The US Hedging Advantage

Potential to increase return by 2% while reducing risk by 2%*

For US investors, the management of currency risk in their portfolios has historically been an afterthought for a variety of reasons and assumptions, chief among them: zero expected return, portfolio diversification, and low materiality in the portfolio. We will touch upon each of these views, discussing their validity, evolution, and relevancy within the current market environment.

Zero Expected Return

Assumption – Currencies have zero expected return, so currency management is unnecessary as it will wash out in the end.

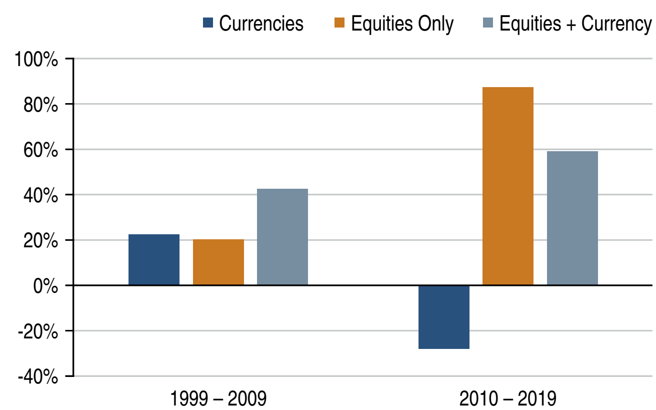
Historically, developed market currencies have not added or detracted meaningful return in multi-decade time horizons. Since the introduction of the Euro in 1999, EAFE currencies have gone full cycle with close to zero realized return.

FIGURE 1 | **EAFE Currency Return**

Source: Bloomberg, MSCI, Mesirow Financial. Performance from January 1999 – June 2019. Past performance is not necessarily indicative of future results. Actual results may materially differ.

However, shorter time horizons become more relevant as both plans and managers are often judged over periods as short as 1 to 5 years. Even within longer 10-year periods, volatile currency swings of 20% to 30% have occurred, episodically adding or detracting significant value as seen in the chart below. Although currencies have returned zero since 1999, a period of healthy appreciation from 1999 through 2009 was followed by a period of strong depreciation since 2010. Of the 43% returned by EAFE equities from 1999 through 2009, 22% can be attributed to currency appreciation. In contrast, although EAFE equities have returned 60% since 2010, over 28% of return was lost due to currency depreciation. These are meaningful numbers that significantly effect risk and return for periods as long as ten years.

FIGURE 2 | **EAFE Currency Effect**



Source: Bloomberg, MSCI, Mesirow Financial. Performance from January 1999 – June 2019. Past performance is not necessarily indicative of future results. Actual results may materially differ.

Currency swings of 20% to 30% over 10-year periods meaningfully impact the investor experience.

An important element attached to currency return is the carry component. Hedging currencies through forward contracts includes a forward yield, predominantly determined through interest rate differentials between countries. At the start of the decade, carry was at zero or below for a US investor. In the latter half of the decade, carry has climbed steadily and has become a strong benefit for the US investor, providing above 2% of annual return based on current conditions.

*Past performance is not indicative of future results. Actual results may materially differ. Please see end disclaimer for additional information.

FIGURE 3 | **EAFE Annualized Carry**

Source: WM/Reuters, MSCI, Mesirow Financial. Performance from Jan 1999 – Jun 2019.
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Although we disputed the simplicity of zero expected return in currencies previously, if you subscribe to that assumption, then both hedging or not hedging would bring zero expected returns when carry is inconsequential. When carry becomes meaningful as it is now, current forward yields can produce 2+% of return. Thus, even investors who expect zero return from the spot price fluctuations of currencies can take advantage of the carry component through hedging their exposures. Although the US Federal Reserve has recently adopted a dovish tilt, the general sentiment among the central banks of other developed countries is also dovish. As carry is a function of interest rates between countries, the relative differentials are what matters, and US rates remain higher than those of other developed nations.

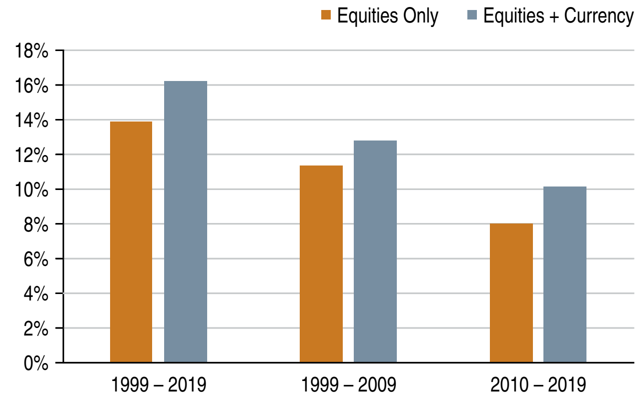
US investors expecting zero return from currencies may produce an annual return of 2% by hedging their currency risk, benefiting from the cost of carry.

Portfolio Diversification

Assumption – Currency return helps lower portfolio risk by diversifying the equity portfolio.

When currency return is introduced into asset classes with low volatility risk profiles, currency risk can overwhelm the portfolio with its higher volatility profile. This is often seen in fixed income portfolios, where the currencies are typically fully hedged to remove currency volatility from the equation. In international equity portfolios, the risk profile of currencies does not dwarf that of equities, and thus if left unhedged, has potential to provide diversification. However, when correlations are positive, the addition of currencies can increase total portfolio risk when compared to that of the local equity return. From 1999 through 2019, the addition of currencies to EAFE equities increased portfolio risk from 13.9% to 16.3%, while adding little return. In other words, uncompensated risk has been added to the portfolio. During 10-year periods of currency appreciation and depreciation, portfolio risk has increased in both environments, increasing from 11.4% to 12.8% from 1999 to 2009 and from 8.1% to 10.1% since 2010.

