

Is Volatility a Useful Signal for Dynamic Currency Hedging?

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WisdomTree and Record Currency Management Ltd.¹ partnered to create a family of dynamic currency-hedged Indexes that utilize three factors to determine the dynamic hedge ratio on each individual currency: interest rate differentials, momentum and value. In the field of currency hedging one oft-debated question is whether there are other effective signals and, in particular, whether volatility could also be a useful signal. We have, of course, carefully considered which signals we believe to be most optimal, and although we recognize that volatility in currency markets can show patterns of behavior, we are convinced that it is not an appropriate independent signal to use in a hedging strategy, for the simple reason that volatility is by definition non-directional. **Volatility Does Not Dictate Direction** What do we mean by non-directional? Simply that rising (or falling) volatility tells us something about the **size** of observed movements in a currency pair, but nothing about the **direction** of those movements. Knowing that the standard deviation of exchange rate movements has become wider or narrower could be consistent with either one currency strengthening or the other—or, indeed, neither. In a dynamic currency-hedging strategy, which is naturally long equities, the only trade available is to be currency hedged (e.g., long U.S. dollar and short euro, or yen, or another currency)—or not. Since the purpose of dynamic hedging is to seek greater exposure to hedges that are expected to be profitable, and less exposure to hedges that are expected to be loss-making, it is essential for each signal to have some explanatory power as to which currency in any pair is expected to appreciate, i.e., to be directional. An example may serve to illustrate the point. We have tried to create a signal hedging strategy that is as widely applicable within developed market currencies as possible, without having been “curve-fitted” to one particular domestic currency or set of foreign currencies. Volatility seems to defy this. If, for example, one investor was looking for a strategy that worked well for hedging euro exposure into dollars, and another wanted to hedge dollar exposure into euros, then rising volatility in the euro/dollar exchange rate might tell both of them to hedge more. Since the exchange rate will only go one way, only one of these hedges will be profitable, while the other will be loss-making—so the signal will have worked for only one of the investors. **Interest Rates, Value and Momentum Are Directional Hedging Signals** By contrast, higher U.S. interest rates, or the momentum of the U.S. dollar, or an undervalued dollar, will all signal to U.S. investors to hedge their euro exposure, while also being a signal to euro-based investors to not *hedge* their U.S. dollars. These three signals are thus consistent by virtue of being directional. **Looking for Volatility Reduction? Adopt Full Passive Hedging** Finally, there’s the question of whether an investor wouldn’t always want to hedge more in a more volatile environment, simply because currency movements are at risk of being bigger. To this we would respond that bigger movements can come in both positive and negative directions, so once again the directionality of the

signal is vital. If an investor is concerned about currency volatility, a full currency-hedged strategy may be most appropriate, as the long-term results showing currency exposure in a broad international framework has historically increased the volatility of international investments.² This is why WisdomTree has long suggested that fully currency-hedged strategies could serve better as core, strategic long-run allocations.

Dynamic Hedging Can Help Returns The goal of the dynamic hedged Indexes WisdomTree and Record created were to tactically add value and return potential above fully hedged and fully unhedged offerings by incorporating the dynamic signals. Our signals were designed to be directional, so while they do lower volatility compared to *unhedged* benchmarks, they are likely to see a small volatility pickup over a fully hedged strategy. But our research leads us to believe that higher returns could compensate investors for this small pickup in volatility. ¹No WisdomTree Fund is sponsored, endorsed, sold or promoted by Record Currency Management (“Record”). Record has licensed certain rights to WisdomTree Investments, Inc., as the index provider to the applicable WisdomTree Funds, and Record is providing no investment advice to any WisdomTree Fund or its advisors. Record makes no representation or warranty, expressed or implied, to the owners of any WisdomTree Funds regarding any associated risks or the advisability of investing in any WisdomTree Fund. ²Sources: WisdomTree, Bloomberg, as of 12/31/2015.

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Hedging can help returns when a foreign currency depreciates against the U.S. dollar, but it can hurt when the foreign currency appreciates against the U.S. dollar.