

# A COST EFFICIENT HEDGE FOR EMERGING MARKET INVESTORS

Bradley Krom — Director, Research

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The surge of inflows to currency-hedged foreign equities shows an increasing level of currency awareness among U.S.-based investors.<sup>1</sup> Today, many investors devote an increasing amount of time to understanding how [currency risk](#) will affect their portfolios. This is particularly true for Europe and Japan, where central banks are pursuing [reflationary](#) policies and there is essentially a free [option to hedge](#). Given current [interest rate](#) differentials, investors actually earn a small amount of positive [carry](#) by hedging the euro or the yen against the U.S. dollar. However, managing emerging market (EM) currency risk is more challenging. This is primarily due to higher interest rates in many emerging markets that drive up the cost of hedging. As an alternative, we believe that combining unhedged emerging market strategies—in either equities or fixed income—with a [long](#) dollar position against a basket of currencies<sup>2</sup> may provide a "[dirty hedge](#)" that helps mitigate the risk of a strengthening U.S. dollar at a more reasonable cost.

**Mechanics of Hedging** As we have explained previously, the cost to hedge a foreign currency is generally driven by the interest rate differential between the two currencies. In the case of emerging markets, higher growth and [inflation](#) rates have generally led to higher short-term interest rates than we are seeing in the United States. As a result, investors must pay the difference in order to be [short](#) the foreign currency against the dollar. If [forward currency contracts](#) did not incorporate this interest rate differential, investors could simply convert their U.S. dollars to a high-yielding currency like the Brazilian real, invest the proceeds in a Brazilian bank account earning an annualized 12.75%, then convert back to the U.S. dollar in one month locking in an [arbitrage](#) opportunity.

**Why Not Hedge Directly?** One of the primary catalysts for hedging developed market currency risk is higher interest rates in the U.S. than in Europe and Japan. As we explained above, investors that are long U.S. dollars and short euros or yen currently can earn positive carry. However, in emerging markets (EM), this carry differential is reversed. In most emerging markets, there is an implied cost of being short an EM currency against the U.S. dollar. Using Brazil as an example, with short-term interest rates currently 12% or more above those in the U.S., investors interested in hedging their Brazilian real exposure would need to have the real depreciate by more than 12% per year to break even on their hedge. In our view, direct hedging of emerging markets only makes sense for a short-term trade in markets that have much higher interest rates. Historically, investors have simply sold out of emerging market assets instead of trying to hedge them.<sup>3</sup>

**Indirect or "Dirty" Hedging** After nearly two years of increasing [volatility](#) in major currency pairs, many investors are looking at ways to reduce or isolate risk. Last year, literally every foreign currency depreciated against the U.S. dollar.<sup>4</sup> As we have written about [extensively](#), U.S. dollar strength may be poised to continue as part of a secular [bull](#) market. Not surprisingly, some of the biggest casualties to dollar strength have been in emerging markets. In markets where the dollar is broadly stronger against foreign currencies, investors could use a basket of developed and emerging market currencies as a way to indirectly hedge the value of the U.S. dollar. **Major**

Country	Ticker	2014	YTD	Annualized Cost to Hedge
Bloomberg Dollar	BBDXY	10.95%	3.30%	0.88%
Hong Kong	HKD	-0.01%	0.05%	0.28%
Thailand	THB	-0.62%	-0.39%	2.80%
Philippines	PHP	-0.73%	0.29%	2.47%
Indonesia	IDR	-1.75%	-4.44%	8.07%
India	INR	-1.97%	-0.60%	10.70%
China	CNH	-2.57%	0.13%	3.45%
S. Korea	KRW	-3.77%	1.74%	1.31%
Singapore	SGD	-4.72%	-0.07%	1.02%
New Zealand	NZD	-5.08%	-2.58%	3.83%
Taiwan	TWD	-5.84%	3.38%	0.09%
Great Britain	GBP	-5.92%	-1.41%	0.54%
Peru	PEN	-6.14%	-4.52%	7.83%
Malaysia	MYR	-6.34%	-1.85%	2.61%
Turkey	TRY	-8.00%	-12.76%	10.97%
Australia	AUD	-8.32%	-3.61%	2.29%
Canada	CAD	-8.59%	-3.69%	0.77%
S. Africa	ZAR	-9.32%	-2.92%	6.28%
Switzerland	CHF	-10.20%	5.62%	-0.95%
EM Average	EM	-10.25%	-2.10%	4.99%
Israel	ILS	-10.90%	0.73%	0.25%
DM Average	DM	-10.91%	-2.36%	0.80%
Brazil	BRL	-11.12%	-11.13%	12.76%
Mexico	MXN	-11.62%	-4.08%	2.85%
Euro	EUR	-11.97%	-7.92%	-0.16%
Japan	JPY	-12.08%	0.22%	-0.05%
Romania	RON	-12.09%	-6.65%	1.37%
Nigeria	NGN	-12.62%	-7.81%	6.67%
Czech Republic	CZK	-13.00%	-7.09%	-0.10%
Chile	CLP	-13.36%	-0.94%	3.39%
Poland	PLN	-14.69%	-2.03%	1.48%
Hungary	HUF	-17.34%	-3.69%	1.18%
Sweden	SEK	-17.54%	-6.67%	-0.42%
Norway	NOK	-18.53%	-1.18%	1.32%
Colombia	COP	-18.81%	-0.92%	3.59%
Argentina	ARS	-22.98%	-4.91%	19.19%
Russia	RUB	-45.88%	17.92%	14.13%

