What to do about currency risk in foreign stocks ?

Unfortunately, the Czech equity market is tiny and, because money should follow the best opportunities, the portfolios of Czech equity investors should logically be dominated by foreign stocks. However, this introduces another risk to the portfolio: the fluctuation of foreign currency values vis-à-vis the Czech crown.

Because the Czech National Bank has for several years artificially maintained the crown at the rate of CZK 27 per euro, and as the dollar has strengthened against the crown by 25% during that same period, no one much cared about currency risk. In that period, many Czech investors made more money on the dollar exchange rate than on appreciation in the value of the US companies they were holding.

This idyllic epoch came to an end in April of this year. The crown has commenced a journey of apparently longer-term appreciation. It has strengthened against the euro by almost 4% and against the dollar by 14%. Losing 14% on the currency over 4 months would be enough, and especially if we consider that US share prices grew only by a little over 4%. Currency risk is back.

What to do about it? This is a question we are getting very often recently. Essentially, there are two extreme possibilities. The first one is to accept the risk, not hedge against it, and count on the fact that exchange rate movements tend somewhat to even out over the course of a full business cycle. The advantage of this approach lies in avoiding the costs of currency hedging, which, as we will see below, can be very high. The disadvantage is that business cycles may be very long. The current cycle has been running for 8 years already and still is not near its end. In addition to cyclical movements, there also are secular movements in currency values. These are movements neither cyclical nor seasonal in nature but which have long-term trends. In our small currency which until recently has been held down artificially, this trend can be substantial.

The second possibility is to hedge against currency risk. The advantage is that in doing so we will eliminate the influence of currency movements on the crown value of the portfolio. But this comes at a cost. There is always a cost to eliminate risk.

A currency can be hedged best using currency swaps and forwards. Their costs are essentially established by the difference between the interest rates of the two currencies. The higher the interest rate for the currency against which one is hedging as compared to the interest rates for the Czech crown, the more expensive the hedge will be. Dollar rates are higher than crown rates, and therefore hedging against the dollar costs money. Euro rates appear at first glance to be lower than crown rates, and therefore it would seem that the cost for hedging the crown against the euro should be negative – that we should make money on such a hedge.

Unfortunately, this is not the case. The Czech financial market is so deformed as a result of the CNB's immense issuance of crowns during the interventions that the forward curve, which is a curve displaying the crown rate against foreign currencies for the approaching weeks, months, and years, is so distorted that, from the perspective of hedging currency risks, it looks as if we had significantly negative short-term rates.

Expressed in numbers, a six-month hedge against the euro costs approximately 12 cents and one against the dollar about 34 cents. Currency risk against the euro can therefore be eliminated for 0.9% p.a. and the risk against the dollar for 3% p.a. Other large currencies such as the sterling or the yen have costs somewhere in between.

Each investor must consider on his or her own whether it is worthwhile to pay the costs of hedging currency risks or whether he or she would prefer to bear that risk. The 0.9% p.a. in the case of the euro seems acceptable, but many will regard the 3% p.a. for the dollar hedge as too high. Moreover, one should take into account that these are numbers before transaction costs and your broker's costs. Especially for medium-sized and small investors, these costs constitute the nail in the coffin for currency hedging plans.

And what will the future bring? Before the CNB began its interventions, currency hedging costs were much lower. In the future, faster growth in crown rates compared to rates on foreign currencies could help, as would a gradual straightening of the deformed forward curve. Hopefully, we will see both.

For the sake of completeness, it is necessary to add that there are also other ways of dealing with currencies. These include, among others, to not hedge in an automatic way but instead to adjust to the current levels of the hedged currencies, to use options and other derivatives, to combine various instruments and approaches. Most of these possibilities, however, contain certain elements of speculation, change the portfolio's risk profile, and of course have their own costs. The old adage that "There ain't no such thing as a free lunch" applies also to hedging currency risk.

Invest with care!

Daniel Gladiš, 31 July 2017

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