



Why 2015 Will Be A Defining Year For Currency-Hedged ETFs

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While currency-hedged ETFs have existed since long, they were never able to come out of the shadows of being just another international ETF the way they are doing now. 2015 has by far been the year of currency-hedged ETF and it's not hard to understand

why.

Let's take the French stock market, the CAC 40 (INDEXEURO: PX1) is up a whopping 22% year-to-date, compared to the measly 1% returns generated by the S&P 500 (INDEXSP: .INX). Although on paper the returns comparison looks astonishing, things are a little bit different in the real world of investing.

Most of international ETFs are un-hedged i.e. they invest in stocks of a particular country in the local currency. So, when a U.S. investor

buys those ETFs by paying in dollars, those dollars are exchanged for the local currency of the country/region in which the ETF invests. The inverse of this procedure happens when those ETF units go for redemption.

Going back to the example mentioned above, while the CAC 40 did outperform the S&P 500 significantly in absolute terms, the magnitude of outperformance takes a severe beating when one brings in the currency rates into the picture. In the same period that the CAC

◀ 40 went up over 22%, U.S. dollar also appreciated over 14%, which basically means that an investor taking direct exposure in CAC 40 without any currency hedging would be up only 5% instead of the 22% absolute return that the CAC 40 provided in the same period.

Currency-hedged ETFs basically eliminate the currency volatility attached with conventional ETFs and as the above example illustrates the difference in returns between a hedged and an un-hedged ETF can be quite drastic, especially in periods of high volatility like the one we are witnessing now.

The Figures

2014 saw nearly \$130 billion net inflow in U.S. stock ETFs. However, since the beginning of 2015 that trend started changing and U.S. stock ETFs overall have seen an outflow of nearly \$15 billion year-to-date. Another important trend worth noting is while investors are moving funds out of U.S. equities, they are putting it in droves in international equities which is evident from the nearly \$50 billion that has flown overall into global or international ETFs since the start of 2015. Out of those near \$50 billion invested in international ETFs almost half of it has gone into currency-hedged ETFs and that too mostly in prominent ones like -

- BlackRock iShares Currency Hedged MSCI EAFE
- WisdomTree Europe Hedged Equity Fund
- DB X-trackers - MSCI JAPAN Hedged Eq DBJP
- Deutsche X-trackers MSCI EAFE Hedged Equity ETF

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What Will Continue To Make Currency-Hedged ETFs Lucrative For Investors?

■ **Relative Underperformance Of U.S. Equities** – U.S. stocks have had a wonderful run post the financial-crisis of 2007-2009. Although no one can say for sure if that run will end anytime soon, but one thing that is highly probable is that the markets remain sideways, like they have been since the start of 2015, for a while. Moreover, with the Fed showing signs of 'impatience', it will start raising rates soon which will see money borrowed at negligible costs making a quick exit from the stock markets and dragging the market down along with it.

■ **High Volatility** – From Russia to European Union to Middle East, there is a crisis going on in several prominent regions of the world and this volatile geo-political scenario is making a direct impact in the currency markets by making it highly volatile. As things stand now, there are no signs that most of these crises will get resolved anytime soon and hence investors must embrace high volatility in currencies being the norm for a considerable period of time.

■ **Inexpensive Hedging** – The cost of hedging a portfolio against currency fluctuations has come down significantly in the last few years. A cursory look at the performance of some of the currency-hedged ETFs will tell you that their hedging cost in the last two years has generally been between 0.20-0.40% (200 to 400 basis points), which is almost insignificant when compared to the fluctuations that happens in the currency markets on a daily basis.

The Other Side Of The Coin

The most important reason why currency-hedged ETFs have become so popular in the last few months is because the U.S. dollar has appreciated a lot versus other currencies. As the CAC 40 example mentioned earlier showed, it's the appreciation in the dollar that caused the real profit for an investor (nearly 5%) to be lower than the absolute profit (over 22%). However, if the inverse of this happens i.e. the dollar depreciates versus the euro, instead of real profit being lesser than the absolute profit, the reverse will happen and the investor will incur more gains than the actual gains of the CAC 40.

Finally, investors need to understand that by investing in currency-hedged ETFs, they are basically omitting both the advantage and disadvantage of currency movements from their portfolios and are actually betting their money solely on the performance of the stocks of that particular country or region.

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