

# A Cost Efficient Hedge for Emerging Market Investors

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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 Currency Market Performance vs. U.S. Dollar

| 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.

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.

1Source: Bloomberg, as of 4/13/15.

2Represented by the Bloomberg Dollar Spot Index (BBDXY).

3Source: 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. 4Sources: 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.