

# Currency Hedging

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For Professional Clients only



HSBC Asset Management

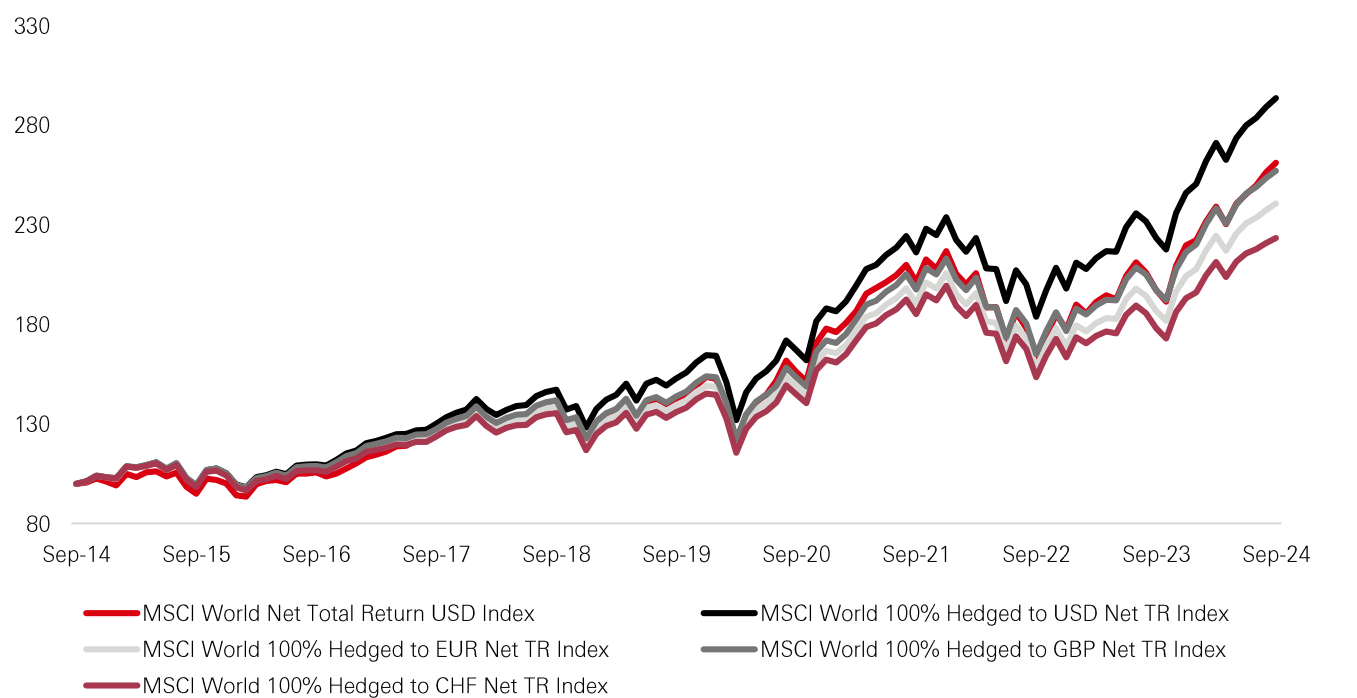


## Currency Hedging

Currency hedging is the process of mitigating foreign exchange risk within a portfolio. A currency hedged share class of an HSBC ETF gives exposure to a portfolio of securities plus currency forwards, the latter hedging every security currency in the portfolio into the target (hedged) currency. Hedging is analogous to an insurance contract involving a separate investment (a currency forward) that has the objective to offset a certain risk.

In certain situations, currency hedging has also helped to reduce the volatility. For example, for the MSCI World Index, when currency hedging over 5 years, volatility also fell for every target currency. (Graph 1 and Table 1).

**Graph 1: Performance of MSCI World Index Unhedged in USD vs. currency hedged indices<sup>1</sup>**



1. The performance of each hedged index has been calculated in the currency into which the hedge has been implemented e.g. MSCI World 100% hedged to USD is calculated in USD. Past performance does not predict future returns. Costs may vary with fluctuations in the exchange rate.

