Efficient hedging for volatile currency markets

by Dr. Christian Gast

Swiss investors whose portfolios have an international focus find themselves diversifying into areas other than investment performance. Currency risk is an unwelcome side effect that can eat into performance, or even destroy it. The strength of the Swiss franc has been responsible for this happening repeatedly in recent years. Until recently, there were virtually no index-tracking products for Swiss investors that minimized currency risk, but iShares ETFs now offer this option.

The end of one year and the beginning of another is a time for all of us to look both forward and back, and investors are no different. For Swiss equity investors, 2012 was an outstanding year, provided they were fully invested from the start of the year. The SPI got off to a brilliant start, overcame the summer lull, then soared toward the year-end and ultimately generated a return of 18 percent. 2005 and 1997 were the only recent years in which it topped this level. 2012 was also a good year for other industrialized countries, with the DAX and the NASDAQ gaining 29 percent respectively 19 percent, US and European markets rising by around 13-14 percent.

However, foreign currency effects have eaten into global equity investors' returns. During the year, the Japanese yen fell more than 13 percent against the Swiss franc, the US dollar slipped by almost 2 percent and even the euro lost more than half a percent of its value against the Swiss currency, despite the 'pegged' exchange rate.

Strong franc hits performance

This scenario is more pronounced if viewed over a multi-year period when currencies have played against the interests of Swiss investors. In the past five years, the US dollar and the euro have fallen against the Swiss franc by 24 percent and 27 percent respectively, and over the past three years by 10 percent and 19 percent respectively. In a portfolio with a global focus, the strength of the Swiss franc would have resulted in losses due to foreign-currency devaluation. The real significance of the currency effect is illustrated by the iShares S&P 500 fund which is denominated in US dollars. In the past three years, this ETF has risen by 31 percent, which would have been a sizeable return, if only the devaluation of the dollar against the Swiss franc had not halved it for Swiss investors.

These actual losses are not the only problem. Overall currency risk has also increased, as demonstrated by the sharp rise in volatility for which 2012 provides a good illustration. Although the US dollar ended the year close to the level at which it started in January, it had anything but a smooth ride, with sharp swings in both directions. Currency volatility may no longer be as pronounced as it was during the financial crisis, but it remains well above the ten-year average.

One-shot currency hedging

Currency hedging can be used for both long-term trends and shorter-term fluctuations, although for a long time it was relatively costly for ETF investors. Broad-based indices are denominated in a range of currencies; there are thirteen in the MSCI World, for one example. Effective reduction of the operational and administrative cost of currency hedging requires special tools – particularly simple tools if possible.

The industry has identified this need and increasingly offers ETFs that minimize fluctuations between an investor's base currency (e.g. the Swiss franc) and the currency of the securities in the index. iShares' new products are the first to physically replicate equity indices with a Swiss franc currency hedge. They enable investors to use ETFs to invest in popular global indices, such as the MSCI World, the MSCI Japan or the S&P 500.

They are hedged on a monthly basis which is now regarded as a common market standard, because monthly hedging represents a good trade-off between hedging cost, efficiency and quality. Currency risk is not eliminated, but it is significantly reduced. iShares currency-hedged ETFs also use the same methodology as leading index providers such as MSCI and Standard & Poor's. The currency risk incurred by both indices is hedged using monthly forward foreign-exchange contracts.

Efficient solution for investing in global equity markets

Investors who want to diversify their portfolio, and want an easy, efficient way to access international markets with minimal currency risk, should take advantage of currency-hedged exchange-traded funds (ETFs). To date, demand for these products has largely been from professional investors who want to invest in a basket of equities using a single, cost-efficient transaction, while keeping currency risk to a minimum. However, the products are gaining popularity among private individuals, because currency-hedged ETFs also allow investors to implement their judgment and asset-allocation decisions efficiently and precisely, without having to invest a minimum amount.

By launching these new products, iShares is not only meeting the growing need for security felt by investors, it is also showing its commitment to Switzerland, one of iShares' core markets in Europe. Investors can use them to minimize long-term exchange-rate losses and hedge currency risk in one transaction. Nobody knows whether or not currency hedging of this type will be necessary in 2013, but minimizing this risk at the cost of a few basis points is an attractive option.

Newly listed iShares ETFs

iShares ETF	ISIN	SIX ticker	Total expense ratio	Trading currency	Tracking method
iShares MSCI Japan Monthly CHF Hedged	IE00B8J37J31	IJPC	0.64%	CHF	Optimization
iShares MSCI World Monthly CHF Hedged	IE00B8BVCK12	IWDC	0.55%	CHF	Optimization
iShares S&P 500 Monthly CHF Hedged	IE00B88DZ566	IUSC	0.45%	CHF	Replication

About the author

Christian Gast, Head of iShares Switzerland

Dr. Christian Gast became head of iShares Switzerland on November 1, 2010. He has over 15 years' experience in the Swiss asset management sector. Before joining iShares, he had worked at UBS Global Asset Management since 1999 where he headed up the ETF business as well as running product development and management for UBS Equity Funds. Before that, he was senior portfolio manager at St. Galler Kantonalbank where he was responsible for asset management for private and institutional clients. Christian Gast has a degree in business studies from the University of Saarbrücken and gained a doctorate in banking at the University of Zurich.

About iShares

iShares is the global product leader in exchange traded funds with over 600 funds globally across equities, fixed income and commodities, which trade on 20 exchanges worldwide. The iShares Funds are bought and sold like common stocks on securities exchanges. The iShares Funds are attractive to many individual and institutional investors and financial intermediaries because of their relative low cost, tax efficiency and trading flexibility. Investors can purchase and sell shares through any brokerage firm, financial advisor, or online broker, and hold the funds in any type of brokerage account. The iShares customer base consists of the institutional segment of pension plans and fund managers, as well as the retail segment of financial advisors and high net worth individuals. For more information, please visit the website www.iShares.ch.