WHY TAKE CURRENCY RISK IF DIVERSIFICATION BENEFIT IS DECLINING?

Jeremy Schwartz — Global Chief Investment Officer
09/10/2014

We have been exploring the case for layering in foreign currency ("FX") on top of foreign equity returns. One of the most common arguments I have heard for taking on FX risk in international equity portfolios in an unhedged fashion is that FX can be a portfolio “diversifier.” But does FX provide a level of portfolio and market return diversification not offered by the local equity markets? If an investor had to decide to allocate to the EAFE FX[1] embedded in the MSCI EAFE Index as a standalone investment, let’s review the case. • Over the history of the MSCI EAFE Index, EAFE FX has added 1.6% annually to the returns of the MSCI EAFE Index. This means the U.S. dollar declined by 1.6% per year over this period. • This return stream had an annualized volatility of 8.4% per year, a little more than half the volatility of EAFE equities (in local currencies). • The correlation of EAFE FX to the S&P 500 over the full 40-year period was fairly low—only 0.09. But note a very important correlation trend: This EAFE FX correlation to the S&P 500 has been rising consistently in recent periods. In the last three years, the correlation between EAFE FX and the S&P 500 was 0.64, so EAFE FX is not providing the same type of diversification as it did historically.[2] **Figure 1: MSCI EAFE Index: Return, Volatility and Correlation**

	Returns			Volatility Levels				Correlations to S&P 500		
	EAFE w/ FX	EAFE No FX	EAFE FX	EAFE w/ FX	EAFE FX	EAFE No FX	S&P 500	EAFE w/ FX	EAFE FX	EAFE No FX
12/31/69-7/31/14	9.3%	7.6%	1.6%	17.1%	8.4%	14.5%	15.3%	0.63	0.09	0.69
3-Year	8.0%	11.7%	-3.3%	16.4%	6.1%	12.2%	12.2%	0.88	0.64	0.86
5-Year	9.4%	9.2%	0.1%	16.7%	7.2%	12.3%	13.2%	0.88	0.58	0.86
10-Year	7.1%	5.9%	1.1%	18.2%	7.6%	14.5%	14.7%	0.89	0.47	0.89
20-Year	10.9%	9.8%	1.0%	16.7%	7.6%	14.6%	15.2%	0.83	0.21	0.84

Sources: WisdomTree, MSCI, 12/31/69–7/31/14. EAFE w/ FX refers to the MSCI EAFE Index priced in USD. EAFE no FX refers to the MSCI EAFE Index price in the local currency. EAFE FX refers to the underlying currency exposure of the MSCI EAFE Index. Past performance is not indicative of future results. You cannot invest directly in an index.

More importantly, one has to wonder if the past gain in EAFE FX can be repeated. We know with hindsight that the U.S. dollar declined. But do we know the U.S. dollar will decline going forward? Theoretical models suggest there is no expected return to owning currency. So why does one want to take on this FX risk embedded in foreign equity exposure unless one is a tactical U.S. dollar bear? • The correlation to the S&P 500 for EAFE with FX and EAFE with no FX shows practically no differentials over the last 3-, 5-, 10- and 20-year periods. There is a slightly lower correlation to EAFE with FX over 40 years of data, but that does not appear to be a compelling case to add currency exposure on top of the local equity market return given the uptick in total volatility from adding FX and the unpredictability of future currency moves. **The Declining Diversification of Owning the Euro** Below is the same chart for the European FX[3] correlation to the S&P 500, which also shows a consistent increase and less diversification from holding euros on top of owning the European equities. • The European FX as a standalone asset class historically had 10% volatility consistently over most major periods—again, just about half the volatility of the local equity market. • The long-term returns to the MSCI EMU Index currencies were only 0.1% per year—this means the risk-return trade-off for European currencies as a standalone asset class showed relatively miniscule historical returns with large volatility (a bad combination). • EMU FX over the long run had a correlation of 0.14 versus the S&P 500, but that has risen significantly to 0.68 over the last three- and five-year periods. This rising correlation means there is less diversification benefit to owning the euro.[4] **Figure 2: MSCI EMU Index: Return, Volatility and Correlation**

	Returns			Volatility Levels				Correlations to S&P 500		
	EMU w/ FX	EMU No FX	EMU FX	EMU w/ FX	EMU FX	EMU No FX	S&P 500	EMU w/ FX	EMU FX	EMU No FX
12/31/87-7/31/14	8.1%	8.0%	0.1%	20.1%	10.4%	17.9%	14.5%	0.75	0.14	0.77
3-Year	6.6%	9.2%	-2.4%	21.8%	8.9%	15.2%	12.2%	0.86	0.68	0.84
5-Year	6.9%	8.2%	-1.2%	22.9%	10.4%	15.2%	13.2%	0.85	0.68	0.82
10-Year	6.3%	5.2%	1.1%	23.1%	10.6%	16.9%	14.7%	0.88	0.53	0.87
20-Year	14.6%	13.6%	0.9%	20.9%	10.0%	18.4%	15.2%	0.82	0.21	0.82

Sources: WisdomTree, MSCI, 12/31/87–7/31/14. EMU w/ FX refers to the MSCI EMU Index priced in USD. EMU no FX refers to the MSCI EMU Index priced in the local currency. EMU FX refers to the underlying currency exposure of the MSCI EMU Index. Past performance is not indicative of future results. You cannot invest directly in an index.

The discussion of currency-hedged strategies has shaken some of the core beliefs of investors. Traditional investment vehicles that package equity risk plus a secondary currency risk on top of the equity risk have been referred to as the traditional "plain vanilla" exposure because they were the first to the market, and it is what investors have been using for so long. I believe it's necessary to take a harder look at the diversification attained by adding in this FX risk. If investors evaluated FX as a pure standalone investment instead of a package product, I think they would rarely find themselves convinced of the reason to add in this exposure to their portfolios. There has been rising correlation to the S&P 500, low historical returns to FX, high historical volatility and a tactical environment that looks likely to favor the U.S. dollar. For more of our research, see our market insight here.

[1]References currency exposure of MSCI EAFE Index. [2]WisdomTree, MSCI, 12/31/69–7/31/14. Applies to all bullet points. [3]References currency exposure of MSCI EMU Index. [4]Sources: WisdomTree, MSCI, 12/31/87–7/31/14. Applies to all bullet points.

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 currency involve additional special risks, such as credit risk and interest rate fluctuations. Past performance is not indicative of future results. Diversification does not eliminate the risk of experiencing investment losses.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Currency : Currency in which the underlying index returns are calculated. Euros: The returns are calculated, and there is no currency conversion; resulting statistics result purely from the returns of the equities. U.S. dollars: The returns are calculated and then converted into U.S. dollars; resulting statistics are the result of a combination of the euro's performance against the U.S. dollar and the returns of the underlying equities.

MSCI EMU Index : A free float-adjusted market capitalization-weighted index designed to measure the performance of the markets in the European Monetary Union.