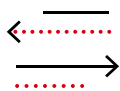
Source: Bloomberg, as of September 2024

**Table 1:**

MSCI World Index			
	Total Return (Annualized 3yr) <sup>1</sup> (%)	Total Return (Annualized 5yr) <sup>1</sup> (%)	Volatility (Annualized 5yr Monthly) <sup>1</sup>
Unhedged	9.08%	13.04%	17.61%
USD Hedged	10.75%	13.95%	16.31%
EUR Hedged	8.09%	11.53%	16.36%
GBP Hedged	9.21%	12.34%	16.41%
CHF Hedged	6.46%	10.45%	16.29%

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Source: Bloomberg, as of September 2024

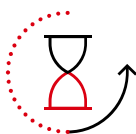


## General description of currency hedging

Currency hedged share classes will generally seek to hedge the underlying portfolio currencies to the currency of the hedged share class. This hedging will typically be implemented via forward foreign currency contracts.

Forward foreign currency contracts are agreements to exchange one currency for another - for example, to exchange a certain amount of Sterling for a certain amount of Euro - at a future date. The date, the amount of currency to be exchanged and the price at which the exchange will take place are negotiated and fixed for the term of the contract at the time that the contract is entered into.

For ETFs, the currency risk inherent in the invested portfolio would determine what needs to be hedged. For example, a GBP based investor buying an ETF having Japan equity exposure is exposed to fluctuations in the GBP/JPY currency pair. By entering into a one-month forward currency contract the investor locks in today's currency forward rate for one month, mitigating the currency risk stemming from the JPY equity exposure for that month. In the case of a multi-currency portfolio, each currency pair needs to be hedged with individual forward foreign currency contracts to mitigate currency exposure. For example, to hedge a HSBC global developed market equity UCITS ETF into EUR, the ETF would take each currency in the portfolio (excluding EUR) and enter into a forward foreign currency contract for each currency pair to EUR.



## Components affecting the total return of a currency hedged exposure

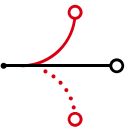
The total return of a currency hedged portfolio is mainly affected by the performance of the unhedged portfolio in the currency of the underlying asset and the forward currency contracts return.

The forward currency contract's return will be impacted mainly by transaction costs and interest rate differentials priced into the forward contracts. The interest rate differential might have a positive or a negative impact.

For example, when investing in a US equity exposure hedged back to JPY there would be a negative impact. The counterparty providing a USD to JPY hedge will in fact need to deliver JPY at the maturity of the forward contract, thus earning JPY interest rates which are currently lower than USD interest rates.

The counterparty is also short USD and has to pay the higher USD interest rates.

This interest rate differential will be embedded in the price of the FX forward. An opposite and symmetric situation (e.g. an investment in a Japan equity exposure hedged back to USD) would instead have a positive impact.



## Hedge ratio

When hedging currency risk for a portfolio of securities, the amount of each forward foreign currency contract is determined by the notional value of the portfolio on the day of rebalance. At this point the “hedge ratio” is targeted to be 100%, as the total value of the investment is targeted to be hedged. However, intra month the value of the underlying securities in the portfolio may vary and cause the hedge ratio to deviate from 100%. If the value of the portfolio of securities:

- ◆ Decreases, then the hedge ratio will exceed 100% and the position will be over hedged
- ◆ Increases, then the hedge ratio will drop below 100% and the position will be under hedged

When the hedge ratio does not equal 100% the hedge is imperfect. Note that in practice, even with a daily hedging currency exposure, it is almost impossible to maintain a ‘perfect hedge’ due to intraday movements in the price of underlying assets and currency pairs.



