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Protect Yourself From 'Ugly' Currencies

British American Tobacco shares have had a nice run in the past year, rising from £37 to £46 in London. But American buyers did not enjoy the ride. Pounds lost their currencies' value almost as fast as the shares gained it. Translated back into dollars, the stock went sideways.

Stack currency risk on top of equity risk and it's no surprise that venturing overseas makes some investors seasick. But there is the option to take Dramamine. When you invest, you can make a side bet against the currency you're investing in. You could couple a purchase of BAT or AstraZeneca or Shell with a short position in sterling. You could marry Toyota to a yen short and Roche to a Swiss franc short.

More realistically, unless you are investing a gigantic sum: Have a fund do the shorting for you. Eighty-nine exchange-traded funds have currency hedges built into their portfolios, and they account for $37 billion of the $456 billion in foreign-stock ETFs, according to a Morningstar tabulation.

WisdomTree Investments was the first in this business, with a hedged Japanese fund that dates to 2006. It's now getting stiff competition from PowerShares, BlackRock's iShares family and Deutsche Bank's X-trackers line. Their sales pitch: Take some of the worry out of foreign portfolios by removing the hefty contribution to volatility (a fourth of it over the average five-year period) that comes from currency moves.

Insurance against weak foreign currencies will cost you some money but not as much as you might think. Hedged ETFs run roughly a quarter of a percentage point more in annual fees than unhedged ones. If the hedge gives you the peace of mind to undertake global diversification you would otherwise have shunned, it's money well spent.

What about the cost of the forex positions? In developed markets, currency hedges have a cost pretty close to zero; arbitrageurs see to that. Indeed, low interest rates in Europe mean that currencies there can be off-loaded in the futures market at a slight premium to spot prices.

Currency hedging is a wonderful exception to the rule that reducing volatility reduces returns. Here's the theory, as expounded by Jeremy Schwartz, director of research at WisdomTree. British investors in Shell are taking on volatility in the value of the business—from oil prices and so on. U.S. investors who buy Shell and do nothing more are taking on that risk plus additional volatility that comes from changes in the value of the pound. By shorting the pound when you buy Shell, you eliminate the second contribution to volatility. "You can't expect currency to add to return," Schwartz says. "It's uncompensated risk." So you should get rid of it.

Note what is not part of the argument in favor of hedging. Schwartz is not predicting that the dollar will continue to steam ahead, which it has been doing since the election. He is simply arguing that stripping out currency exposure will make your foreign adventures less scary.

The past half-decade has been a good time for dollar patriots. Or, to put it equivalently, the period has been bad, collectively, for the euro, yen and pound. That means U.S. investors who bought stocks overseas and did not hedge are full of regrets. They have lost in the currency markets half of the 11% a year they were gaining with their stocks. (This is the return on an MSCI index of developed foreign markets, which include Europe, Japan and Australia but not China or Brazil.) Those who hedged got something close to the full 11%.

There have been other stretches, though, when the dollar tumbled (see graph). There weren’t any hedged ETFs around at the time to prove the point, but if one had opened for business in 2002 it would have looked like a clunker for the next five years.

What happens over the very long pull? Morningstar fund analyst Patricia Oey studied this question by comparing global portfolios that mix U.S. stocks with either hedged or unhedged foreign stocks. Oey’s paper portfolios were a 60/40 blend of the S&P 500 and the MSCI indexes, rebalanced annually. There were years when the hedged portfolio raced ahead, others when the unhedged one did. But over 25 years the two approaches to going international had identical risk-adjusted returns.

Oey’s comparison was on index returns; real-life performance will be lower by whatever fees you pay to the fund’s manager. Whether these fees are worth paying is a matter of how much safety you seek.

WisdomTree’s oldest hedged ETFs levy 0.48% to 0.58% in annual expenses. Newer offerings from both WisdomTree and its rivals are better buys (see table). One can hope that Vanguard gets into the fray, but for now this mecca for cheapskates offers hedged stock funds only in Canada and Australia.

It’s a scary world out there. But it’s getting less scary.

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