

WHY TAKE CURRENCY RISK IF DIVERSIFICATION BENEFIT IS DECLINING?

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We [have been exploring](#) the case for layering in [foreign currency \("FX"\)](#) on top of foreign equity returns. One of the most common arguments I have heard for taking on FX risk in international equity portfolios in an [unhedged](#) fashion is that FX can be a portfolio “diversifier.” But does FX provide a level of portfolio and market return diversification not offered by the local equity markets? If an investor had to decide to allocate to the EAFE FX¹ embedded in the [MSCI EAFE Index](#) as a standalone investment, let’s review the case.

- Over the history of the MSCI EAFE Index, EAFE FX has added 1.6% annually to the returns of the MSCI EAFE Index. This means the U.S. dollar declined by 1.6% per year over this period.
- This return stream had an annualized [volatility](#) of 8.4% per year, a little more than half the volatility of EAFE equities (in local currencies).
- The [correlation](#) of EAFE FX to the [S&P 500](#) over the full 40-year period was fairly low—only 0.09. But note a very important correlation trend: This EAFE FX correlation to the S&P 500 has been rising consistently in recent periods. In the last three years, the correlation between EAFE FX and the S&P 500 was 0.64, so EAFE FX is not providing the same type of diversification as it did historically.²

Figure 1: MSCI EAFE Index: Return, Volatility and Correlation

| | Returns | | | Volatility Levels | | | | Correlations to S&P 500 | | |
|------------------|---------------|---------------|------------|-------------------|------------|------------|---------|-------------------------|------------|---------------|
| | EAFE w/ FX | EAFE No FX | EAFE FX | EAFE w/ FX | EAFE FX | EAFE No FX | S&P 500 | EAFE w/ FX | EAFE FX | EAFE No FX |
| 12/31/69-7/31/14 | 9.3% | 7.6% | 1.6% | 17.1% | 8.4% | 14.5% | 15.3% | 0.63 | 0.09 | 0.69 |
| 3-Year | 8.0% | 11.7% | -3.3% | 16.4% | 6.1% | 12.2% | 12.2% | 0.88 | 0.64 | 0.86 |
| 5-Year | 9.4% | 9.2% | 0.1% | 16.7% | 7.2% | 12.3% | 13.2% | 0.88 | 0.58 | 0.86 |
| 10-Year | 7.1% | 5.9% | 1.1% | 18.2% | 7.6% | 14.5% | 14.7% | 0.89 | 0.47 | 0.89 |
| 20-Year | 10.9% | 9.8% | 1.0% | 16.7% | 7.6% | 14.6% | 15.2% | 0.83 | 0.21 | 0.84 |

Sources: WisdomTree, MSCI, 12/31/69–7/31/14. EAFE w/ FX refers to the MSCI EAFE Index priced in USD. EAFE no FX refers to the MSCI EAFE Index price in the local currency. EAFE FX refers to the underlying currency exposure of the MSCI EAFE Index. Past performance is not indicative of future results. You cannot invest directly in an index.

More importantly, one has to wonder if the past gain in EAFE FX can be repeated. We know with hindsight that the U.S. dollar declined. But do we know the U.S. dollar will decline going forward? Theoretical models suggest there is no expected return to owning [currency](#). So why does one want to take on this FX risk embedded in foreign equity exposure unless one is a tactical U.S. dollar bear?

- The correlation to the S&P 500 for EAFE with FX and EAFE with no FX shows practically no differentials over the last 3-, 5-, 10- and 20-year periods. There is a slightly lower correlation to EAFE with FX over 40 years of data, but that does not appear to be a compelling case to add currency exposure on top of the local equity market return given the uptick in total volatility from adding FX and the unpredictability of future currency moves.

The Declining Diversification of Owning the Euro Below is the same chart for the European FX³ correlation to the S&P 500, which also shows a consistent increase and less diversification from holding euros on top of owning the European equities.

