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Thought Leadership, Exchange Traded Funds
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Market outlook

More myths and misconceptions about currency hedging

In our previous Xpert Insights, we dispelled a number of myths and misconceptions around the long term impact of currencies on the return, risk, and diversification benefits of international equities. In this piece, we hope to dispel a number of other common concerns that investors sometimes voice around currency hedging.

— Do I need to currency hedge when investing in companies with a global footprint?
— If I currency hedge, am I betting on currency moves?
— Will an American Depository Receipt (ADR) help to protect me from currency fluctuations?
— Isn't it expensive to hedge currency exposure?

Misconception #1: Currency hedging is not beneficial for an investment in a global company

Companies that operate globally tend to have more complex exposure to foreign currencies. Most large companies generate revenue and incur costs beyond the borders of their nation of domicile.

For example, German companies, as measured by the MSCI Germany Index, derive over 75% of their revenue abroad—no surprise, given Germany's status as an export powerhouse. Anheuser-Busch Inbev, the Belgium beverage manufacturer, generated less than 10% of its revenue for 2015 in Europe. The firm was exposed to many currencies: a third of revenue was booked in U.S. dollars, and only 6% in euros.

Further complicating matters, multinational corporations often engage in corporate currency hedging, which is when companies themselves hedge their currency exposure to reduce cash flow and balance sheet risks arising from currency fluctuations. For example, a Japanese company that derives most of its revenue from the United States might use forward currency contracts to hedge its expected cash flow from abroad. With companies becoming more and more international, do investors need to currency hedge anymore?

Simply put, currency hedging undertaken by multinationals does not mitigate the impact of currency on an investor's risk and return.

Currency exposure at the corporate level can significantly impact earnings, and in turn, effect stock prices. For example, exporters typically

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benefit when their home currency depreciates, as their products become cheaper and more in-demand to consumers abroad. Revenue generated abroad can be exchanged for more units of local currency, boosting performance. Conversely, if a company's costs are denominated in a currency that appreciates and/or its revenues are generated in a region with a weakening currency, earnings could be negatively impacted when revenue generated abroad is exchanged for fewer units of local currency.

How a company handles its currency exposure can meaningfully impact earnings/cash flow and therefore stock prices, and hedging at the corporate level can help reduce stock price volatility or even increase equity valuations.[1]

But even if a company hedges at the corporate level, when it comes time for an investor to repatriate an investment in equities abroad, the return realized could be impacted by changes in exchange rates, independently from the factors mentioned above.

We can take the German automotive group, Daimler AG, as an example. Daimler engages in corporate currency hedging and is a major exporter: During the first half of 2015, the company generated only 15% of its revenue in Germany. Daimler announced its 2015 half-year results in late July. Group earnings before interest and taxes (EBIT) rose €623 (a 20% increase) in the second quarter of 2015 thanks primarily to its luxury car division. Foreign exchange rates, specifically the weak euro, were a tailwind to the tune of €279 million.

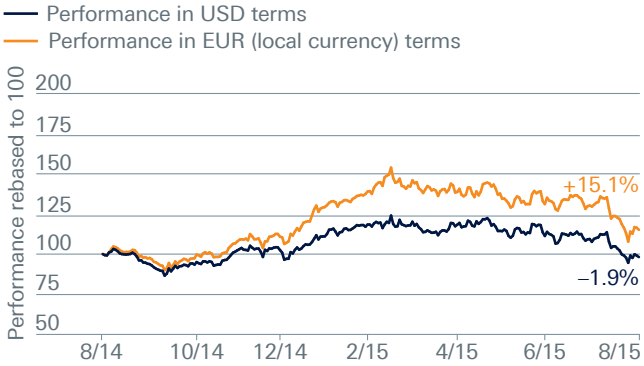
Despite Daimler's global cash flows, the beneficial impact of currencies on earnings, and the firm's corporate hedging program, investors who did not hedge the currency exposure of an investment in Daimler would have found their returns dramatically reduced by the strength of the U.S. dollar against the euro (shown in Figure 1).

