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To hedge or not to hedge: the performance of simple strategies for hedging foreign exchange risk

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Abstract

This paper investigates the efficacy of simple strategies for hedging foreign exchange risk. The strategies are: to always hedge, to never hedge, to hedge when the forward rate is at a premium, to hedge only when the premium is large, and a strategy based upon relative purchasing power parity. We find a strategy which hedges based upon large premia generally outperforms the other strategies for the period 1989–1998. Moreover, we document that in every sample and time horizon period, an unhedged strategy performs better than a hedged strategy. We illustrate our results using a data set of five countries. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The merits of diversifying securities portfolios internationally have long been recognized. Concomitant with such diversification is the assumption of foreign

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exchange risk. As was pointed out by Eaker and Grant (1990) and Eun and Resnick (1997), portfolio managers may not merely wish to mitigate foreign exchange risk, but may also wish to take advantage of foreign currency returns.

This paper examines, with different data, the efficacy of those hedging strategies explored by Eaker and Grant. Those strategies being: a) to leave foreign exchange exposures unhedged; b) to always hedge exchange risk with forward contracts; and c) to selectively hedge such risk, buying forward contracts only when the forward rate is at a premium. Moreover, we also look at two additional strategies. One is a modification of the selective hedging rule. It requires the investor to purchase a forward contract when the forward rate is at a premium only when such a premium is 'large' historically. The other strategy is based upon a relative purchasing power parity (ppp) equilibrium exchange rate, and stipulates that one hedge foreign exchange risk when the current spot rate is above its relative purchasing power parity equilibrium rate.

Like Eaker and Grant (1990) we examine the relative performance of the strategies using ex post efficient frontiers. In addition, we use return per unit of risk measures to compare the strategies. We find the 'large' premia strategy generally outperforms the other strategies. Moreover, we document that every sample and time horizon period, an unhedged strategy performs better than a hedged strategy.

The rest of the paper is organized as follows. Section 2 discusses the data used in the analysis. Section 3 discusses the hedging strategies. Section 4 discusses the results of the hedging strategies. Section 5 concludes the paper.

2. Data

There are four types of data used in the analysis: spot exchange rates, forward exchange rates, share price indexes, and to measure purchasing power parity, consumer price indexes.

The spot and forward data correspond to the bid-price of the last trading day of each month for the months between January 1974 and December 1998. The data from 1974 to 1992 are from the Harris Data Banks tapes and the data subsequent to this are from General du Banque, New York and the Federal Reserve Bank of Chicago.[1] The exchange rate data are in U.S. Dollar terms and are for five countries: Canada, Germany, Japan, Switzerland, and the United Kingdom. The forward rate data are for 3-months forward and for 1-year forward.

The Consumer Price Index and share price index data are from the International Financial Statistics database. They are all calculated using a base year of 1990.

All hedged positions are equal to the size of the foreign equity position at the beginning of the holding period, as the size of the position at the end of the holding period would not be known at the time the hedging decision would have been made.

[1] The Federal Reserve of Chicago has daily exchange rate data for most countries going back to the mid and early 1990s. See http://www.frbchi.org/index.html.

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