

# 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.

### Zero expected return

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 with close to zero realized return.

FIGURE 1: EAFE CURRENCY RETURN



Source: Bloomberg, MSCI, Mesirow. Performance from January 1999 – December 2021. Past performance is not necessarily indicative of future results. Actual results may materially differ.



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



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

Past performance is not indicative of future results. Actual results may materially differ. Please see end disclaimer for additional information.

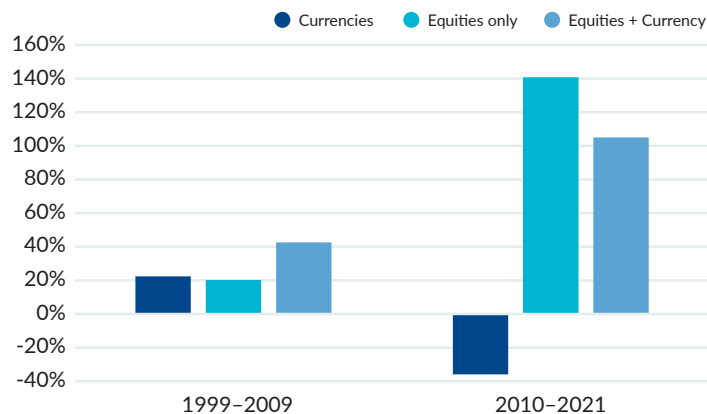
The information contained herein is intended for institutional clients, Qualified Eligible Persons, Eligible Contract Participants, or the equivalent classification in the recipient's jurisdiction, and is for informational purposes only. Nothing contained herein constitutes an offer to sell an interest in any Mesirow Financial investment vehicle. It should not be assumed that any trading strategy incorporated herein will be profitable or will equal past performance. Please see the disclaimer at the end of the materials for important additional information.

However, the impact over shorter time horizons is relevant as both plans and managers are often judged over periods as short as 1 to 5 years. Even within longer time horizons of 10 years or more, volatile currency swings up to 35% have occurred, episodically adding or detracting significant value to the total equity portfolio, as seen in the chart to the right. Although currencies have returned close to zero 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 105% since 2010, over 35% of return was lost due to currency depreciation. These are meaningful numbers that significantly effect 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 benefiting 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.

US investors expecting zero return from currencies may produce excess returns by simply hedging their currency risk, benefiting 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. While the US has maintained higher rates than most developed nations over the pandemic, its faster exit velocity from quantitative easing promotes wider interest rate differentials and consequently, a continued US hedging advantage.

FIGURE 2: EAFE CURRENCY EFFECT

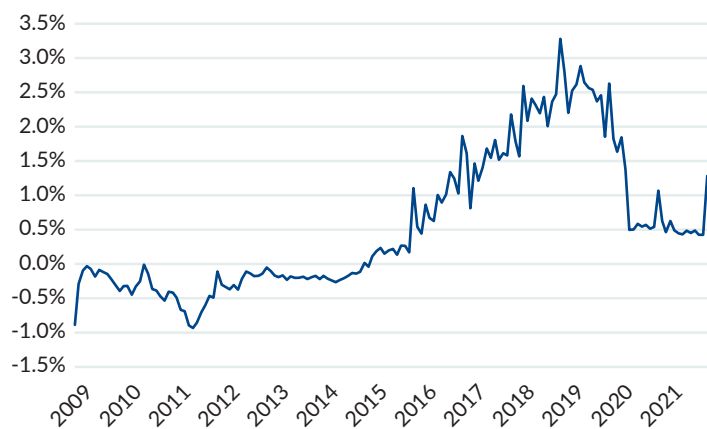


Source: Bloomberg, MSCI, Mesirow. Performance from January 1999 – December 2021. Past performance is not necessarily indicative of future results. Actual results may materially differ.



Currency swings up to 35% over 10+-year periods meaningfully impact the investor experience.

FIGURE 3: EAFE ANNUALIZED CARRY



Source: WM/Reuters, MSCI, Mesirow. Performance from Jan 1999 – December 2021. Past performance is not necessarily indicative of future results. Actual results may materially differ.

## Portfolio diversification

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 2021, the addition of currencies to EAFE equities increased portfolio risk from 14.1% to 16.4%, while adding little 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 10.8% to 12.1% over rising currencies (1999 to 2009) and from 9.1% to 11.2% over falling currencies (2010 to 2021).

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 -56.7% between November 2007 and February 2009, including foreign currency depreciation of -5.7%. By fully hedging currencies, the hedged portfolio dropped less in value, falling -50.4% 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 7.3% to 6.0%. 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.

