The ‘free lunch’ in currency hedging?

Published 22 March 2023

Pierre Debru
Head of Research, WisdomTree Europe.

Since 2012, WisdomTree has been a leader in helping investors understand the impact that currency risk can have on their portfolios. When investors allocate funds internationally, there are two sources of return: the local asset return and the return from changes in foreign exchange (FX) rates. This can be problematic during periods in which foreign currencies are depreciating against the investor’s home currency, leading to underperformance.

Historically, the default allocation of a majority of investors has been to keep the equity and currency exposure combined. However, this doesn’t have to be the case and it is possible to uncouple those risks.

Currencies, a significant source of risk and tracking difference

A globally diversified equity portfolio, like the MSCI World point of view, is a bundle of equity and currency risk. 68% of the MSCI World is invested in US equities and, therefore, denominated in US dollars. 6% is invested in Japanese equities and, therefore, denominated in Japanese yen and so on. The exposure to currency can add to or detract from the performance of the equities themselves. This means that the performance of the MSCI World (unhedged) is quite different for an investor with the US dollar as the base currency compared to an investor with the euro as the base currency.

Figure 1: Yearly performance of the MSCI World in different base currencies

Source: Bloomberg, WisdomTree. 31 December 2011 to 31 December 2022. You cannot invest directly in an index. Above numbers include backtested data.

Historical performance is not an indication of future performance and any investments may go down in value.

Figure 1 shows that, every year, the difference in performance between the MSCI World hedged or unhedged is significant for both euro and pound-based investors. For euro-based investors, the difference in performance driven by the currency exposure oscillated between -9.41% and +10.1%. For a British pound investor, the difference is between -5.9% and +20.4%.

This embedded currency exposure also tends to increase the risk in the portfolio. Figure 2 shows that the MSCI, when unhedged, would have exhibited volatility of 15.4% and 14.8% for European investors depending on their base currency over the last 50 years. The hedged version has exhibited a volatility of 13.9% over the same period, a reduction of 1.5% and 0.9% respectively.

WisdomTree®

Because the currency risk sits on top of the equity risk when investing in global equities, taking currency risk or not taking currency risk has to be a conscious investment decision.

Figure 2: Long term volatility of hedged and unhedged exposure to MSCI World

Source: Bloomberg, WisdomTree. 31 January 1971 to 28 February 2023. Volatility is calculated on monthly returns. MSCI World Hedged is proxied by the MSCI World Net Total Return Local Index. You cannot invest directly in an index. Above numbers include backtested data.

Historical performance is not an indication of future performance and any investments may go down in value.

Currency hedging as a tactical endeavour

Foreign exchange rates change over time. Many factors contribute to those deviations:

- interest rate expectations
- inflation differentials
- public policy
- growth forecast
- balance of payments

Over the short to medium term, currencies can move quite dramatically against each other leading to potential losses or gains for investors invested in unhedged foreign equities. For investors with strong conviction on the direction of foreign currencies relative to their domestic currency, it is therefore possible to tactically currency hedge, or not, their portfolio to try to benefit from those moves.

Currency hedging for the long run

Whilst in the short and medium term foreign exchange rates fluctuate, over the very long term, currencies tend to fluctuate around a long-term equilibrium. This phenomenon is often called 'long term mean reversion'. This means that for long term investors in global equities, the performance impact of currencies should offset itself over long periods of time. In other words, the performance of currency hedged and unhedged investments should be similar.

However, from a risk point of view, this is not the case. As discussed previously, the long-term volatility of the unhedged investment tends to be higher than that of the currency hedged investment. A reduction of risk with zero long term expected returns sounds like a 'free lunch' which is why investors could look at currency hedged investments in foreign equities as their default long term investment policy.

The mechanics of currency hedging

Currency hedging aims to minimise the risk associated with movements in the foreign currency or currencies in which non-domestic investments are denominated. There are two principal steps involved in currency hedging:

- At a particular point in time, investors need to sell the currency in which international investments are denominated forward (that is, at some point in the future). This has the effect of removing the foreign currency risk over the period of the FX forward.
- From time to time, the portfolio manager needs to roll its FX forward to keep the hedge in place.

For example, a portfolio manager with a base currency of euro and a holding of 1 million US dollars of US equities can hedge the US dollar currency risk by selling a 1 million US dollar forward contract against euro for settlement in a month's time at today's rate.

Operationally, this process can be quite cumbersome, in particular for a portfolio with multiple currencies and/or with hard to access currencies. The MSCI World comprises 13 currencies which means that investors would need to trade 12 FX forwards every time they want to hedge the currency exposure and then they would need to roll those 12 forwards on a regular basis.

This is why WisdomTree has been launching currency hedged share classes for its strategies, providing turnkey solutions for their investors and their currency hedging need.

Related blogs

+ 4 reasons to consider quality stocks as core, long-term holdings

+ Value, Growth or neither?

Important Risks Related to this Article

IMPORTANT INFORMATION

Marketing communications issued in the European Economic Area ("EEA"): This document has been issued and approved by WisdomTree Ireland Limited, which is authorised and regulated by the Central Bank of Ireland.

Marketing communications issued in jurisdictions outside of the EEA: This document has been issued and approved by WisdomTree UK Limited, which is authorised and regulated by the United Kingdom Financial Conduct Authority.

WisdomTree Ireland Limited and WisdomTree UK Limited are each referred to as "WisdomTree" (as applicable). Our Conflicts of Interest Policy and Inventory are available on request.

