DEFENSIVE ASSETS: CURRENCIES, A POWERFUL TACTICAL OVERLAY

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*This blog is the fifth instalment of our blog series on Defensive Assets: '**Offence wins games but defence wins championships**'.*

Last week, we highlighted the risk on, risk off[1] behaviour of currencies and how it can be used as part of a defensive portfolio. However, currency exposure is most of the time gained as an overlay to other asset classes. In this instalment, we will focus on assessing the combinations between funded assets like government bonds or equities with a currency overlay through the prism of our defensive framework. In particular, we will observe that:

- Combining a defensive asset with a risk off currency overlay typically improves the defensiveness in crisis of the investment
- Such combinations may be more volatile day to day but can still deliver significant outperformance in equity crisis
- Currency hedging, can be a powerful tool to control and pilot the defensive characteristics of an asset. In some cases, such hedging would allow the investor to make money over time through the collection of a positive carry.

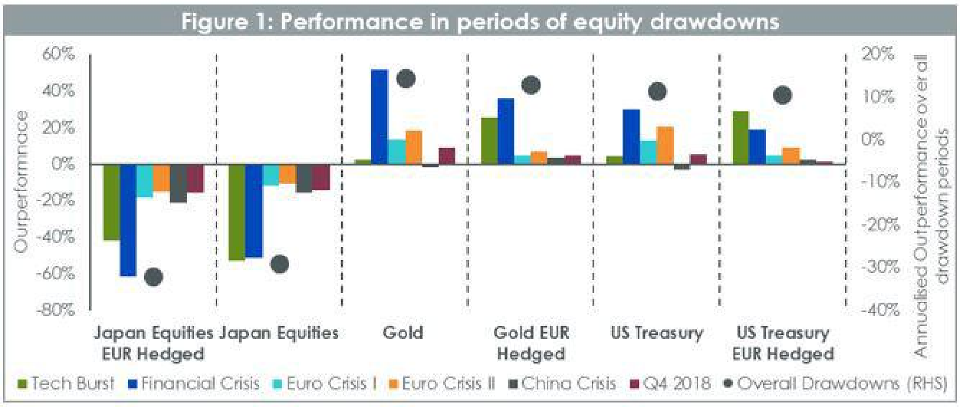
Currencies, a natural overlay

Since 2009, when WisdomTree introduced the concept of currency-hedged equities to the exchange-traded fund (ETF) structure in the US–a concept that caught fire subsequent to the introduction of Abenomics[2] in Japan in late 2012–, investors have fully awakened to the "currency factor". Currency exposures, that are gained mainly though investing in foreign assets, have rather significant impacts on the risk /return profile over time.

We have observed in last week blog that risk off currencies like, for example, Japanese yen tend to perform positively in times of stress and equity drawdowns. In most cases, a euro-based investor investing in Japanese equities would gain exposure to Japanese equity performance but also to the performance of Japanese yens versus euro. In order to remove this implicit currency overlay, the investor would need to hedge this portfolio against the currency risk and buy exposure to Japanese equity hedged in euro.

Having just described Japanese yen's behaviour in crisis, it seems only natural to believe that the hedged exposure would, in fact, do worse than the unhedged one when equities face a downturn. This is indeed what we observe in Figure 1. In 5 out of 6 drawdowns, Japanese equities unhedged have outperformed the euro hedged exposure. On average, the unhedged strategy outperformed the hedged one by 3% per annum in equity drawdowns.

Overall, we can expect that adding risk off currency exposure to already defensive assets would increase their risk reduction. For example, we can imagine that Gold, a very powerful defensive asset already as illustrated in the commodity focused instalment of this blog series, would do better in equity drawdown if unhedged in US Dollars than hedged in euro. Or US Treasuries unhedged would do better than US Treasuries hedged in euros. Figure 1 illustrates those two cases as well. Similarly to Japanese equities, Gold and US Treasuries unhedged have outperformed their hedged exposures 4 out of 6 times and by 1% per annum on average.



Source: WisdomTree, Bloomberg. In EUR.

Historical performance is not an indication of future performance and any investments may go down in value.

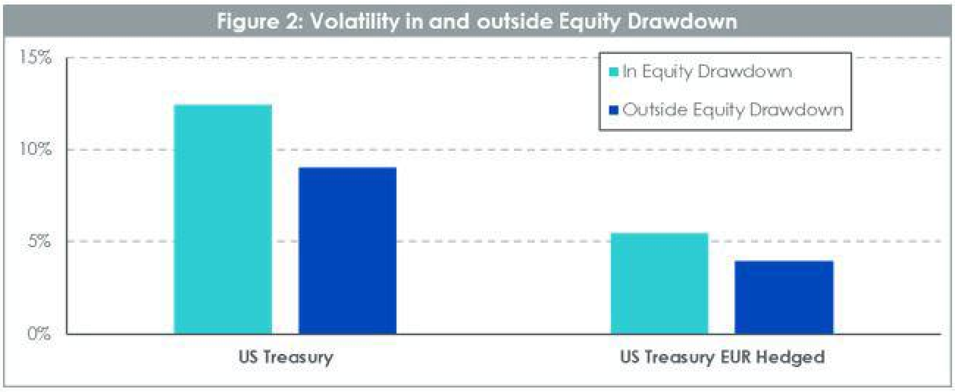
The 6 well known equity drawdown periods used in this graph are the Tech Burst (September 2000 to March 2003), the Financial Crisis(July 2007 to March 2009), the Euro Crisis I (April 2010 to July 2010), the Euro Crisis II (My 2011 to October 2011), the China Crisis (April 2015 to February 2016) and Q4 2018.

