INVESTMENT

Shielding your investment:

The power of active currency hedging

Mesirow Currency Management senior investment strategist, Uto Shinohara, **outlines the benefits active currency hedging can provide to European investors**

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European pension plans invest their assets broadly, distributing them geographically across the globe, in order to access the most compelling opportunities. With only about 55% of assets from pension funds invested domestically, just under half of assets reside in international investments according to the *ECB Economic Bulletin* issued in July 2020. At the higher end of the spectrum, the Netherlands' long-standing tradition of favouring international investment is evident through the 91% of Dutch assets invested abroad as of 2020 (according to *OECD's Pensions Markets in Focus*). With international investments materially impacting the portfolio, managing currency risk becomes an important consideration.

Euro Fluctuations and Currency Risk

Since its introduction in 1999, Euro has experienced numerous structural movements that have meaningfully impacted international investments. With the United States accounting for a large percentage of international assets due to the country's leading economic presence, substantial market share, ample liquidity, and political stability, the movements of Euro vs. US dollar are highly influential on portfolio outcomes. The following chart displays the path of EUR-USD since the inception of Euro, with shaded regions representing periods of US dollar weakness, i.e., when USD investment returns have suffered due to movements in the underlying currency. Sustained, high magnitude episodes of US dollar weakness have occurred, ranging from over 60% in the early 2000s to the current episode that began in late September 2022, registering close to 14% so far.

As a result of currency impact, investments in US securities can face substantial headwinds. Although the EUR-USD relationship is marginally in US dollar's favor over the past 20+ years, double-digit currency losses over periods as long as 4-years present significant drags on performance, especially as the time horizon to evaluate investment strategies have tilted shorter. While long-term returns have netted to marginal US dollar strength over the time period, the annualised risk from the currency exposure measured at over 9%, i.e., uncompensated risk.

Active Hedging Benefits

While passively hedging currency exposures reduces currency risk in the portfolio, this approach applies a blunt instrument when compared to the benefits of active risk management. There is lost opportunity when currencies rise, and there can be an inherent carry penalty from the instruments typically used to hedge, notably FX forwards and futures.

Passive hedging is naïve, in that all currencies exposures are typically managed identically. With central bank policies differing among regions along with other area-specific drivers evolving over time, their movements against Euro are not uniform.

The chart on the right displays spot movements of the 3 largest exposures typically found in international portfolios over a 6-month period last year. While Sterling and Yen exhibited similar weakness relative to a stronger Euro, US dollar gained substantially over the same timeframe, with passive hedges against Sterling and Yen netting positive cashflows while those against US dollar produced strongly negative cashflows. Different views on different currencies create opportunities. Active hedging provides a means to hedge against episodes of currency weakness while enhancing returns by participating in currency gains at a currency-specific level.

For European investors, carry has historically been a structural cost for passive hedgers. In an MSCI-weighted normalised portfolio of the 6 largest exposures, the carry-penalty to fully hedge the portfolio has been -1.80% annualised since 2005 through Q1 2023. A thoughtful, strategic active hedging program can help offset the carry penalty while managing currency risk in the portfolio.

Insights & Outlook

The strong influence of central bank policy on currency movements last year has continued into 2023, as the ECB and other central banks balance sustained inflation against recessionary pressures. The Fed's hawkish push in 2022 drove US dollar higher relative to Euro with a comparatively slow-moving ECB. As the ECB began closing the policy gap vs. the Fed in the latter part of 2022 into 2023, Euro has been resurgent, rising in tandem with the lowering interest rate differential between regions.

For European investors with international portfolios, active hedging can navigate this changing backdrop with more flexibility than a passive hedge while having the potential to be compensated for the currency risk inherent in global investments. As central banks reach their terminal rates and consider cutting rates, policy divergence across regions will continue to drive FX markets this year, creating active hedging opportunities. Improving risk appetite and China's reopening has been Euro-supportive, putting pressure on currency exposures. With FX volatility increasing from the historical lows in 2020 and 2021, a currency hedging policy with a dynamic, active element can help steer the portfolio through the turbulence.

Source: Mesirow, Bloomberg

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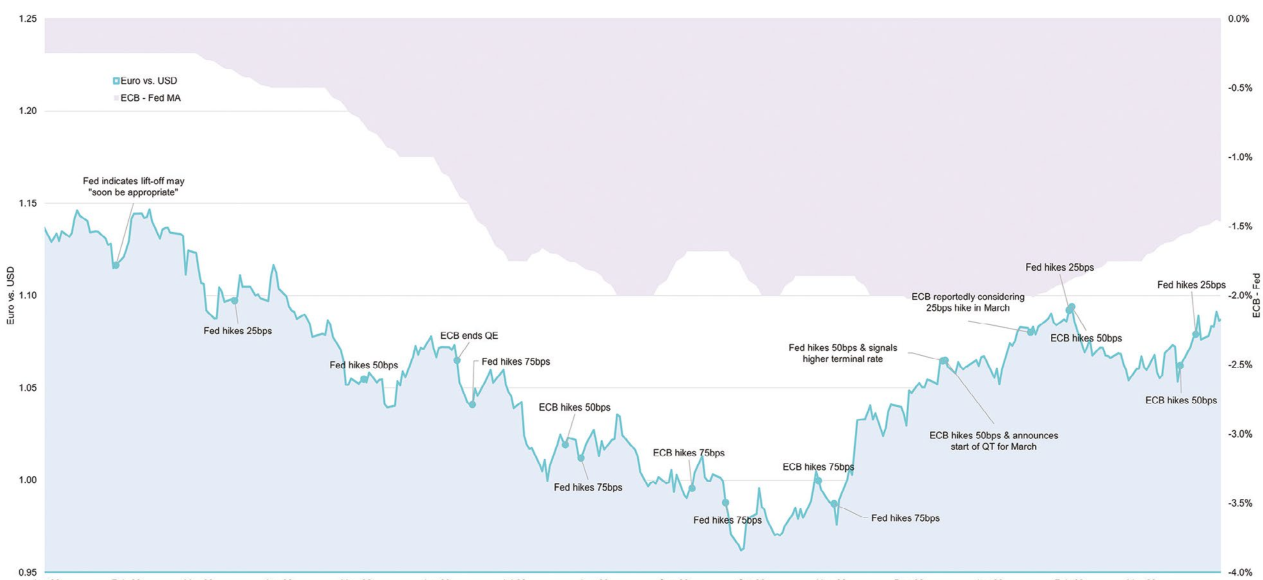

Source: Mesirow, Bloomberg. 20D centered moving average of interest rate differential between the ECB and the Fed.