A BENEFIT TO HEDGING THE EURO FROM A DIFFERENT PERSPECTIVE

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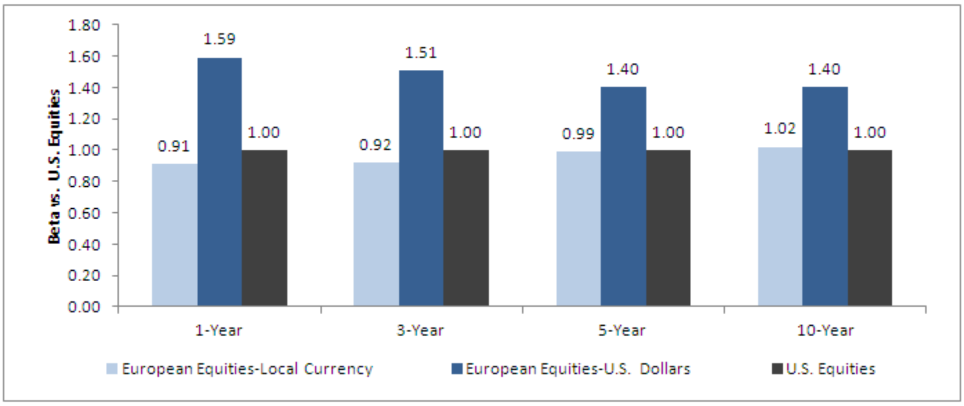
I recently wrote a blog about how currency exposure—specifically to the euro—impacted volatility of European equities (the MSCI EMU Index over the last 10 years[1]). The central analytics of that blog measured the "beta" of European equities in local currency terms against European equities in U.S. dollars. The index measured in U.S. dollars includes the fluctuations of the euro against the U.S. dollar, which tends to increase its volatility. I make a similar point in this blog but from a different perspective, specifically by measuring the beta of these European equities against the S&P 500 Index. This analysis highlights how sensitive European equities are to moves in the S&P 500—a common framework for evaluating investment strategies. Indexes with a beta greater than 1.0 relative to the S&P 500 Index have tended to be more sensitive, with the potential to magnify movements of this benchmark during the periods studied, while strategies with a beta below 1.0 have tended to exhibit lower sensitivity to those same movements. **Two Sources of Risk** For U.S. investors in international equities, there are traditionally two sources of volatility: 1) Volatility of equity prices 2) Volatility of the currency relative to the U.S. dollar Oftentimes, U.S. equities appear less volatile than international equities—not because of volatility in their actual equity price movements, but rather because of the respective currency's movements against the U.S. dollar. The chart below illustrates how much higher the beta (measured against the S&P 500 Index) of European equities is *with* euro exposure (meaning the incremental volatility from movements of the euro against the U.S. dollar) than *without* euro exposure. **How Euro Exposure Increased Volatility**



Period: 10 years ended 2/28/2013. Sources: MSCI, Zephyr StyleADVISOR
European Equities-Local Currency is represented by MSCI EMU Local Currency Index.
European Equities-U.S. Dollars is represented by MSCI EMU Index.
U.S. Equities is represented by S&P 500 Index.

(For definitions of terms in this chart, please see our Glossary.) • **Risk Reduction:** Removing the euro risk from the equation significantly lowered the beta of European equities compared to U.S. equities. In fact, over the one-, three- and five-year periods, this index had a beta of less than 1, and the beta was approximately equal to 1 over the 10-year period. • **Incremental Risk of Euro Exposure:** It is worth noting that for the 10-year period ending February 28, 2013, exposure to the euro increased the beta of European Equities by nearly 40%. Over shorter periods, this additional risk was even more pronounced. **Why Be 100% Unhedged?** When it comes to a currency such as the euro, I believe there will be cycles of both appreciation and depreciation against the U.S. dollar. Given the difficulty in predicting exactly when these cycles will turn, we question why typical allocations should always fully assume this currency risk. To me, an allocation that is 50% hedged and 50% unhedged—especially for someone without a strong view as to a currency's future performance—would seem a better baseline to dial up or down from, depending on one's conviction regarding the direction of any future currency trend. **Take the euro out of Europe (Video)** [1]2/28/2003–2/28/2013.

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DEFINITIONS

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

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

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

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.