citi World Government Bond Index 1-5 years (unhedged). Hedged bond returns are measured using the Citi World Government Bond Index 1-5 years (hedged to EUR). The sample period is January 1999–June 2017. Citi Bond Indices at 2017 by Citigroup. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

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INVESTOR TAKEAWAY

For investors with global portfolios, their return is determined by the return of the foreign asset and the return of the currency. Consequently, it makes sense to be aware of whether currency returns are a driver of expected returns. Research shows that for investors who maintain a consistent portfolio exposure, currencies are not expected to be a driver of returns.

Should an investor with a global portfolio hedge the currency exposure? The answer depends on investor goals and the underlying asset. For global equities, our research indicates that currency hedging does not meaningfully reduce portfolio volatility. In contrast, for fixed income investors with investment grade securities, hedging can be an effective way to reduce the volatility of returns.

GLOSSARY

Absolute value: The value of a number without its sign.

Currency hedging: Establishing a position that mitigates or decreases the risk associated with an existing currency position.

Forward contract: An agreement to buy or sell an asset at a specified price on a future date.

Market capitalisation: The total market value of a company's outstanding shares, computed as price times shares outstanding.

Standard deviation: A measure of the variation or dispersion of a set of data points. Standard deviations are often used to quantify the historical return volatility of a security or portfolio.

Volatility: A statistical measure of the dispersion, or variability, of returns for a given security or portfolio. Volatility is often measured using standard deviation.