# The US hedging advantage

## Potential to increase return while reducing risk by simply hedging currencies

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.


**Uto Shinohara, CFA**
Managing Director
Senior Investment Strategist

**Aaron Wham**
Senior Vice President
Head of Portfolio Management


### 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, crossing the 0% return line again in early 2022.

FIGURE 1: **EAFE CURRENCY RETURN**


Source: Bloomberg, MSCI, Mesirow. Performance from January 1999 – December 2023. Past performance is not necessarily indicative of future results. Actual results may materially differ.

However, the impact over shorter time horizons is relevant as both plans and managers are often judged over periods as short as one to five years. Even within longer time horizons of ten years or more, volatile currency swings up to 50% have occurred, episodically adding or detracting significant value to the total equity portfolio, as seen in Figure 2.

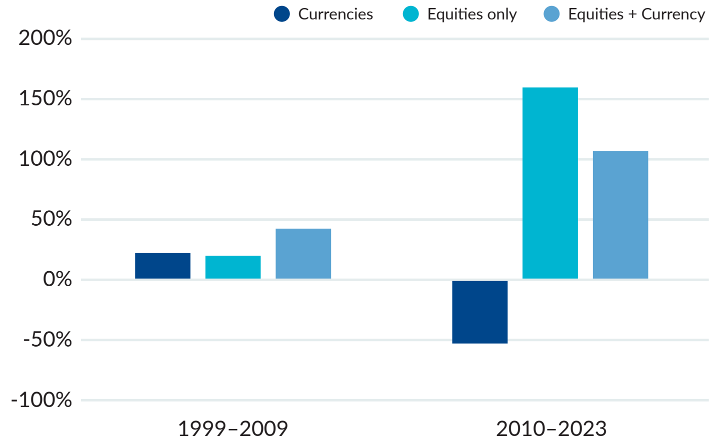
Although currencies have returned to zero multiple times since 1999, a period of healthy appreciation from 1999 through 2009 was followed by a period of strong depreciation since 2010. Of the 43% returned by EAFE equities from 1999 through 2009, 22% can be attributed to currency appreciation. In contrast, although EAFE equities have returned 107% since 2010, over 50% of return was lost due to currency depreciation. These are meaningful numbers that significantly affect risk and return for periods as long as ten years or more.

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 2010, carry was at zero or below for a US investor. In the latter half of the decade, carry climbed steadily, strongly benefitting the US investor by providing 2+% of annual return leading up to the onset of COVID, at which point global interest rates converged in response to the pandemic. With inflationary pressures rising subsequently, the Fed led the hawkish charge across central banks with the carry advantage for US investors crossing above 3% towards the end of 2022.

US investors expecting zero return from currencies may produce excess returns by simply hedging their currency risk, benefitting from the cost of carry. 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 is meaningfully beneficial, forward yields produce additional return, upwards of 2+% historically.

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. As carry is a function of interest rates between countries, the relative differentials are what matters. Since the pandemic, the Fed's faster exit velocity from quantitative easing promoted wider interest rate differentials and consequently, a continued US hedging advantage.

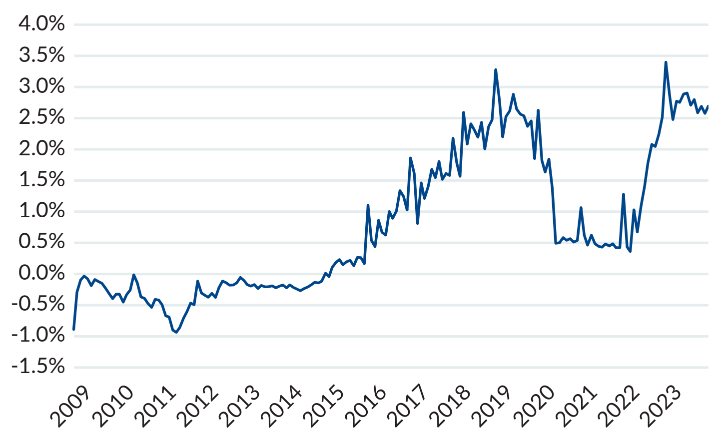
FIGURE 2: **EAFE CURRENCY EFFECT**




Source: Bloomberg, MSCI, Mesirow. Performance from January 1999 – December 2023. Past performance is not necessarily indicative of future results. Actual results may materially differ.