Volatility and Drawdowns are not the same things

The US Treasury case is an interesting one because in some ways it is counterintuitive. In Figure 2 we show the volatilities of this asset, in both hedged and unhedged terms, during equity drawdowns as well as outside of equity drawdowns. Hedging the currency risk significantly reduced the volatility in both periods which could be construed as being defensive and yet Figure 1 clearly demonstrated that the unhedged portfolio was a better hedge to equity drawdowns. This brings us to our initial observation on the non-fungibility of risk measures (see the first instalment of this blog series) and the need to clearly identify what an investor is trying to achieve. There is a difference between:

1) A strategy that leads to generally lower volatility across time and,

2) A strategy that has the potential to outperform during times of peak volatility.



Source: WisdomTree, Bloomberg. Period July 2000 to December 2019. Calculations are based on daily returns in EUR.

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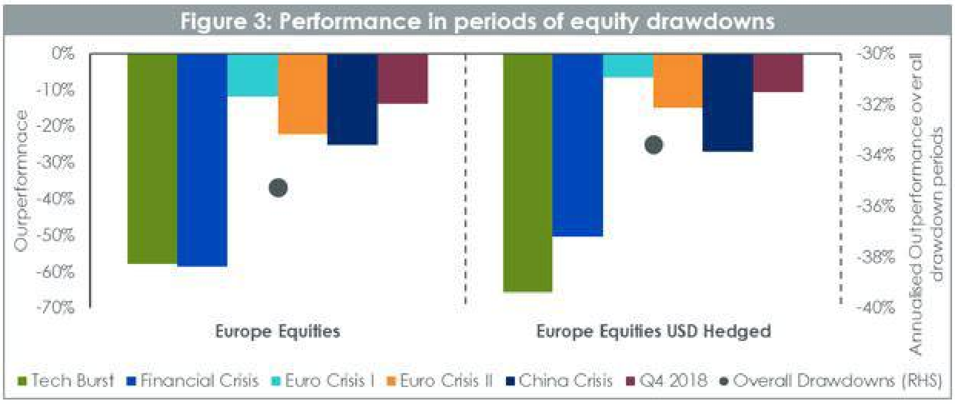
In the above 3 examples, the risk off currency overlay was built in the exposure. Gold is naturally a USD denominated asset. What about assets that are denominated in risk on currencies like the euro or the Australian dollar for example. In this case, it is possible to use Currency hedging as a way to add the required risk off currency exposure to any asset. For example, if a euro investor were to buy Eurozone equities hedged in USD it would gain Eurozone equity exposure as well as US Dollar exposure. In Figure 3 we illustrated the performance of both assets in the 6 drawdown periods we have been considering in this series, the currency overlay using a risk off currency (in this examples USD) added some defensiveness to the eurozone equities. In a portfolio context, this opens a wide range of possibilities that can be exploited by investors.

In Figure 3, we observed the performance of European equities unhedged (ie mostly in euro) and hedged in USD. In 4 out of the 6 drawdown periods, the USD hedged exposure as outperformed the unhedged one. On average European equities hedged in USD have outperformed by 1.5% per annum.



Source: WisdomTree, Bloomberg. In EUR.

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One last consideration, in this specific case, is that currency hedging is impacted by carry. Intuitively, most investors would expect this carry to be a cost but in fact, it can be positive or negative depending on the level of the short-term rates in the two considered currencies. Coming back to eurozone equity hedged in US dollars, it is worth noting that as of the time of writing this series, the U.S. Federal Reserve's Fed Funds rate was significantly higher than the European Central Bank's (ECB's) interest rates of similar tenor, which means that hedging euro asset in US dollars carry a positive carry of around 2.1%[3]. In other words, assuming that all things stay equal, hedging an asset denominated in euros over to exposure in U.S. dollars would add approximately 2.1% to the return profile on an annualised basis.

In conclusion, since currencies can be added as an overlay to almost any exposure, it is a very powerful tool for investors when designing a defensive portfolio. Our next instalment will focus on the last major asset class that we will cover in this series: Commodities. Gold and precious metals will feature extensively but we will also examine how broad commodities could be a strong portfolio diversifier and if energy commodities are potentially a geopolitical hedge.

[1] Risk-on risk-off refers to changes in investment activity in response to global economic patterns.

[2] Abenomics refers to the economic policies advocated by Shinzo Abe since the December 2012 general election, which elected Abe to his second term as Prime Minister of Japan.

[3] Source: WisdomTree, Bloomberg. As of 20 February 2020.

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