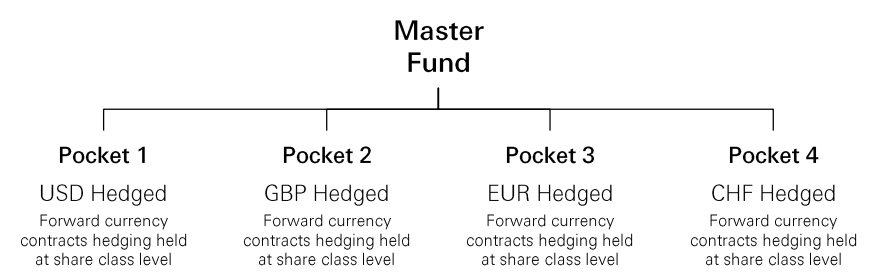
## HSBC ETFs Forex Hedged share classes

ETFs set up under a share class structure will share one common pool of assets. For direct replication ETFs, this common pool holds the underlying securities used to track the benchmark index and is typically an unhedged exposure.

Certain share classes of the ETF may offer currency hedging. Any forward foreign currency contract used to gain this exposure will be assigned at the specific forex hedged share class. (Table 2).

An investment in a currency hedged share class is equal to a portion of the common pool plus the relevant forward foreign currency contract relating to that share class.

Table 2:



Source: HSBC Asset Management.  
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## Currency hedging methodologies

Historically, several providers used a monthly static currency hedge approach. This implied a monthly rebalancing for the forward foreign currency contract regardless of currency or asset price movements intra-month.

In 2017 ESMA announced new guidelines in Europe around UCITS currency hedged share classes specifically aimed at reducing the contamination risk across different share classes.

These regulatory changes were implemented in 2018. Guidelines stipulate that the hedge ratio of any currency hedged share class must not exceed 105% or fall short of 95% of the asset value of the share class. Thus, ETF providers must monitor hedge ratios for currency hedged share classes within these tolerances (95% -105%) to ensure there is no breach of ESMA guidelines.

Following the publication of this ESMA opinion, the 'dynamic hedge' has been increasingly adopted.

Table 3 compares commonly used currency hedging methodologies. HSBC ETFs model will be very similar to the "dynamic hedge" model mentioned in the Table 3. i.e. 1 month forward foreign currency contract which aims to combine the benefits of monthly and daily hedging.

HSBC currency hedged ETFs will generally implement tighter internal thresholds compared to ESMA tolerances (95% -105%) with the aim to ensure more accurate currency hedging. HSBC ETFs will not be in the position to track the hedged benchmarks as the index providers typically do not publish an index for a dynamic hedge approach.

**Table 3: Commonly used currency hedging methodologies**

	Static monthly hedge	Static daily hedge	Dynamic hedge
<b>Instrument used</b>	1 month FX Forward contracts		
<b>Hedge reset frequency</b>	Monthly, typically at month end to coincide with portfolio rebalance	Daily, typically at end of day	Whenever hedge ratio thresholds are breached (ESMA requires 95% - 105% threshold but some providers may use tighter internal thresholds)
<b>Benefits</b>	<ul style="list-style-type: none"> <li>Lower transaction costs as the hedge is only reset once a month</li> <li>Common method of currency hedging, used by many index providers making performance monitoring versus the index easier</li> </ul>	<ul style="list-style-type: none"> <li>Lower risk of an imperfect hedge (i.e. unwanted currency risk) intra-month as the forward contract is reset daily</li> <li>Many index providers offer daily hedged indices making performance monitoring versus the index easier</li> </ul>	<ul style="list-style-type: none"> <li>Combines benefits of monthly and daily static hedging: <ul style="list-style-type: none"> <li>Hedge is reset if currency or asset price moves lead to the hedge ratio falling outside of tolerances. This mitigates intra-month currency risk from imperfect hedging whilst reducing transaction costs vs static daily hedging</li> </ul> </li> </ul>
<b>Disadvantages</b>	Intra-month, the hedge ratio will not reset with currency or asset price moves, this could make the hedge imperfect, potentially causing unwanted currency risk	<ul style="list-style-type: none"> <li>Typically incurs higher transaction costs vs monthly/dynamic methods, removing the benefit of daily resetting</li> <li>Higher operational costs when used for direct replication funds</li> </ul>	Currently index providers do not publish an index which accounts for a dynamic hedge approach

Source: HSBC Asset Management.

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