Currency swings up to 50% over 10+-year periods meaningfully impact the investor experience.

FIGURE 3: **EAFE ANNUALIZED CARRY**




Source: WM/Reuters, MSCI, Mesirow. Performance from Jan 2009 – December 2023. Past performance is not necessarily indicative of future results. Actual results may materially differ.

## 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 amplify total portfolio risk when compared to that of the local equity return. From 1999 through 2023, the addition of currencies to EAFE equities increased portfolio risk from 14% to 17%, while detracting 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 10% to 12% over rising currencies (1999 to 2009) and from 9% to 12% over falling currencies (2010 to 2023).

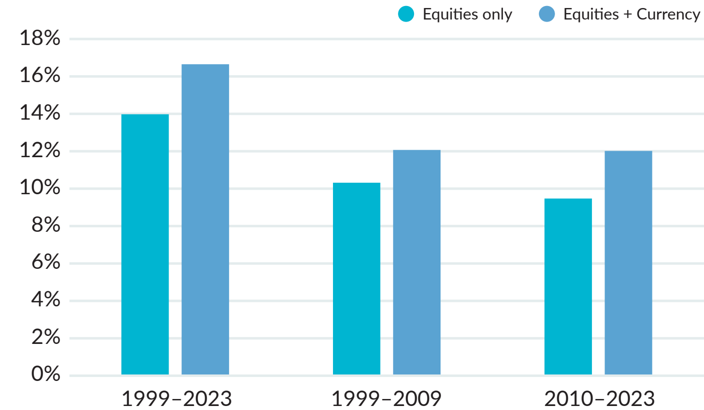
For the US investor, US dollar can act as a safe-haven currency during risk-off periods – when equity markets fall, US dollar can strengthen. Thus, foreign currencies can fall along with equity markets, with the positive correlation between equities and foreign currencies exacerbating the loss in international portfolios.

During the Global Financial Crisis, EAFE equities dropped -56% between November 2007 and February 2009, including foreign currency depreciation of -6%. By fully hedging currencies, the hedged portfolio dropped less in value, falling -50% over the same period as the foreign currency loss was hedged away, plus an additional carry benefit was experienced. At the same time, annualized risk was reduced from 7% to 6%. Subsequent EAFE drawdowns have coincided with falling foreign currency valuations as seen in the shaded areas of the next chart.

When return-to-risk is viewed as an efficient frontier, the highest return and the lowest risk EAFE portfolio resides within the 100% hedged portfolio, with return decreasing and risk increasing as the hedge ratio is lowered.

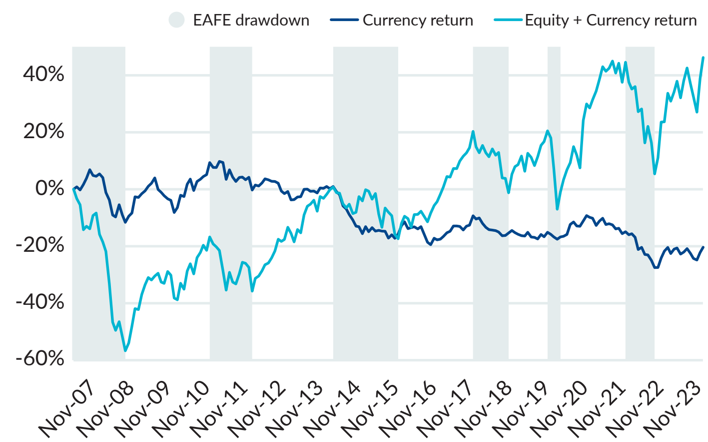
US investors with international equity portfolios have experienced higher risk than that of the local equity portfolios due to the currency component, in both rising and falling currency environments.