- Through the end of August 2015, Daimler's stock price rose 15.1% in local currency terms.
- In U.S. dollar terms (with currency risk left unhedged), however, Daimler's price return was –1.9%, illustrating the difference between corporate hedging and currency hedging at the investor level.

Although Daimler is a global firm, stock returns must always be translated back to an investor's home currency, potentially impacting returns. Regardless of how a company itself is helped or harmed by currency fluctuations, investors must be cognizant of the impact on return that currency will have on the returns they themselves realize.

The currency hedging decision for individual investors should not be influences by whether a corporation has a global business model or engages in its own currency hedging program.

Figure 1: One-year performance of Daimler stock in local currency and U.S. dollar terms (as of 8/31/15)



Source: Deutsche Asset Management and Bloomberg as of 8/31/15. Price performance of DAI GY shown from 8/29/14 to 8/31/15. **Past performance does not guarantee future results.** USD denotes U.S. Dollar. EUR denotes euro. See page 4 for more details.

Misconception #2: Currency hedging is betting on currency moves

For many investors, currency forecasting is not their core competency. They would like to focus on what is: equities. They worry that hedging currency is taking an active stance on currencies. We would argue the opposite: leaving currency exposure unhedged is making a directional call on currency moves.

The return of an unhedged investment has two components: local equity returns, and currency returns. Currency hedging aims to minimize the latter component, leaving the desired local equity returns isolated. Without hedging, investors are making an implicit bearish call on the U.S. dollar.

[1] Source: The Deutsche Bank Guide to FX Hedging, 2011.

An investor who does not want to take a view on the direction of currencies can remain neutral by currency hedging. With the impact of currencies minimized through the hedge, investors can just focus on the investment they desired in the first place: international equity returns. Whether the U.S. dollar (or foreign currencies) strengthens or weakens, a currency- hedged investment should very closely approximate the return a local equity market investor would receive.

The performance of currency-hedged and unhedged Japanese equities in 2013 illustrates this point. Japanese equities, as represented by the MSCI Japan Index, surged in 2013 on the back of monetary easing. In what was generally a strong year for equities (the S&P 500 rose by 32%), Japanese equities performed particularly well, rising 54.6% in local currency terms (Figure 2).

However, the yen also weakened significantly, falling 17.6% against the U.S. dollar (Figure 3).

Figure 2: Japanese equities performed well in 2013…

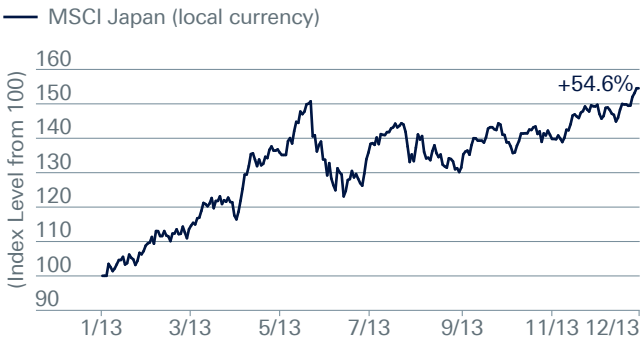


Figure 3: …but the USD also strengthened against the yen…

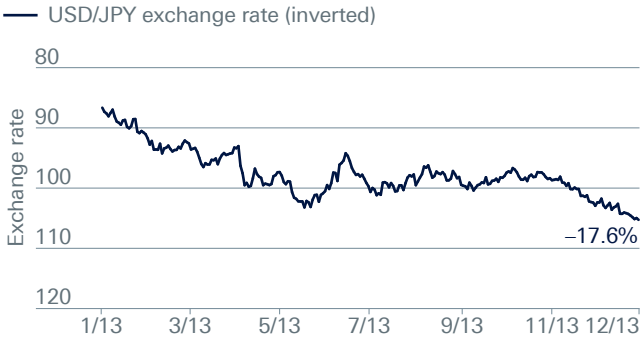
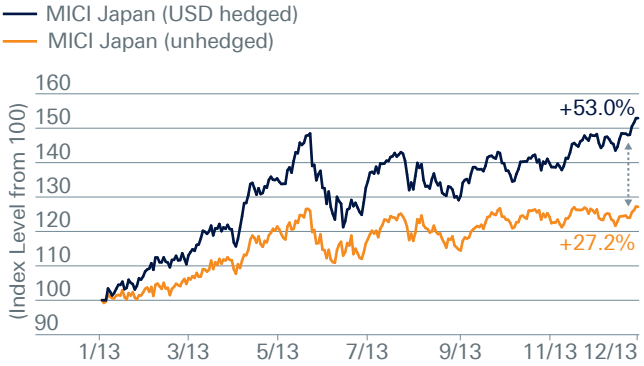