- The European FX as a standalone asset class historically had 10% volatility consistently over most major periods—again, just about half the volatility of the local equity market.
- The long-term returns to the [MSCI EMU Index](#) currencies were only 0.1% per year—this means the risk-return trade-off for European

currencies as a standalone asset class showed relatively miniscule historical returns with large volatility (a bad combination). • EMU FX over the long run had a correlation of 0.14 versus the S&P 500, but that has risen significantly to 0.68 over the last three- and five-year periods. This rising correlation means there is less diversification benefit to owning the euro.⁴

Figure 2: MSCI EMU Index: Return, Volatility and Correlation

| | Returns | | | Volatility Levels | | | | Correlations to S&P 500 | | |
|------------------|--------------|--------------|-----------|-------------------|-----------|--------------|---------|-------------------------|-----------|--------------|
| | EMU w/ FX | EMU No FX | EMU FX | EMU w/ FX | EMU FX | EMU No FX | S&P 500 | EMU w/ FX | EMU FX | EMU No FX |
| 12/31/87-7/31/14 | 8.1% | 8.0% | 0.1% | 20.1% | 10.4% | 17.9% | 14.5% | 0.75 | 0.14 | 0.77 |
| 3-Year | 6.6% | 9.2% | -2.4% | 21.8% | 8.9% | 15.2% | 12.2% | 0.86 | 0.68 | 0.84 |
| 5-Year | 6.9% | 8.2% | -1.2% | 22.9% | 10.4% | 15.2% | 13.2% | 0.85 | 0.68 | 0.82 |
| 10-Year | 6.3% | 5.2% | 1.1% | 23.1% | 10.6% | 16.9% | 14.7% | 0.88 | 0.53 | 0.87 |
| 20-Year | 14.6% | 13.6% | 0.9% | 20.9% | 10.0% | 18.4% | 15.2% | 0.82 | 0.21 | 0.82 |

Sources: WisdomTree, MSCI 12/31/87-7/31/14. EMU w/ FX refers to the MSCI EMU Index priced in USD. EMU no FX refers to the MSCI EMU Index priced in the local currency. EMU FX refers to the underlying currency exposure of the MSCI EMU Index. Past performance is not indicative of future results. You cannot invest directly in an index.

The discussion of currency-hedged strategies has shaken some of the core beliefs of investors. Traditional investment vehicles that package equity risk plus a secondary currency risk on top of the equity risk have been referred to as the traditional “plain vanilla” exposure because they were the first to the market, and it is what investors have been using for so long. I believe it’s necessary to take a harder look at the diversification attained by adding in this FX risk. If investors evaluated FX as a pure standalone investment instead of a package product, I think they would rarely find themselves convinced of the reason to add in this exposure to their portfolios. There has been rising correlation to the S&P 500, low historical returns to FX, high historical volatility and a tactical environment that looks likely to favor the U.S. dollar. For more of our research, see our market insight [here](#).

¹References currency exposure of MSCI EAFE Index.

²WisdomTree, MSCI, 12/31/69-7/31/14. Applies to all bullet points. ³References currency exposure of MSCI EMU Index. ⁴Sources: WisdomTree, MSCI, 12/31/87-7/31/14. Applies to all bullet points.

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DEFINITIONS

Foreign Exchange (FOREX, FX): The exchange of one currency for another, or the conversion of one currency into another currency.

Hedge: Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

MSCI EAFE Index: is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Volatility: A measure of the dispersion of actual returns around a particular average level.

Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Currency: Currency in which the underlying index returns are calculated. Euros: The returns are calculated, and there is no currency conversion; resulting statistics result purely from the returns of the equities. U.S. dollars: The returns are calculated and then converted into U.S. dollars; resulting statistics are the result of a combination of the euro's performance against the U.S. dollar and the returns of the underlying equities.

MSCI EMU Index: A free float-adjusted market capitalization-weighted index designed to measure the performance of the markets in the European Monetary Union.