FIGURE 4: **EAFE PORTFOLIO RISK**



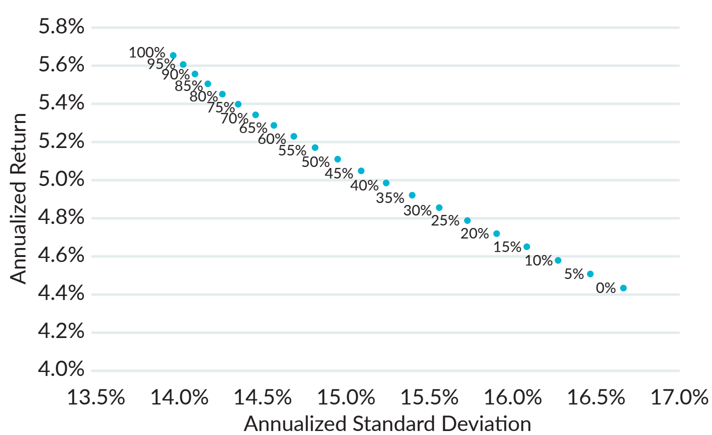

Source: Bloomberg, MSCI, Mesirow. Performance from January 1999 – December 2023. Past performance is not necessarily indicative of future results. Actual results may materially differ.

FIGURE 5: **EAFE DRAWDOWNS**




Source: Bloomberg, MSCI, Mesirow. Performance from November 2007 – December 2023. Past performance is not necessarily indicative of future results. Actual results may materially differ.

FIGURE 6: **HEDGE RATIO**




Source: Bloomberg, MSCI, Mesirow. Performance from January 1999 – December 2023. Past performance is not necessarily indicative of future results. Actual results may materially differ.

## Low materiality

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

With US financial markets playing a major role 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 global pension assets study by the Thinking Ahead Institute and Willis Towers Watson[1] supports the view that US domestic equity allocations as a percentage of total equity have decreased over the past 20 years. As the trend towards interconnected markets has been spreading on a global scale, the US is investing more and more overseas as international equity allocations have continued to increase in US investor portfolios.

## Conclusion

Unpacking antiquated arguments and assumptions surrounding currency hedging 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. While developed currencies can experience relatively flat returns over multi-decade time horizons, the episodic nature of currencies has caused price swings up to 50% over periods as long as ten years, significantly affecting risk and return. For those expecting currencies to return zero over the long-term, hedging currency risk manages episodic volatility while additionally providing US investors with incremental returns through the beneficial carry component. Total portfolio risk has increased due to the currency exposure inherent within 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 left unhedged. As international equity allocations continue to grow in typical US portfolios, the currency component looms large.

For the US investor, currency hedging accomplishes both a lowering of portfolio risk and an increase in currency return derived from the carry component – the US hedging advantage.

## About Mesirow

Mesirow is an independent, employee-owned financial services firm founded in 1937. Headquartered in Chicago, with locations around the world, we serve clients through a personal, custom approach to reaching financial goals and acting as a force for social good. With capabilities spanning Global Investment Management, Capital Markets & Investment Banking, and Advisory Services, we invest in what matters: our clients, our communities and our culture.

To learn more visit mesirow.com or contact Joe Hoffman at 312.595.7019 or joseph.hoffman@mesirow.com

1. Source: Thinking Ahead Institute, "Global Pension Assets Study 2023." Willis Towers Watson, 2023



This communication may contain privileged and/or confidential information. It is intended solely for the use of the addressee. If this information was received in error, you are strictly prohibited from disclosing, copying, distributing or using any of this information and are requested to contact the sender immediately and destroy the material in its entirety, whether electronic or hardcopy