

DON'T LAYER CURRENCY RISK ON TOP OF EQUITY EXPOSURE

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How many people think it is a smart idea to take their exposure to U.S. equities and layer on top of it—dollar for dollar—an additional exposure to the U.S. dollar? This type of layering of additional [risk](#) might be called a form of [leverage](#), as an investor would be providing two sources of return for a given dollar investment. For example, consider a \$1 investment in a hypothetical fund that provides exposure to \$1 of U.S. equities and \$1 of exposure to the U.S. dollar (\$2 of distinct asset class risk for every \$1 invested). Few [long](#)-only investors in the U.S. desire this strategy, and I have rarely seen anything like this exposure offered to investors in the U.S.¹ If few U.S. investors would leverage up their [S&P 500](#) exposure with a secondary bet on the U.S. dollar, why should it always make sense to layer on euro risk when buying European equities or yen risk when buying Japanese equities? When investors buy overseas assets, they have to sell U.S. dollars and buy euros or yen to purchase those overseas stocks. Unless a currency ([foreign exchange](#) or “FX”) [hedge](#) is made to mitigate this FX risk, investors are fully exposed to FX fluctuations. But why is it beneficial to add currency risk on top of local equities? Let's go through 2 common rationalizations. **Isn't it Expensive to Hedge?** One answer to why many take on the FX risk: a misperception that it is expensive to hedge foreign currencies. This can be a valid concern in *some* countries today: Brazil, India, South Africa and Turkey, for example—all countries that have very high short-term [interest rates](#) when measured against U.S. interest rates. I'd agree the case to hedge these emerging market currencies is diminished, as there is a higher hurdle for how much these currencies have to depreciate for the hedge to pay off. But the cost to hedge developed world currencies such as the euro and the yen has been brought down to virtually zero because all their interest rates are pegged near zero². Central bankers have been guiding us to believe that the U.S. Federal Reserve will be the first major central bank to increase short-term interest rates. The European Central Bank and the Bank of Japan have set their [forward guidance](#) to keep interest rates low for a long period—so it is possible to collect some interest to hedge the euro and yen at some point in 2015. This environment makes currency hedging particularly relevant in the developed world today. **What about FX as Portfolio Diversification?** I believe it's necessary to take a harder look at the diversification attained by adding in this FX risk. If investors evaluated FX as a pure standalone investment instead of a package product, I think they would rarely find themselves convinced of the reason to add in this exposure to their portfolios. There has been rising [correlation](#) of FX to the S&P 500, low historical returns to FX, high historical volatility and a tactical environment that looks likely to favor the U.S. dollar. It is fairly easy now and rather inexpensive—especially on a relative interest rate basis—to hedge developed world FX exposure to currencies like the euro and the yen. I think more and more U.S. investors will come to this view in the coming years. For more research on the declining diversification of layering in foreign currency on top of equity risk, see our market insight [here](#).¹ One example of a product that does add two exposures in this format is tied to the S&P 500 Gold Hedged Index, which provides exposure to both the S&P 500 and gold—in a sense to hedge exposure to purchasing power of the dollar relative to gold. This product effectively provides two sets of exposures for a given \$1 invested in it—\$1 in the S&P 500 and \$1 in gold. Japanese investors use this type of “double decker” strategy, often taking Japanese equities and adding a high-yielding currency exposure on top of them.² Source: Bloomberg, as of 8/15/14. References Bank of Japan, European Central Bank and Federal Reserve policy rates of 0.1%, 0.15% and 0.25%, respectively. Cost of hedging estimate based on one-month forwards using interest rate differentials.

Important Risks Related to this Article

Foreign investing involves special risks, such as risk of loss from currency fluctuation or political or economic uncertainty. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Diversification does not eliminate the risk of experiencing investment losses.

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Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Forward guidance : A central bank policy tool intended to guide market expectations regarding the future of policy rates.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.