PASSIVE CURRENCY HEDGING

Reducing the Currency Risk of International Investing
Including currency hedging in international investment strategies should, in our view, be an integral part of the investment process for institutional investors.

**OUR SOLUTIONS**

Simply allowing currency exposure to equal the exposure to a portfolio’s underlying international assets, be they equities, fixed income, real assets or alternatives, seldom results in the most efficient portfolio.

**Implementation Services**

Let us handle the details. We provide complete operational support, from providing ISDA agreements where necessary and working with custodians during the set-up process, to executing/settling trades and determining required cash flows on an ongoing basis.

Our proprietary currency management systems, developed with the benefit of years of currency trading and management experience, help ensure accuracy and precision execution.

Transparency is critical in our client relationships. We provide our overlay clients with detailed, customisable reporting on performance and exposures as well as comprehensive transaction cost analysis.

**Advisory Services**

Many of our clients come to us with a detailed hedging policy. In many cases, however, the specific hedging policy has not been determined or needs to evolve organically with the broader portfolio. We specialise in advising investors on the impact of currencies on their portfolios, to help guide the choice of the appropriate hedging methodology.

**Who Its For**

Investors with incidental, unmanaged currency exposure imbedded in their international portfolios who do not wish to manage that risk via other currency management strategies.

**Why Use It**

Investors often underestimate how much foreign exchange rate volatility can erode, or contribute to, international investment returns. Simple passive hedging can help to mitigate those risks.

**STRATEGY COMPONENTS**

**CHOICE OF HEDGE RATIO**

Hedging is not a binary decision i.e., whether to hedge 100% or 0%. The most efficient hedge ratio depends crucially on factors such as the size of the foreign exposure, asset class composition, investor risk preferences, investment horizon, costs of hedging and the correlation of the currency exposure with underlying assets. We examine these and other factors with our clients, using our historical backtesting tools to better inform the choice of hedge ratio.
In essence, the approach is a simple buy and hold hedge, constructed by selling foreign currency and buying the investor’s base currency, typically using currency forward contracts. The goal of reducing exposure to currency fluctuations resulting from foreign investments.

The first step is to determine the investor’s foreign currency exposure. We work directly with clients, custodians and, in some cases, other asset managers to determine each client’s foreign currency exposure. Typically, these exposures are updated monthly, but they can be updated more or less frequently.

Once we’ve established the level of foreign currency exposure, we construct hedges to achieve the desired hedge ratio. The amount of exposure reduction is determined by the hedge ratio.

We offer hedging overlay services for single international investments or complete multi-asset-class international portfolios. Hedge ratios may differ across asset classes and currencies.

**An Example†**

A Swiss investor purchases one share of IBM stock in the US for US$100. If the exchange rate is 1 Swiss franc (CHF) per US dollar (USD), the CHF value of the investment is 100 CHF. The investor is exposed not only to changes in the price of IBM shares, but also to changes in the value of the US dollar versus the Swiss franc. If after one month, IBM’s share price is unchanged, but the US dollar depreciates by 10%, the investor will lose 10%. In this case, the exchange rate drops from 1CHF/USD to 0.90CHF/USD and the US$100 investment is now worth only CHF90, a loss of 10% despite the fact that IBM’s share price was unchanged.

Now assume that the investor has a 100% currency hedge in place. In this scenario, the investor would have sold $100 USD and purchased CHF 100 using a one-month currency forward. At the end of the month, the investor could buy back the US$100 for only CHF90, generating a profit of CHF10 and thereby offsetting the loss incurred in the currency unhedged example. (For simplicity, we assume in this example that Swiss and US 1-month interest rates are identical.)

**HOW IT WORKS**

**THE BENEFITS**

Each client must choose whether to apply the hedging policy to benchmark exposures or actual currency exposures. This choice has important consequences for benchmark tracking error and/or the interaction of the hedge with active positions in the underlying portfolio. We help investors understand and examine these effects to help choose the method that best suits their goals. When hedging benchmark exposures, we receive the total NAV of each investment and assume that it is invested exactly in line with an underlying reference benchmark. When hedging actual exposures, we receive the exact currency holdings of the underlying portfolio.

Local regulations, choice of forward contract tenor (for example, hedging using 1-month vs. 3-month currency forwards) and the liquidity of the assets being hedged are among the important determinants of the cost and impact of managing the cash flows required when hedging. We provide a variety of options and historical simulations to assist investors to select the optimal method.
About Us

For nearly four decades, State Street Global Advisors has been committed to helping our clients, and those who rely on them, achieve their investment objectives. We partner with many of the world’s largest, most sophisticated investors and financial intermediaries to help them reach their goals through a rigorous, research-driven investment process spanning both indexing and active disciplines. With trillions* in assets under management, our scale and global reach offer clients access to markets, geographies and asset classes, and allow us to deliver thoughtful insights and innovative solutions.

State Street Global Advisors is the investment management arm of State Street Corporation.

*AUM reflects approx. $33.33 billion (as of 31 March 2017) with respect to which State Street Global Advisors Funds Distributors, LLC serves as marketing agent; State Street Global Advisors Funds Distributors, LLC and State Street Global Advisors are affiliated.

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Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Currency Hedging involves taking offsetting positions intended to substantially offset currency losses on the hedged instrument. If the hedging position behaves differently than expected, the volatility of the strategy as a whole may increase and even exceed the volatility of the asset being hedged. There can be no assurance that hedging strategies will be effective.

In investing in forwards is highly risky. Forward contracts are not standardized, nor are they traded on an index. Rather, they are negotiated privately between the counterparties and are not settled by a centralized clearing-house. Additionally, Forward positions might not be marked-to-market and may subject a party to significant counterparty risk. Forward positions are considered highly leveraged because the initial margins are significantly smaller than the cash value of the contracts. The smaller the value of the margin in comparison to the cash value of the forward contract, the higher the leverage. There are a number of risks associated with forward investing including but not limited to counterparty credit risk, basis risk, currency risk, derivatives risk, foreign issuer exposure risk, sector concentration risk, leverage and liquidity risks.

1 The information contained in the example is for illustrative purposes only. In the context of hedging equity investments against currency risk, these materials use the term “100% Hedging” to refer to portion of the nominal amount that is hedged at the beginning of a hedging period. After hedging 100% of the beginning nominal amount, the nominal amount may vary with time due to market forces, and the hedge will not be reset until the beginning of the next hedging period. In the interim, the hedge may vary from the 100% level. As such, a “100% Hedge” does not guarantee perfect hedging.