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FX hedging: Turning an accidental risk into a strategic choice

Foreign exchange (FX) risk is a significant factor for investors holding international equities, affecting returns independently of equity performance. Managing FX exposure strategically rather than passively can enhance portfolio resilience and align risk with investor objectives.

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Key takeaways

- In recent years, a weaker US dollar and Japanese yen have reduced the appeal of unhedged US and Japanese equities for overseas investors, underlining the importance of FX in global investing.
- Unlike equity risk, FX risk does not guarantee long-term rewards and may dent portfolio performance due to factors unrelated to equity fundamentals.
- When managing FX risk, investors can choose the “do nothing” approach to rely on long-term currency mean reversion or take a more proactive approach to use selective hedge ratios based on investment goals and currency characteristics.
- Hedging decisions should factor in interest rate differentials (carry), transaction costs, and may use static or dynamic hedging approaches aligned with investor goals.

For UK and European investors, a stronger US dollar boosted returns on US equities through much of the 2010s and early 2020s. However, since early 2025, dollar weakness has reduced those returns, leaving unhedged overseas investors worse off than US-based peers holding the same assets (see Exhibit 1).

Similarly, the continued depreciation of the yen has significantly reduced returns for non-Japanese investors with unhedged exposure to Japanese equities (see Exhibit 2).

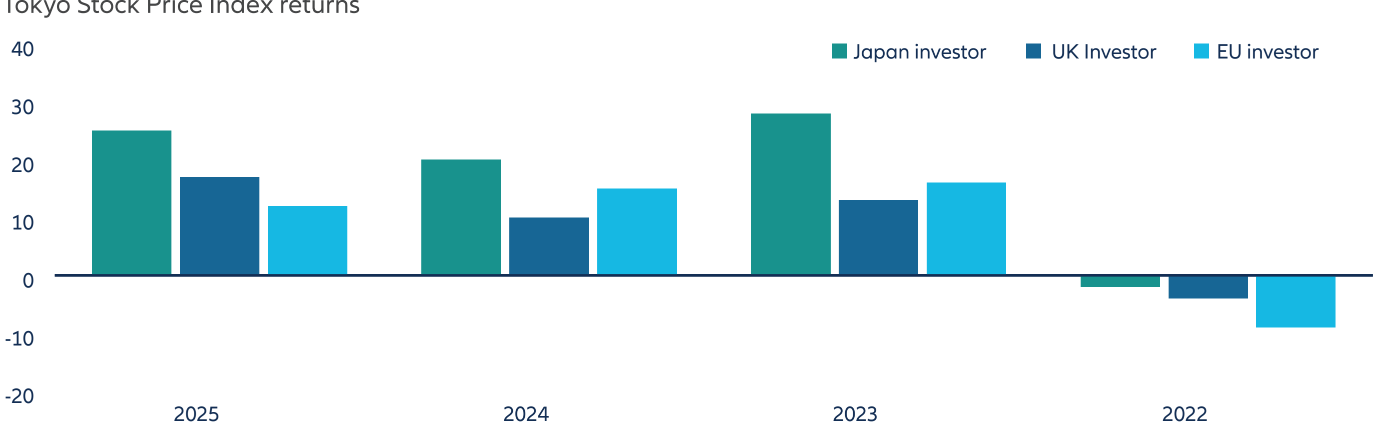
Exhibit 1: US dollar weakness during 2023 and 2025 eroded US equity returns for international investors

S&P 500 returns

Source: Bloomberg. Data as at 31 December 2025.

Exhibit 2: Persistent falls in the Japanese yen have hurt international investors in Japanese equities

Tokyo Stock Price Index returns



Source: Bloomberg. Data as at 31 December 2025.

Such examples underline the importance of foreign exchange (FX) risk when investing abroad.

Over the past decade, investors have steadily shifted from home-biased equity portfolios towards a more global approach, often anchored around the US, the largest market. The motivation is clear: international equities offer broader opportunity sets, richer sector diversification, and reduced reliance on any single domestic economy.

However, the risks associated with this shift are often overlooked. In many multi asset portfolios, FX exposure isn't intentionally chosen or deeply researched – instead, it is often a passive by-product of owning overseas assets.

Equity risk is generally expected to be rewarded over the long term. But FX risk offers no such assurance. Currency pairs can swing meaningfully over months or even years, driven by interest rate differentials, capital flows, or policy shifts – factors unrelated to equity fundamentals. As a result, investors may find themselves taking FX risk without any expectation of long-term reward.

FX: a risk factor rather than a source of return

How much does FX matter? Currency moves of 10% are not unusual and can add to or subtract from the home currency return of an unhedged foreign asset, regardless of the underlying equity's performance. Therefore, FX can have a material impact on total returns and is a risk investors should take seriously.

Research on international asset pricing shows that exchange-rate and foreign inflation risk help explain variation in returns, but do not guarantee a positive expected premium for long-only foreign equity holders in their base currency. This is why, in our view, equity currency decisions should be framed primarily as risk management choices, rather than sources of expected return.

