DOES CURRENCY HEDGING HAVE A BRANDING PROBLEM?

Wisdomtree EU
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One topic we often find exploring with investment professionals is the role of currency risk in international portfolios. We believe the industry has a branding problem with currency-hedged strategies; this is a legacy issue that may never be fixed for the industry, so education is critically important. The branding issue goes to the heart of what should be the default choice for international investments, in our view.

Let's say we erase all legacy biases, start with a clean slate and face the following choice:

+ Investment A: International Stocks
+ Investment B: International Stocks Plus Currency

If fund choices were branded International Stocks Plus Currency and others more simply International Stocks, we think the vast majority of investors would choose 'International Stocks' only.

The branding problem for currency hedging is the default labelling and branding makes it seem like the active decision to do something more exotic and complicated is the International Stocks Plus Currency Hedge choice.

The reality is that unhedged international strategies carry a second layer of risk and exposure, not the hedged strategies. The currency-hedged strategies have the goal of getting you the stock returns in their local markets.

So why do people continue to buy International Stocks Plus Currencies, especially if many people have no conviction on the direction of currency moves?

We believe this in part is due to the status quo bias. For as long as people have invested internationally, the most common investment option was this default to be unhedged (Stocks Plus Currencies). Now, over the last three to five years, currency hedging has made dramatic investment gains compared to being unhedged because the US Dollar has moved significantly.

This leads many value-oriented investors—who tend to be the ones going overseas today for their valuation opportunities—to argue that perhaps now is exactly the time not to be hedged and to take on currency exposure. This line of thinking says the US Dollar should head back down from here. Maybe. But also maybe not.

No one knows for sure which direction the US Dollar is going to go–and we would argue that taking these bets on currencies is not something one is paid to do via any natural currency risk premium akin to the equity risk premium. That is why we suggest the default should be to be currency neutral to lower overall volatility (in other words, hedged with no ability to benefit from currency appreciation but also no headwinds from currency depreciation).

And this “hedged” or currency-neutral default should be the norm, in our view, unless one has the more tactical view that the US Dollar is going to fall. If you have this specific tactical view, you absolutely should express that view.

The argument to be bearish on the Dollar and bullish on the Euro or Sterling is just a reflection that people feel the Dollar has moved a lot already. And yes, of course, it has moved a lot.

But when we look at what factors drive currencies over time, the academic research settles on three factors that tend to be most influential in driving the direction of currencies: Value, momentum and interest rate differentials.

Tug of war between value and interest rates

Today the currency “value factor” and “interest rate factor” are tugging the US Dollar in opposite directions.

We’ve recently had the US Federal Reserve continue its interest rate policy normalisation cycle.

When there is a “cost to hedge” developed world currencies–and today that exists only for Australia and New Zealand–you’d rather be unhedged. When you are paid interest rate differentials to hedge–as you are today for currencies such as the euro, yen and pound–you ought to be hedged, in our view.

Rising rate differentials suggests being hedged

The amount you could be paid to hedge just widened with the Fed hike, suggesting a stronger signal to stay hedged, or at least lengthening how long the signal will suggest being hedged. We could see this interest rate factor signal suggesting to be hedged versus the Euro for the next five years or more. As an example of how rate differences can be persistent, the interest rate factor suggested staying hedged on the Yen for the last 24-plus years. Japan has been lower for longer.

Where are today’s opportunities?

Opportunities abound in global equities, be it the US, Japan or the Eurozone, and in each case–as discussed–putting in place a currency hedged exposure, is the lower risk strategy.

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