Figure 4: …significantly reducing performance of the unhedged index



Source: Deutsche Asset Management, Morningstar, Factset as of 12/31/13. Data from 12/31/12 to 12/31/13. Index performance is rebased to 100. **Past performance does not guarantee future results.**

As a result, investors in Japanese equities who did not hedge their yen exposure found themselves in the awkward position of picking the right equities, but not realizing the full return because of the depreciation of their (perhaps unintended) long yen position. As a result of the weaker yen, the currency-unhedged MSCI Japan Index returned only 27.2%, a difference of 27.4 percentage points (Figure 4).

Misconception #3: ADRs are an alternative to currency hedging because they are not exposed to currency risk

American Depositary Receipts (ADRs) trade on stock exchanges in the U.S., and are a common way for U.S.-based investors to gain access to individual international equities. By purchasing an ADR instead of a locally-listed share, investors can avoid the complications of cross-border transactions. But ADRs do not protect investors from currency risk.

ADRs are typically issued by large banks that hold many of a company's locally-listed shares. An ADR share is backed by a certain number of those locally-listed shares, determined by the ratio set by the bank. To maintain that conversion ratio, the price of an ADR must incorporate currency fluctuations.

For example, take Honda Motor Company, the Japanese automobile manufacturer and one of the largest Japanese firms by market-capitalization. Honda's primary listing is on the Tokyo Stock Exchange, and JP Morgan sponsors an ADR on the New York Stock Exchange with a 1:1 ratio. Over the year ending June 2015, Honda's stock price on the Japanese exchange rose 12%. However, the ADR price listed on the NYSE actually declined –7.4% over the same period, similar to the performance of Honda's local stock performance if converted to U.S. dollars. This was because the yen weakened against the U.S. dollar over the course of those 12 months. ADRs do not mitigate currency risk and are not an alternative to currency hedged investments.

Figure 5: One-year performance of Honda Motor Co. Ltd. ADR and local listing

	Ticker	Exchange	Currency	Price return
Honda Motor (ADR)	HMC	NYSE	USD	–7.4%
Honda Motor	7267	Tokyo	USD	–7.1%
Honda Motor	7267	Tokyo	JPY	12.0%

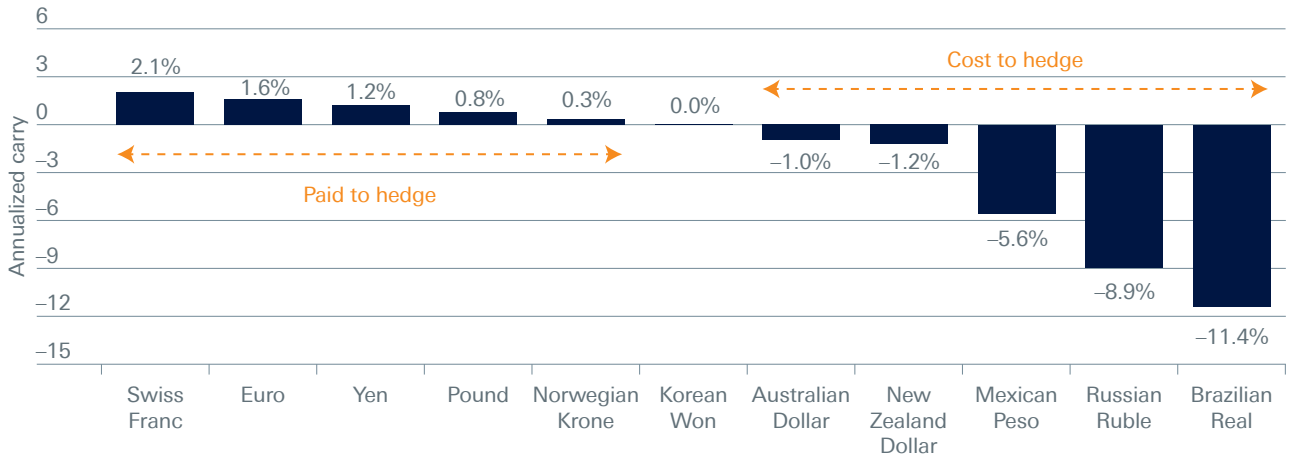
Source: Deutsche Asset Management, Bloomberg as of 6/30/15. See page 4 for more details.