How to manage FX risk

Typically, investors can choose one of two approaches – or a combination of both – to manage FX risk:

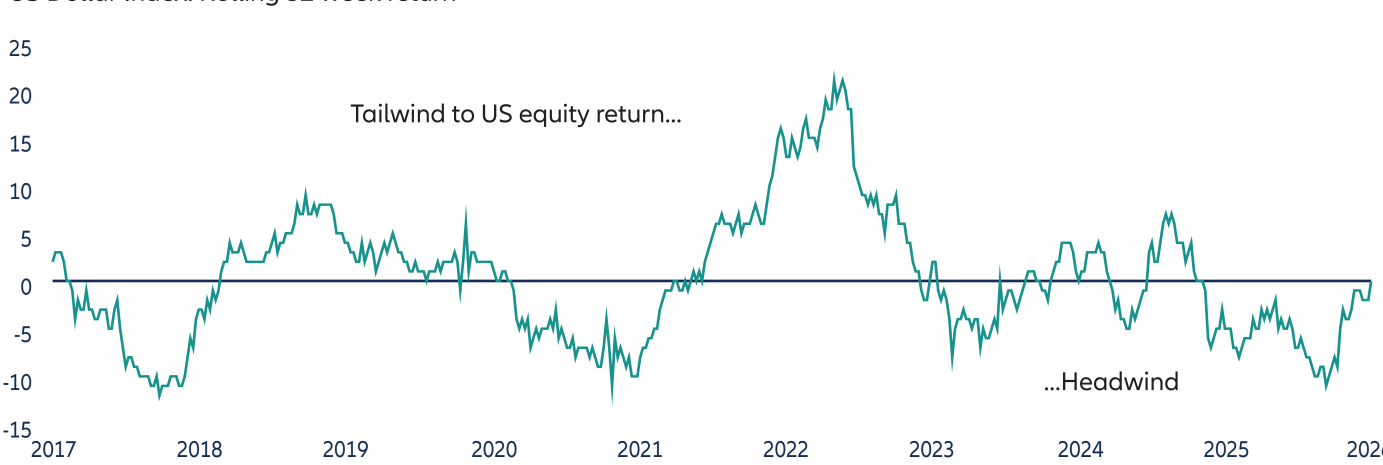
- **The "wash out" argument – otherwise known as the "do nothing" approach:** Some market participants argue that currency fluctuations "average out" over long horizons, reducing the need to hedge. There is some merit to this, as real exchange rates tend to revert towards purchasing-power parity over the long term.

  But these cycles can last for years, meaning FX can remain a persistent tailwind or headwind for unhedged returns (see Exhibit 3). If that works in the investor's favour, it helps; if not, it can be a painful surprise.

- **Currency hedge – the proactive strategic approach:** The right answer to managing currency risk is rarely hedging 100% of equity FX. Equally, it is unlikely to be hedging 0%. FX can diversify equity risk because some currencies – notably the US dollar, Swiss franc, and historically the yen – have exhibited "safe-haven" properties during periods of market stress, tending to appreciate when global equities sell off, helping offset risk. Research from the IMF and NBER links the global financial cycle closely to dollar fluctuations, showing that unhedged exposure can sometimes lower portfolio volatility by offsetting equity declines. In Canadian and UK allocator studies, unhedged global equities have often been less volatile than hedged, because currency moves partly counterbalance equity swings. However, these outcomes are highly time- and currency-specific.

  Choosing a hedge ratio depends on an investors' objectives, as well as the costs and currencies involved – with safe-haven currencies often requiring less hedging than more pro-risk peers, such as those linked to commodity exports or emerging markets.

Exhibit 3: For international investors in US equities, US dollar performance can be a headwind or tailwind



Source: Bloomberg. Data as at 22 May 2026.

Careful currency management can deliver a well-balanced portfolio

Diversification is fundamental in multi asset investing, and a global equity approach strengthens it. But investors should remain alert to passive, unintended risk exposures, with FX among the most significant and most overlooked. Treating currency as a deliberate strategic choice, rather than an accidental byproduct, is therefore essential to building resilient, well-balanced portfolios.

Making FX exposure a deliberate design choice

The strategic consideration for investors managing FX exposure resulting from global equity investments is how and where they wish to allocate risk. We think there is merit in treating currency like any other major risk budget item by following four steps:

1. **Define the role of FX.** Is the aim pure equity beta – owning companies, not currencies – or to use FX as a shock absorber? If the former, a higher hedge ratio may make sense. If the latter, a partial or zero hedge could be an option, especially against safe-haven currencies that tend to move opposite to global risk.

2. **Be currency-specific.** Not all FX behaves the same. A partial hedge against safe-havens might reduce the effectiveness of equity beta hedging, while hedging riskier currencies may help minimise investment losses. This approach argues for differentiated hedge ratios by currency, rather than a single blanket number.

3. **Consider carry and costs.** Investors need to consider interest rate differences between currencies (known as carry) when hedging. Carry is also impacted by exchange rate volatility and broader market risk sentiment.

4. **Decide between static and dynamic.** A static 50% equity FX hedge is a common compromise to reduce volatility while preserving some diversification – reflecting a “minimise regret” approach. Others pursue dynamic hedging, using signals such as trend, carry or valuation to adapt across cycles. The optimal strategy depends on each investor’s objectives: static hedges tend to suit those prioritising stability, while dynamic approaches may be more appropriate for investors seeking to actively manage currency exposure.

FX can either diversify or amplify risk. The right approach is often to be explicit about where to take risk and to adjust hedge ratios according to an investor’s goals, investment time frame, and base currency.

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Past performance does not predict future returns. If the currency in which the past performance is displayed differs from the currency of the country in which the investor resides, then the investor should be aware that due to the exchange rate fluctuations the performance shown may be higher or lower if converted into the investor's local currency.

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