BostonPartners

White Paper | May 2015

Certain Costs, Uncertain Benefits: The Case Against Hedging Currency Exposure

Executive Summary

One of the key decisions that U.S. managers of international stock portfolios face is whether to actively manage currency risk. Those who opt to hedge—typically through derivatives, such as foreign currency forwards—convert the value of shares from the local currencies of overseas markets back to U.S. dollars. The other approach is to accept currency risk as a reality of cross-border investing. Rather than hedging against unpredictable currency movements and incurring the transaction costs from derivative trading, it is better to focus time and resources on other areas, such as stock picking, the thinking goes.

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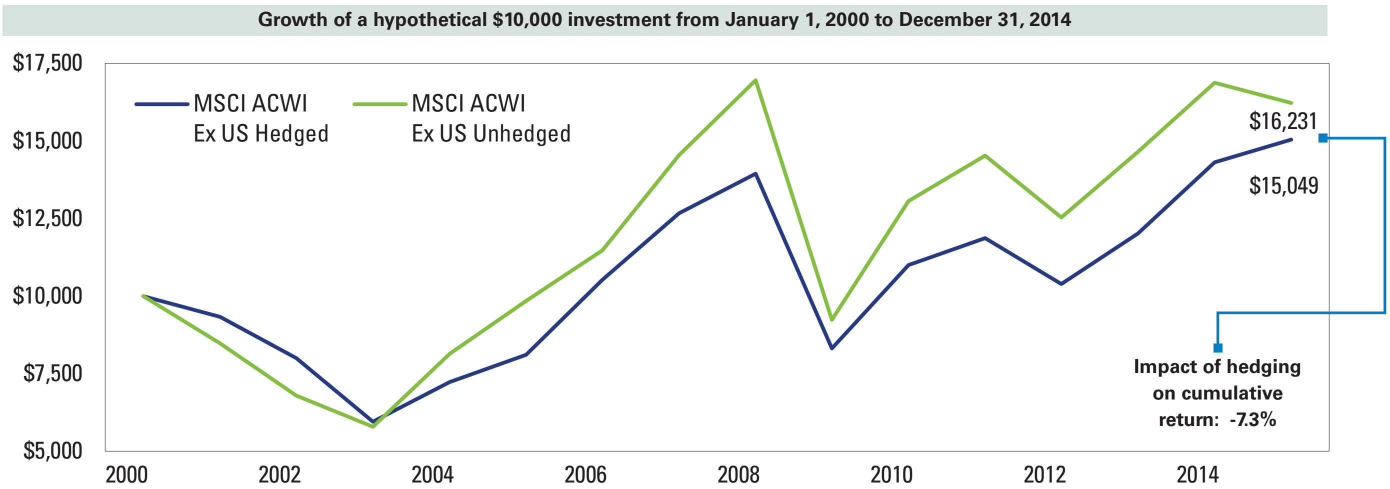
Table 1: Hedging an Investment in International Equities Produced Lower Returns Over the Past 15 Years



Source: Morningstar, Inc., 2015. The MSCI All Country World ex-US Index (MSCI ACWI) tracks the performance of publicly traded large- and mid-cap stocks of developed-market companies outside the United States. Total returns are calculated gross of foreign withholding tax on dividends. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Past performance is not an indication of future results.

Clearly, there are times when hedging can add value. We have recently experienced one of these periods as the U.S. dollar staged a remarkable rally. The dollar-denominated returns of international funds that do not hedge were squeezed as the dollar rose about 20% versus the euro from July 2014 through late April 2015. The managers of funds that employ hedging mitigated this negative effect, boosting performance over this stretch of currency volatility.

The dollar's strength relative to currencies such as the euro and the yen is a result of today's crosscurrents in global monetary policies. In the United States, anticipation of a tightening in monetary policy by the U.S. Federal Reserve has lifted the dollar. The European Central Bank and the Bank of Japan are on an opposite course, keeping rates at record lows and purchasing sovereign bonds. While these policies provide stimulus by making exports from the eurozone and Japan more affordable, they also devalue euro- and yen-denominated assets.

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Given the negative impact that currency translation has recently had on investors' international portfolios, currency hedging may appear to be an effective tool to manage current risks. Yet, at Boston Partners, we do not actively target currency exposures, nor do we seek to be benchmark neutral with regard to currency. Currency exposure is solely dictated by our bottom-up security selection process, which we believe is the best approach, for several reasons.

Hedging has Fixed Costs and Uncertain Benefits

One reason we do not hedge is that our core competency is picking stocks through fundamental analysis, rather than forecasting the shifting geopolitical winds that influence currency moves. Currency impacts tend to even out over long time periods, in our view. In contrast, we believe that employing a bottom-up approach to stock selection based on a repeatable process can add lasting value. We seek to identify stocks that exhibit attractive relative valuations, strong business fundamentals, and positive business momentum, without specific regard to currencies, geographic regions, countries, or sectors.

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Because of the fickle nature of currency movements, hedging presents logistical challenges and costs that are fixed and inescapable. It's one thing to hedge currency risk for a portfolio focused on a single overseas market or currency union, but quite another if the portfolio is geographically diversified across multiple markets; a dozen or more currencies may need to be hedged to fully offset currency risk across the portfolio. Whether or not these hedges successfully manage risks, they come with transaction costs.

In addition, hedging may come at the cost of a potential benefit that many investors seek from portfolio exposure to international equities. Currency provides a source of return that may have a low or even negative correlation with U.S. equities. As a result, hedging may remove some of this potential diversification benefit.

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Currency Analysis is Part of Our Bottom-Up Approach

To the extent that we factor in currency, it is confined to the impact that currency may have on the fundamentals of companies' businesses. For example, the profitability of a non-U.S. company that is a major exporter may diminish if its local currency appreciates. Any resulting decline in the company's share price could present a buying opportunity if our analysis indicates that the company's business is sufficiently resilient to recover from a short-term currency move. Such dislocations between company valuations and fundamentals are to be expected when currency movements trigger market volatility. In our view, such an environment provides a potentially target-rich opportunity set for bottom-up stock pickers. In contrast, any benefits resulting from currency hedging are uncertain, but come at a certain cost.

About Boston Partners:

Boston Partners is a premier provider of value equity investment products that are firmly rooted in fundamental research and are based on a disciplined investment philosophy and process. Boston Partners, which currently manages $74.5 billion*, is focused on investing in companies with attractive value characteristics and strong business fundamentals, where there is a catalyst for positive change. The firm, founded in 1995, has a longstanding reputation for superior client service. Boston Partners is part of Netherlands-based Robeco Group, one of the largest European asset management firms.

** As of March 31, 2015.*

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Mr. Hart is an equity portfolio manager for Boston Partners Global Equity and International Equity products. Prior to this, he was the portfolio manager for the Boston Partners International Small Cap Value product and before that, an assistant portfolio manager for the Boston Partners Small Cap Value products for three years. Previously, he was a research analyst and specialized in conglomerates, engineering and construction, building, machinery, aerospace & defense, and REITs sectors of the equity market. He joined the firm from Fidelity Investments where he was a research analyst. Mr. Hart holds a B.S. degree in finance, with a concentration in corporate finance from Clemson University. He holds the Chartered Financial Analyst® designation. He has twenty-four years of investment experience.

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