Aspect Capital Insight Series

The Currency Hedging Conundrum

Why Investors Should Consider Dynamic Hedging Solutions

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Introduction

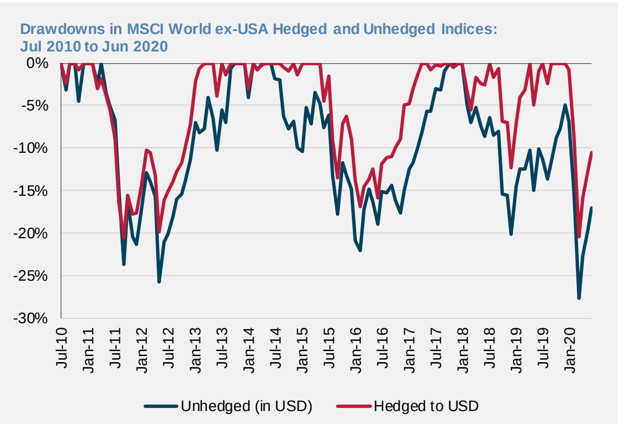
Sophisticated investors understand the benefits of diversifying their portfolios globally. They actively seek out investment opportunities around the world in order to reduce their exposure to their own local stock and bond markets. However, in nearly all cases this means investing in assets which are denominated in a foreign currency. This in turn brings exposure to fluctuations in the exchange rate between the foreign currency and the investor's base currency. If ignored, this currency exposure can represent a significant unmanaged – and typically undesired – risk to the portfolio. Depreciation of a foreign currency can impair or completely offset the positive returns from a good overseas investment decision.

In this note, we examine the different possible approaches to managing this unavoidable exposure, outlining the benefits of a dynamic currency hedging approach, especially in the current environment.

1. Why hedge foreign currency exposures?

Currency markets tend to be less volatile than stock markets, but they can still experience significant fluctuations and the impact of this is often underestimated by investors. As an example, an unhedged portfolio of overseas equities (MSCI World ex-US) experienced 25% higher volatility over the last decade[1] and a 35% larger worst drawdown purely from exchange rate fluctuations, as shown in Figure 1.

Figure 1: Unhedged Overseas Investments Suffer Larger Drawdowns



Source: Datastream. Please see important note on page 4.

Given the growing weight to overseas equities in many institutional portfolios, this seems too large for an investor either just to ignore or to persuade themselves that they invest overseas to capture positive returns from foreign currencies as well as from the underlying equities.

The four main options for addressing this currency exposure, and some of their benefits and drawbacks, are:

- **An active decision to remain entirely unhedged**

It is hard to explain a decision to remain completely unhedged as being anything other than a single big discretionary macro prediction that the investor's base currency will depreciate. Some investors might believe that currency returns will revert over the long-term and that the extra volatility can be tolerated. However, there is no guarantee of such mean-reverting behaviour and one could be waiting a very long time and incurring significant avoidable losses along the way. US-based investors may believe that investing overseas is an explicit view that overseas currencies will strengthen as the overseas assets appreciate. However, in a risk-averse correction or crisis, losses will be magnified by currency losses as the safe-haven appeal of the US Dollar causes it to strengthen. Conversely, non-US based investors with a large allocation to US equity markets may believe that same safe-haven appeal of the US Dollar in a crisis will help offset losses in a sharp equity sell-off. However, this ignores the ~50% of

1 For a USD-denominated investor: unhedged MSCI World ex-US annualised volatility of 15.1% and worst drawdown of -27.6% vs hedged to USD volatility of 11.9% and drawdown of 20.6%.

typical portfolios not invested in US Dollar denominated assets, as well as potential impairment of profits from US Dollar weakening in normal non-crisis environments.

- **Implementing a full passive hedge**

A complete hedge using currency forward contracts is appealing in theory as it removes all the undesired currency risk. However, in practice such a full passive hedge needs managing anyway, typically at a cost (both management fee and potential cost of carry when hedging). When a hedge moves adversely then it needs to be funded with cash. This may in severe instances require liquidation of underlying assets. Finally, this blunt approach doesn't distinguish between currencies, some of which might be more likely to move adversely than others, or market environments, which might change the likely behaviours of different currencies.

- **Implement a partial hedge on a fixed ratio of the exposure**

While it may seem that an appealing middle-ground is to hedge passively, say, 50% of a portfolio's currency risk, this compromise solution should still be seen as an active view on base currency depreciation – albeit with reduced risk – and may therefore represent the worst of all worlds. Risk is not eliminated, but the problems of managing and funding the hedge remain. Deciding the hedge ratio, or what proportion of the exposure should be hedged, remains a discretionary macro view on currency markets, and if the same ratio is used across the different exposures it can be a blunt tool which fails to take into account differences between currencies or changes in market regimes. Currencies can react very differently to market crises or changes in risk appetite.

