Financial Planning

Fight Volatility with Currency-Hedged ETFs

By Bruce W. Fraser | April 22, 2016

30 DAYS 30 WAYS

Bless them or curse them, but don’t dismiss them.

During especially volatile times, advisors and investors are latching onto currency-hedged ETF equity funds as a way to neutralize currency risk in local markets around the world.

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Up to now, currency hedging has been primarily the province of institutional investors to mitigate currency risk in international securities.

Now, as concerns about migrating to a fully hedged currency model begin to recede, the concept is seeping down to the retail level.

BlackRock’s iShares now field a suite of 26 such funds out of 328 iShares ETFs globally, according to the firm.

Morgan Stanley seeded its lineup of ETFs this year with two currency-hedged ETFs.

And ETF specialist WisdomTree Investments recently added several to its family of ETFs.

“Essentially, ETF currency funds are tools investors use to mitigate the volatility of their equity portfolios. They work by placing a bet that the [e.g., euro or yen] is going down (or up) relative to the U.S. dollar or another currency,” says wealth manager Craig Ferrantino, founder and president of Craig James Financial Services in Melville, N.Y.

So, for instance, if an advisor believes that the effect of a strong dollar will affect a company’s earnings, they can use a currency-hedged ETF that reflects the nature of that portfolio, say U.S companies with a large amount of sales in Europe, and hedge against the risk.

EASIER THAN SOME HEDGING STRATEGIES

There are pros and cons.

One positive, says Ferrantino, is that these funds are easy to understand as opposed to more complex hedging strategies such as currency futures, Ferrantino says.

And many boast low expense ratios.

But there are drawbacks.

A currency-hedged ETF under certain circumstances could jeopardize an overall diversification strategy, said Christopher McMahon, president of Pittsburgh-based McMahon Financial Advisors.

“Sometimes, the return of the currency is positive, while the country return is negative,” he says. “The opposite can also happen as well if both move in the same direction.

Also, many of these funds are young, with little or no track records, and may use momentum and similarly questionable tactics to jack up returns.

WisdomTree, based in New York, for example, rolled out a suite of dynamic currency-hedged funds in January.

Examples include the WisdomTree Dynamic Currency Hedge Europe Fund (DDEZ), which tracks the performance of European dividend-paying firms; the WisdomTree Dynamic Currency Hedged Japan Fund (DDJP), and the WisdomTree Dynamic Currency Hedged International Equity Fund (DDWM), representing more than 20 countries ex- the U.S., with the heaviest weightings on firms in the United Kingdom and Japan.

The dynamic hedged strategy represents another approach that, if successful, may limit volatility and increase returns over time, some say.

Bruce W. Fraser, a New York financial writer, contributes to Financial Planning and On Wall Street.

This story is part of a 30-30 series on smart ETF strategies.