Cornerstones

Why engage in foreign currency hedging?

The effects of FX movements on total return

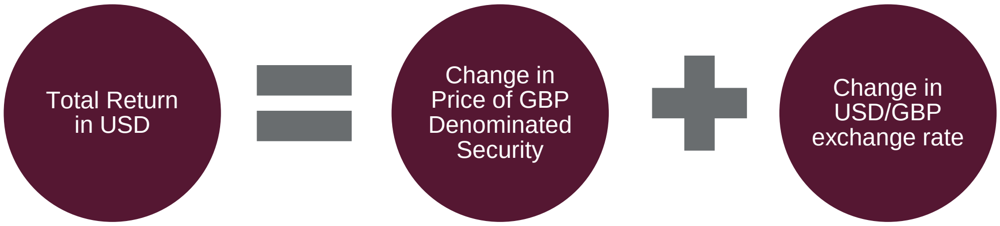
Since the advent of the information age, the world's economies have become increasingly intertwined, leading to what economists call The Global Economy. To an investor looking for optimal diversification in this market, investing on a global scale has become nothing short of a necessity. With 180 different currencies in circulation,[1] investments with exposure to foreign currencies are inevitable—and the fluctuations between currencies can have a pronounced effect on investment returns.

In the following illustrated example, we can see the components of total return when investing in a foreign denominated security. If a US investor buys and sells a UK security, the investor's total return will reflect a combination of both the change in price of that security plus the change in the (US Dollar / British Pound ("USD/GBP") exchange rate over the investment period.

In this example, if the GBP appreciates relative to the USD during the investment period, the US investor will receive more USD per GBP on the sale of the security therefore enhancing the total return. If the GBP depreciates relative to the USD over the period, the US investor will receive less USD per GBP on sale and the total return will be diminished.

[1] As recognized by the United Nations. Source: Travelex Currency Services Inc.

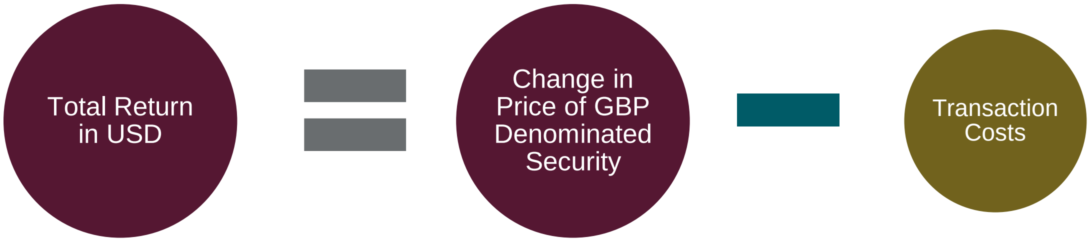
Total return components for a US investor in a British Pound denominated security[2]


Total Return in USD
=
Change in Price of GBP Denominated Security
+
Change in USD/GBP exchange rate

This is where an investor might want to consider currency hedging. Currency hedging offers an investor the potential to reduce the effect of exchange rate fluctuations on the total return of a foreign investment. If a hedge is executed effectively and currency fluctuations behave as expected, the currency-hedged investor will be left with a total return that primarily reflects the change in the price of a security—almost as if the investment had been denominated in their home currency.

However, as with any investment there are additional risks associated with currency hedging. Exchange rates are highly unpredictable and when they do not behave as markets expected, a currency hedge can act as a detractor to total return. In addition, there are transaction costs inherent in the hedging process that will serve to reduce the total return on a foreign investment.

Total return components for a perfectly hedged US investor in a British Pound denominated security[2]



The same principles apply to a basket of securities denominated in any number of currencies, like an index. If each currency in the basket is hedged perfectly the investor will receive a total return on the basket of securities that reflects the price fluctuations of the underlying components less the associated hedging transaction costs which can be significant depending on the number of currencies being hedged and the size of the positions.

In sum, currency hedging is worth consideration as foreign investments have become increasingly important to maintaining a well-diversified portfolio. An investor should weigh the benefits of currency hedging with all associated risks and costs.

[2] For illustrative purposes only. This illustration assumes a theoretical perfectly executed currency hedge. Any currency fluctuation not accounted for in the hedge could significantly reduce the total return.

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