

# The 'free lunch' in currency hedging?

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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.

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.*

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### **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.

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