To Hedge or Not to Hedge: Reconsidering Currency Risk

By Carl Mastroianni
Head of Client Portfolio Management
Insight Pareto*

A strengthening US dollar is prompting many US institutional investors to revisit their views toward currency hedging. For as long as the dollar was weak, US investors stood to enhance their total return when investment gains from abroad were translated back into dollars. Carl Mastroianni, Head of Client Portfolio Management at Insight Pareto, discusses how a rising dollar is changing that calculation and why US investors might want to rethink the need for a strategic policy on currency management.

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How does a rising dollar pose risks for US investors with substantial international allocations?

In the low interest rate environment we're in, there is a continued need to seek return. Many institutional investors look for return outside the domestic market, and in asset classes outside of equity, where they are exposed to non-US dollar risk. US-based investors must pay their liabilities, such as pension payments in US dollars, so there is that inherent risk that if something happens to the dollar's relationship with foreign currencies over a sustained period of time as we have seen in the past, they may have to translate those returns back into US dollars at a time when it may be less advantageous to do that unless they have some sort of protection from currency risk.

As allocations outside the domestic market have increased, and continue to increase, we've recently seen a bigger movement in the dollar amid optimism for a US recovery and projected monetary policy divergence by the Federal Reserve relative to global counterparts, which is having an impact on larger allocations. A 15% non-US allocation and a 10% strengthening of the dollar produces a 1.5% translation loss coming back to your portfolio. We think investors should address that uncompensated risk that could potentially wipe out a portion of their return.

Why haven't US investors been more attentive to currency risk in their international portfolios?

Since the financial crisis, the dollar has been weak for the most part. Global central banks, including the Federal Reserve have kept interest rates low and the dollar has remained weak. Most investors have remained unhedged, so they are taking all the currency translation gains when the dollar is weak and all the currency translation losses when the dollar is strong. Many investors have not been cognizant of this "hidden" risk in their portfolios because it has not really hurt them. That's still the

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predominant view today and many still believe these risks all wash out in the end and they're not going to worry about them. Our belief is that they should at least recognize these risks and make some strategic decisions around them.

What is your advice for investors who want to manage their currency risk?

First, we advise investors to look at their currency risk holistically across the portfolio, outside of only international equity. This allows them to identify whether they potentially have a larger allocation they're not accounting for by only looking at non-US equity. After they've added up all their non-US asset class exposures, they can think about how much they can afford to lose from that if the dollar strengthens. They need to assess their tolerance for an adverse event from currency, then think about how much they'd be willing to lose due to currency. We recommend they have policies in place to figure out how to address the currency risks in their portfolios. Many investors say they don't care about currency and remain unhedged; however, that in fact is really a strategic decision to take all of the currency translation losses as well as all of the currency translation gains. Saying they do nothing is really taking a strategically unhedged position in regard to currency exposure. Being unhedged is a policy and even if they decide to remain unhedged after a strategic review of their entire portfolio, they've at least created a framework to analyze currency risk in their portfolio and can then make tactical decisions around that going forward as necessary.

What value does the analytic currency policy framework provide?

It prepares them to respond if and when they determine that currency risk has begun to bite. It could also help them decide that their risk levels are modest and that they should elect to increase their international allocation, now that they have a strategic framework for managing currency. It also helps them to decide whether they adopt a hedging strategy or even seek alpha through currency. Perhaps after analyzing their level of risk and return objectives, they may conclude they want additional exposure to commodity currencies for example, such as the Australian dollar or to look into opportunities in non-USD crosses such as the Brazilian real and the Japanese yen. With an analytic currency policy framework in place, they can start thinking about expanding from solely a risk mitigation policy to a complementary alpha-seeking one. If they build the building blocks, they can then flesh out how they will look at currency from there on out.

Does the rising dollar create currency alpha opportunities as well as risk?

Since 2008, there's been little currency volatility as global central banks tried to keep rates low and out-ease each other with their monetary policies. Countries were all trying to keep the value of their currencies low to boost exports, so you didn't see a lot of volatility to manage for alpha opportunities. Most currency managers need some sort of directionality in the market to capture as part of their alpha strategy. If there are no moves, it's hard to generate alpha and institutional investors have looked to other options such as global macro strategies to try to deliver alpha rather than currency as a stand-alone strategy. If the dollar remains strong for a while, and/or currency volatility persists you'll likely see people begin to look more at currency alpha strategies.

So will the dollar remain strong, or do expect it to plateau or decline?

We expect the dollar to remain strong, but we don't see a rising dollar as a straight-line move. We've seen some data that favors a persistently strong dollar and some that doesn't. The eurozone economy appears to be picking up. Many developed market central banks have already eased to near-zero interest rate levels or beyond. The timing of Federal Reserve interest rate hikes amid uneven economic data pose a risk to continued dollar strengthening, but we look at history and we think this could be the start of something a bit more pronounced. Regardless of what the dollar does in the short term, currency risk is a fact of life for institutional investors accessing investment opportunities outside the US market. Nobody is generally moving away from international investing. Investors still need return and while some may be looking to reduce risk, most are still in the return seeking mode and looking outside the domestic market.

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