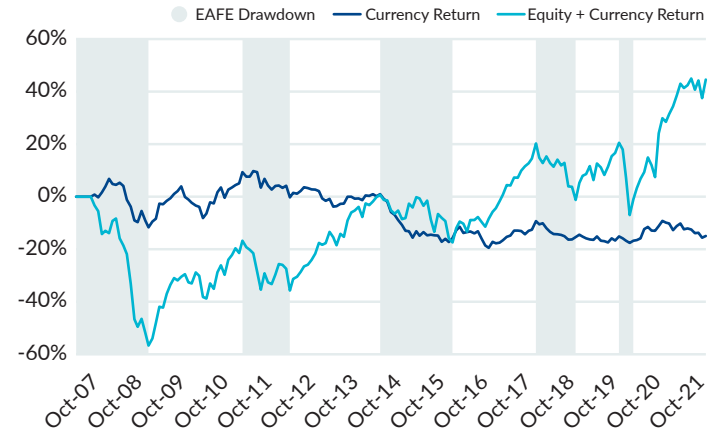
US investors with international equity portfolios have experienced higher risk than that of the local equity portfolios due to the currency component, in both rising and falling currency environments.

FIGURE 4: EAFE PORTFOLIO RISK



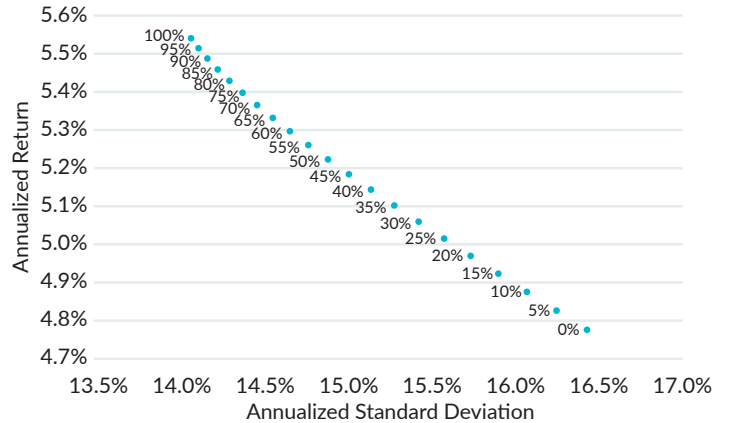
Source: Bloomberg, MSCI, Mesirow. Performance from January 1999 – December 2021. Past performance is not necessarily indicative of future results. Actual results may materially differ.

FIGURE 5: EAFE DRAWDOWNS



Source: Bloomberg, MSCI, Mesirow. Performance from January 1999 – December 2021. 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 2021. Past performance is not necessarily indicative of future results. Actual results may materially differ.

## Low materiality

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<sup>1</sup> 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 have produced relatively flat returns over multi-decade time horizons, the episodic nature of currencies has caused price swings up to 35% over periods as long as 10 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.

1. Source: Thinking Ahead Institute, "Global Pension Assets Study 2021." Willis Towers Watson, 2021  
Mesirow Currency Management ("MCM") is a division of Mesirow Financial Investment Management, Inc. ("MFIM") a SEC registered investment advisor, a CFTC registered commodity trading advisor and a member of the NFA and Mesirow Financial International UK, Ltd. ("MFIUK"), authorized and regulated by the FCA, a CFTC registered commodity trading advisor and a member of the NFA. The information contained herein is intended for institutional clients, Qualified Eligible Persons and Eligible Contract Participants or the equivalent classification in the recipient's jurisdiction and is for informational purposes only. This information has been obtained from sources believed to be reliable but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice. It should not be assumed that any recommendations incorporated herein will be profitable or will equal past performance. Mesirow does not render tax or legal advice. Nothing contained herein constitutes an offer to sell or a solicitation of an offer to buy an interest in any Mesirow investment vehicle(s). Any offer can only be made through the appropriate Offering Memorandum. The Memorandum contains important information concerning risk factors and other material aspects of the investment and should be read carefully before an investment decision is made.

Currency strategies are only suitable and appropriate for sophisticated investors that are able to lose all of their capital investment. 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.

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](https://mesirow.com) or contact Joe Hoffman at 312.595.7019 or [joseph.hoffman@mesirow.com](mailto:joseph.hoffman@mesirow.com)

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

Certain strategies discussed throughout the document are based on proprietary models of MCM's or its affiliates. No representation is being made that any account will or is likely to achieve profits or losses similar to those referenced.

Comparisons to any indices referenced herein are for illustrative purposes only and are not meant to imply that a strategy's returns or volatility will be similar to the indices. The strategy is compared to the indices because they are widely used performance benchmarks.

The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada. It is maintained by MSCI Inc., a provider of investment decision support tools; the EAFE acronym stands for Europe, Australasia and Far East.

Mesirow refers to Mesirow Financial Holdings, Inc. and its divisions, subsidiaries and affiliates. The Mesirow name and logo are registered service marks of Mesirow Financial Holdings, Inc., © 2022 Mesirow Financial Holdings, Inc. All rights reserved. Investment management services provided through Mesirow Financial Investment Management, Inc., a SEC registered investment advisor, a CFTC registered commodity trading advisor and member of the NFA, or Mesirow Financial International UK, Ltd. ("MFIUK"), authorized and regulated by the FCA, a CFTC registered commodity trading advisor and a member of the NFA, depending on the jurisdiction.