Sources: Bloomberg, WisdomTree, as of 4/30/15.

Past performance is not indicative of future results.

### Currency Market Performance vs. U.S. Dollar

While some emerging market currencies, such as the Russian ruble and Colombian peso, fell by more than the yen and euro in 2014, on average, the [Bloomberg Dollar Spot Index](#) rose by 10.95%. While this “dirty” hedging strategy would not have helped much with the Russian ruble, we believe that it would have performed well for hedging the vast majority of other emerging market currencies. As we show in the table, this strategy would have also performed well so far in 2015. At the end of the day, the value of this approach is that investors are able to profit from a strengthening U.S. dollar without the significant costs of hedging all emerging markets directly. In the case of the [Bloomberg Dollar Spot Index](#), the annualized cost of hedging is less than 1%, a significant discount to hedging EM currencies directly. While currency risk seems to be top of mind for many investors, currency volatility in emerging markets has been a difficult risk to manage. In our view, a broad-based strategy that goes long the U.S. dollar against a basket of foreign currencies could be an attractive alternative to direct hedging of EM currency risk. While this approach will not perfectly offset losses in all market scenarios, we believe that current tradeoffs favor an indirect approach to hedging. <sup>1</sup>Source: Bloomberg, as of 4/13/15. <sup>2</sup>Represented by the [Bloomberg Dollar Spot Index \(BBDXY\)](#). <sup>3</sup>Source: Nier, Erlend and Sedik, Tahsin and Mondino, Tomas, Gross Private Capital Flows to Emerging Markets: Can the Global Financial Cycle Be Tamed? (October 2014). IMF Working Paper, Vol. , pp. 1-34, 2015. <sup>4</sup>Sources: Bloomberg, WisdomTree.

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 emerging, offshore or frontier markets are generally less liquid and less efficient than investments in developed markets and are subject to additional risks, such as risks of adverse governmental regulation and intervention or political developments. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

For more investing insights, check out our [Economic & Market Outlook](#)

**Currency risk** : the risk that an investment will decline in value due to a change in foreign exchange rates.

**Reflationary** : Characterized by an environment of rising price levels.

**Nominal interest rate** : Interest rate that does not account for the impact of inflation.

**Carry** : The amount of return that accrues from investing in fixed income or currency forward contracts.

**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).

**Dirty hedge** : a position that is used to offset a portion of risk in an investment. A dirty hedge will often exhibit an imperfect, negative correlation to the original investment.

**Inflation** : Characterized by rising price levels.

**Short (or Short Position)** : The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

**Forward currency contracts** : A forward contract in the forex market that locks in the price at which an entity can buy or sell a currency on a future date.

**Arbitrageur** : A person who attempts to profit from price inefficiencies in the market by making simultaneous trades that offset each other and seek to capture a risk free profit.

**Volatility** : A measure of the dispersion of actual returns around a particular average level.&nbsp;.

**Bullish** : a position that benefits when asset prices rise.

**Bloomberg Dollar Spot Index (BBDXY)** : Tracks the performance of a basket of ten leading global currencies versus the U.S. dollar. Each currency in the basket and their weight is determined annually based on their share of international trade and FX liquidity.