

STRIKING A BALANCE: THE OPTIMAL HEDGING RATIO AND COST TRADE-OFFS IN GLOBAL CURRENCY RISK MANAGEMENT

JUNE 2023

Authors: Luis Viceira, *Harvard University*
Sally Shen, *Global Risk Institute*



EXECUTIVE SUMMARY

This paper explores the effectiveness of global currency hedging, assessing both its risk-reducing benefits and cost efficiency. Our research suggests that while currency hedging can help to reduce volatility and minimize downside risk, it can also come with a cost, particularly in emerging markets. Furthermore, the efficacy of hedging strategies can vary depending on the prevailing market conditions, and different approaches may be more suitable for different asset classes. Our findings can serve as a valuable resource for investors looking to optimize their currency hedging choices in international portfolios. The study conducted an in-depth historical analysis of market rates, currency hedging strategies and portfolio returns over the period of January 1975 to October 2021 covering Canada, United States, UK, Germany, Japan, Australia, China, Brazil and India.

Key takeaways for Canadian investment managers:

- When hedging currency risk in emerging markets, investors should carefully consider the cost effectiveness of using forward contracts versus a borrow/lend strategy. There can be a significant cost difference between these two approaches.
- While the Covered Interest Parity (CIP) may hold true in developed markets, the discrepancy between the hedging cost obtained through "borrow/lend" and "forward" approaches suggests that CIP is less likely to hold true in emerging markets.

- For Canadian investors, the cost of currency hedging is generally lower than for US investors, regardless of whether they are investing in developed or emerging foreign stock markets. This highlights the importance of considering the investor's base currency when hedging currency risk.
- Neglecting currency risk can lead to a loss of potential gains, as demonstrated by the optimal long CNY position for Canadian investors in the Chinese stock market. Investors should carefully consider the potential benefits of currency hedging for each market in which they are invested.
- Investing in multi-country portfolios can be a way to lower investment volatility and increase diversification. The cost of minimizing currency fluctuation for a Canadian investor in a multi-country stock portfolio is relatively low, at less than 1%.
- The benefits of currency hedging can vary depending on the type of investment, the currency being hedged, and the investor's base currency. It's important for investors to carefully consider their individual circumstances and investment goals before deciding whether to hedge currency risk.

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