FIGURE 4 | **EAFE Portfolio Risk**



Source: Bloomberg, MSCI, Mesirow Financial. Performance from January 1999 – June 2019.
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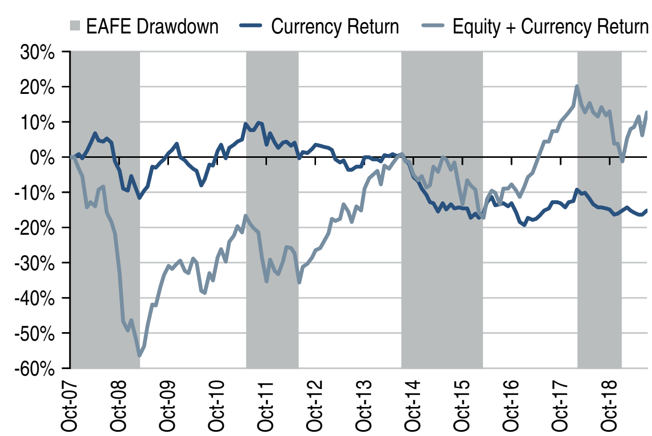
For the US investor, USD can act as a safe-haven currency during risk-off periods. Based on that assumption, when equity markets fall, USD can strengthen. Thus, foreign currencies can fall along with equity markets, leading to positive correlation between equities and foreign currencies, helping to explain the increased portfolio risk in both rising and falling currency environments.

During the Global Financial Crisis, EAFE equities dropped -56.7% between November 2007 and February 2009, including foreign currency depreciation of -5.7%. By fully hedging currencies, the hedged portfolio dropped less in value, falling -50.4% over the same period as the foreign currency loss was hedged away, plus an additional carry benefit based on the rates at the time was experienced. At the same time, risk was reduced from 7.3% to 6.0% annualized. Subsequent EAFE drawdowns have coincided with falling foreign currency valuations as seen in the shaded areas of the chart below.

FIGURE 5 | **EAFE Drawdowns**



Source: Bloomberg, MSCI, Mesirow Financial. Performance from January 1999 – June 2019.
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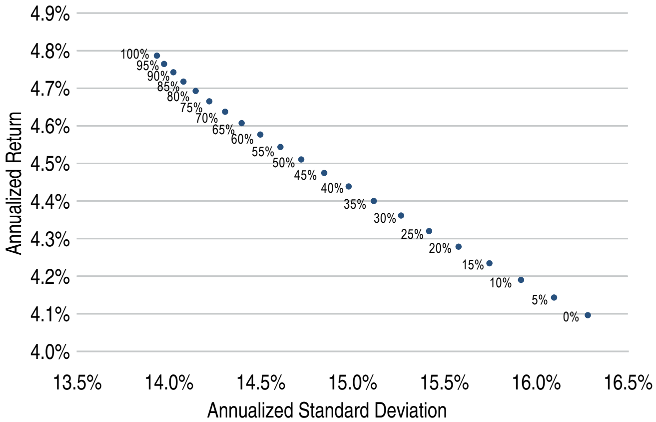
When return-to-risk is viewed as an efficient frontier, the highest return and the lowest risk EAFE portfolio can be found in the 100% hedged portfolio, with decreased return and increased risk as the hedge ratio is lowered.

FIGURE 6 | **Hedge Ratio**



Source: Bloomberg, MSCI, Mesirow Financial. Performance from January 1999 – June 2019. Past performance is not necessarily indicative of future results. Actual results may materially differ.

US investors with international equity portfolios have experienced higher risk than that attributed to local equity portfolios, in both rising and falling currency environments.

Low Materiality

Assumption – International investments are a small allocation of the portfolio, with currencies having little material effect.

As the US financial markets have been a major player in global markets, US plans have historically invested primarily in domestic markets. As the world has become more interconnected, the ease of investing internationally has made broadening the opportunity set a more palatable option. A recent Willis Towers Watson paper[1] supports the view that US domestic equity allocations as a percentage of total equity have decreased over the past 20 years, as the US is moving more towards the rest of the world in terms of percentage invested overseas.

While investment allocation is portfolio-specific, the trend towards interconnected markets has been spreading on a global scale, as international equity allocations have continued to increase in US investor portfolios.

Conclusion

Unpacking previous assumptions reveals a strong advantage in hedging foreign currency exposures, both from a risk and return perspective.

The case to leave currency risk unaddressed and unmanaged for the typical US investor has changed significantly in recent years. The episodic nature of currencies has caused 20%-30% swings in periods as long as 10 years. For those expecting currencies to return zero, hedging currency risk can provide meaningful returns to the portfolio in the current interest rate environment through the beneficial carry component. Total portfolio risk has increased due to the currency component of international equity portfolios, with specific characteristics of the US dollar causing positive correlations between foreign currencies and equities for a US investor. The risk-return profile has been most attractive for portfolios that are 100% hedged, and least attractive for those that are 0% hedged. As international equity investments continue to increase in typical US portfolios, the currency component looms large.

In the current environment, currency hedging accomplishes both a lowering of portfolio risk and an increase in currency return derived from the carry component.

About Mesirow Financial

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1 Source: Thinking Ahead Institute Research, "Global Pension Assets Study 2019." Willis Towers Watson, 2019

To learn how Mesirow can help you please contact Joseph Hoffman at 312.595.7017 or jhoffman@mesirowfinancial.com.

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