For professional clients only. Past performance is not a reliable indicator of future performance. Any historical performance included in this document may be based on back testing. Back testing is the process of evaluating an investment strategy by applying it to historical data to simulate what the performance of such strategy would have been. Back tested performance is purely hypothetical and is provided in this document solely for informational purposes. Back tested data does not represent actual performance and should not be interpreted as an indication of actual or future performance. The value of any investment may be aected by exchange rate movements. Any decision to invest should be based on the information contained in the appropriate prospectus and aer seeking independent investment, tax and legal advice. These products may not be available in your market or suitable for you. The content of this document does not constitute investment advice nor an oer for sale nor a solicitation of an oer to buy any product or make any investment.

An investment in exchange-traded products ("ETPs") is dependent on the performance of the underlying index, less costs, but it is not expected to match that performance precisely. ETPs involve numerous risks including among others, general market risks relating to the relevant underlying index, credit risks on the provider of index swaps utilised in the ETP, exchange rate risks, interest rate risks, inflationary risks, liquidity risks and legal and regulatory risks.

The information contained in this document is not, and under no circumstances is to be construed as, an advertisement or any other step in furtherance of a public oering of shares in the United States or any province or territory thereof, where none of the issuers or their products are authorised or registered for distribution and where no prospectus of any of the issuers has been filed with any securities commission or regulatory authority. No document or information in this document should be taken, transmitted or distributed (directly or indirectly) into the United States. None of the issuers, nor any securities issued by them, have been or will be registered under the United States Securities Act of 1933 or the Investment Company Act of 1940 or qualified under any applicable state securities statutes.

This document may contain independent market commentary prepared by WisdomTree based on publicly available information. Although WisdomTree endeavours to ensure the accuracy of the content in this

document, WisdomTree does not warrant or guarantee its accuracy or correctness. Any third party data providers used to source the information in this document make no warranties or representation of any kind relating to such data. Where WisdomTree has expressed its own opinions related to product or market activity, these views may change. Neither WisdomTree, nor any ailiate, nor any of their respective oicers, directors, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this document or its contents.

This document may contain forward looking statements including statements regarding our belief or current expectations with regards to the performance of certain assets classes and/or sectors. Forward looking statements are subject to certain risks, uncertainties and assumptions. There can be no assurance that such statements will be accurate and actual results could dier materially from those anticipated in such statements. WisdomTree strongly recommends that you do not place undue reliance on these forward-looking statements.

The products discussed in this document are issued by WisdomTree Issuer ICAV (“WT Issuer”). WT Issuer is an umbrella investment company with variable capital having segregated liability between its funds organised under the laws of Ireland as an Irish Collective Asset-management Vehicle and authorised by the Central Bank of Ireland (“CBI”). WT Issuer is organised as an Undertaking for Collective Investment in Transferable Securities (“UCITS”) under the laws of Ireland and shall issue a separate class of shares ("Shares”) representing each fund. Investors should read the prospectus of WT Issuer (“WT

Prospectus”) before investing and should refer to the section of the WT Prospectus entitled »Risk Factors¼ for further details of risks associated with an investment in the Shares.

Notice to Investors in Switzerland – Qualified Investors

This document constitutes an advertisement of the financial product(s) mentioned herein.

The prospectus and the key investor information documents (KIID) are available from WisdomTree¼s website: **https:** //www.wisdomtree.eu/en-ch/resource-library/prospectus-and-regulatory-reports

Some of the sub-funds referred to in this document may not have not been registered with the Swiss Financial Market Supervisory Authority (“FINMA”). In Switzerland, such sub-funds that have not been registered with FINMA shall be distributed exclusively to qualified investors, as defined in the Swiss Federal Act on Collective Investment Schemes or its implementing ordinance (each, as amended from time to time). The representative and paying agent of the sub-funds in Switzerland is Société Générale Paris, Zurich Branch, Talacker 50, PO Box 5070, 8021 Zurich, Switzerland. The prospectus, the key investor information documents (KIID), the articles of association and the annual and semi-annual reports of the sub-funds are available free of charge from the representative and paying agent. As regards distribution in Switzerland, the place of jurisdiction and performance is at the registered seat of the representative and paying agent.

For Investors in France:

The information in this document is intended exclusively for professional investors (as defined under the MiFID) investing for their own account and this material may not in any way be distributed to the public. The distribution of the Prospectus and the oering, sale and delivery of Shares in other jurisdictions may be restricted by law. WT Issuer is a UCITS governed by Irish legislation, and approved by the Financial Regulatory as UCITS compliant with European regulations although may not have to comply with the same rules as those applicable to a similar product approved in France. The Fund has been registered for marketing in France by the Financial Markets Authority (Autorité des Marchés Financiers) and may be distributed to investors in France. Copies of all documents (i.e. the Prospectus, the Key Investor Information Document, any supplements or addenda thereto, the latest annual reports and the memorandum of incorporation and articles of association) are available in France, free of charge at the French centralizing agent, Societe Generale at 29, Boulevard Haussmann, 75009, Paris, France. Any subscription for Shares of the Fund will be made on the basis of the terms of the prospectus and any supplements or addenda thereto.

For Investors in Malta: This document does not constitute or form part of any oer or invitation to the public to subscribe for or purchase shares in the Fund and shall not be construed as such and no person other than the person to whom this document has been addressed or delivered shall be eligible to subscribe for or purchase shares in the Fund. Shares in the Fund will not in any event be marketed to the public in Malta without the prior authorisation of the Maltese Financial Services Authority.

For Investors in Monaco: This communication is only intended for duly registered banks and/or licensed portfolio management companies in Monaco. This communication must not be sent to the public in Monaco.