- **Implement a dynamic hedging solution**

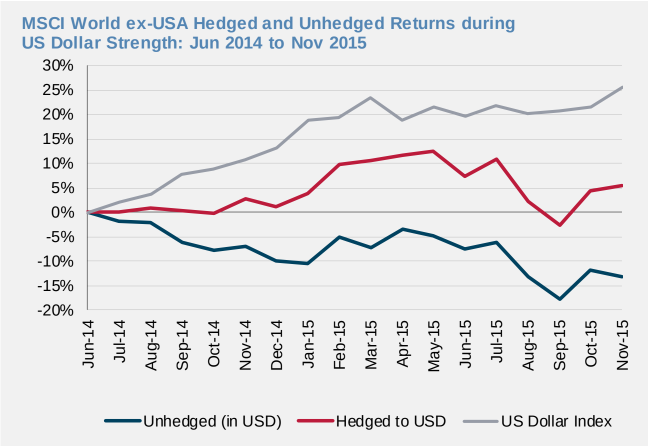
A dynamic hedge involves using currency forwards but, rather than holding static positions, trading dynamically to vary the hedge ratio, and usually treating each currency independently. The aim is to reduce risk with a higher hedge ratio when the foreign currency is depreciating but using a lower hedge ratio to take advantage of periods where the foreign currency is strengthening. This therefore has potential to mitigate currency risk while also adding significant uncorrelated alpha returns to the overall portfolio. Typically, a dynamic hedging solution will use systematic investment models to forecast the different currencies and make the timing decisions to vary the hedge ratios accordingly.

2. Why Implement a Hedging Solution Now?

Deciding not to hedge, or even to hedge only partially, is akin to making a macroeconomic forecast on your base currency depreciating. If overseas equity exposures are significant, this could represent one of the larger-risk forecasts being made in the portfolio – and it may be a completely unintended risk.

In the recent past, investors in this situation may have got away with having this unintended risk in their portfolio. Overall, exchange rate fluctuations were relatively muted for several years between 2015 and 2019 as the global economy mostly moved in a relatively homogeneous fashion. However, even in this period, there were some very notable currency moves. This included some very sharp single day moves, which belie the belief that currencies are a relatively low-risk asset class, such as the Swiss Franc's appreciation in January 2015 when the Swiss National Bank ended its policy of capping its strength against the Euro, or Sterling's decline in June 2016 when the Brexit referendum result emerged. Prior to 2015 however, even larger swings in currencies over longer periods were the norm. Between June 2014 and November 2015, the US Dollar strengthened by 25.6% against a trade-weighted basket of foreign currencies. Figure 2 illustrates how if left unhedged, potential positive returns of +5% from overseas equities (MSCI World Ex-US) would have been totally wiped out by this move and turned into a 13.3% loss.

Figure 2: Profits Wiped Out by USD Strength



Source: Datastream. Please see important note on page 4.

However, there seem to be many good reasons why the recent relatively benign environment in currency markets might have ended. Since the start of the Covid-19 pandemic we have witnessed unprecedentedly sharp changes in economic output, and similarly unprecedented stimulus responses from governments and central banks. Perhaps most relevant is the fact that different regions have been hit by the pandemic to differing extents and at different times, and that the size of policy response has also varied dramatically by country.

It seems highly likely that these differences might generate significant imbalances between economies, large unbalanced flows and potentially large adjustments in exchange rates as a result. And this is before considering the potential inflationary consequences over the medium term of the massive stimulus measures being deployed.

All these factors seem likely to cause big currency fluctuations. And even if an investor's base currency remains relatively stable on average (in terms of a trade-weighted index of currency strength), this could still mask significant depreciation against some currencies and appreciation against others, which would still introduce increased risk into a portfolio of unhedged foreign asset exposures.

The other factor to consider is the performance of the underlying assets themselves. Over the last decade equities have performed unusually well, including the remarkable recovery from the virus-induced lows in March 2020, such that bearing the extra risk of currency fluctuations has not typically caused any problems for investors. But looking forward, there are many who believe that this level of performance is unlikely to be repeated over the next decade, which would mean increasing focus on the risks being taken in portfolios.

So, while managing currency risk has always been a desirable part of investing in overseas assets, it would become even more critical from the perspective of risk-adjusted returns in a scenario of lower expected asset returns and increased risk from larger expected fluctuations in exchange rates.

Summary

Holding a diverse portfolio of global assets means an investor will be exposed to currency risk, which can be significant and shouldn't be ignored. Full or partial passive hedges can mitigate that risk, but typically come with a cost, and operational burden and do not allow investors to profit if their base currency depreciates. Over the past few years the hedging decision hasn't had a huge impact because of both strong equity returns and relatively stable exchange rates. However, the future outlook may be becoming less favourable in both cases, making the currency hedging decision more significant.

Charts Disclaimer

Figures 1 and 2: The data above with respect to various indices is shown for illustrative purposes only. Detailed descriptions of the indices used are available from Aspect upon request.

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