Misconception #4: Currency hedging is expensive

Is currency hedging expensive? Investors may be surprised to learn that historically the answer has been "no" for most developed market currencies.

The more important potential cost of a currency hedge, carry, comes from interest rate differentials. If U.S. dollar rates are higher than those of the foreign currency being shorted, currency-hedged investors earn the difference between the two rates. If U.S. dollar rates are lower, investors pay the difference. This difference, or "carry," can be a positive or negative contributor to the performance of currency-hedged strategies. Currencies with significantly higher interest rates (often the case for emerging markets) are typically more "expensive" to hedge. But, as Figure 6 shows, near-zero interest rates in many major economies mean that the rate differential between many currencies is close to zero, implying little net cost or even positive return from currency hedging. In fact, with rates now lower in Switzerland, Japan, and the Eurozone than in the U.S., investors may be "paid" to hedge the franc, yen and euro.

Figure 6: Estimated annualized carry of various currencies



Source: Deutsche Asset Management, Bloomberg as of 1/25/17.

Daimler had the following weight in each designated index as of 8/31/15: 0.96% MSCI Europe Index, 0.46% MSCI ACWI ex-USA Index, 0.63% MSCI EAFE Index, 1.83% MSCI EMU IMI Index, 7.00% MSCI Germany Index. Honda Motor had the following weight in each designated index as of 8/31/15: 0.01% MSCI ACWI ex-USA Index, 0.02% MSCI EAFE Index, 0.08% MSCI Japan Index, 0.11% JPX-Nikkei 400 Index. Source: Bloomberg.

EBIT is earnings before interest and tax. The MSCI EAFE Index tracks the performance of stocks in select developed markets outside of the United States. The MSCI EAFE U.S. Dollar Hedged Index is calculated using the same methodology as the MSCI EAFE Index, but is designed to mitigate exposure to fluctuations between the value of the U.S. dollar and non-U.S. currencies. The MSCI Germany Index tracks the performance of German stocks. The MSCI World Index tracks the performance of stocks in select developed markets around the world, including the United States. The S&P 500 Index tracks the performance of 500 leading U.S. stocks and is widely considered representative of the U.S. equity market. Standard deviation is often used to represent the volatility of an investment. It depicts how widely an investment's returns vary from the investment's average return over a certain period. The U.S. Dollar Index tracks the performance of the U.S. dollar relative to other world currencies. Correlation is a measure of how closely two variables move together over time. A 1.0 equals perfect correlation. A –1.0 equals total negative correlation. A currency forward is a contract in the foreign-exchange market that locks in the price at which an entity can buy or sell a currency on a future date. American Depositary Receipts (ADRs) are certificates issued by banks representing shares in a foreign stock traded on a U.S. exchange. The MSCI Japan Index is designed to measure the performance of the large- and mid-cap segments of the Japanese market. The MSCI Japan U.S. Dollar Hedged Index is calculated using the same methodology as the MSCI Japan Index, but is designed to mitigate exposure to fluctuations between the value of the U.S. dollar and non-U.S. currencies. Valuation is a strategy that seeks to generate returns by capturing the fair-value differential between currencies. The valuation methodology is based on the view that currencies tend to move towards their "fair value" over time. A carry trade is a strategy in which an investor sells a certain currency with a relatively low interest rate and then buys another, higher-yielding currency.

Diversification does not eliminate the risk of experiencing investment loss.

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