The case for hedging currency in global bonds

13 September 2019 | Portfolio construction

Print Share

This article explores the key to unlocking the diversification benefits of global bonds.

The diversification characteristics of bonds are well known. And adding global bond exposure provides additional benefits. But, as our research demonstrates, currency hedging is crucial to tapping into those advantages.

Bond values generally don't bounce around in the same way as equities, making them an ideal counterbalance in a portfolio. But, like most investments, they are at the mercy of economic cycles. They are especially sensitive to interest rates, and it's not just changes in the rate set by monetary authorities that matter. Expectations about those changes can also affect bond values. That's anything that could influence interest rate movements – inflation data, economic growth, unemployment, business confidence, the list goes on.

One way to decouple a portfolio from the vagaries of the economic cycle is to diversify beyond an investor's home market. After all, economic activity differs from country to country and region to region.

Adding bonds from other countries gives a portfolio exposure to different economic cycles, often at different stages, with their own prevailing interest and inflation rates. When rates are rising in one market, they could be stable or falling in another. The net effect of this could dilute or cancel out interest rate movements, leading to a more stable return profile.

For this reason, a global bond portfolio is typically less sensitive to changes in local interest rates than the weighted average durations of its individual bonds.

Global bonds provide other diversification benefits. Bond markets in different countries offer different exposures in terms of sectors, issuers, maturities and credit quality. For example, the US bond market has relatively lower exposure to government debt than say the UK and euro area, but it offers greater exposure to corporate and securitised debt. The UK has a relatively higher weight in long-dated, ten-year-plus bonds compared with the US.

All this diversification and lower volatility sounds great. But there is a catch. Exchange rate movements – currency risk – are a significant source of volatility in a bond portfolio. To reap the benefits of diversification, investors need to hedge back to their local currency.

It's well documented that currencies can and do deviate from their fair value in the short to medium term. Our research shows that these deviations add significant volatility to global bonds relative to what could be achieved through the same investment hedged back to the investor's local currency. We found that hedging the currency of global bonds back into the investor's own currency results in a return stream that is more typical of a high-quality investment-grade bond portfolio.

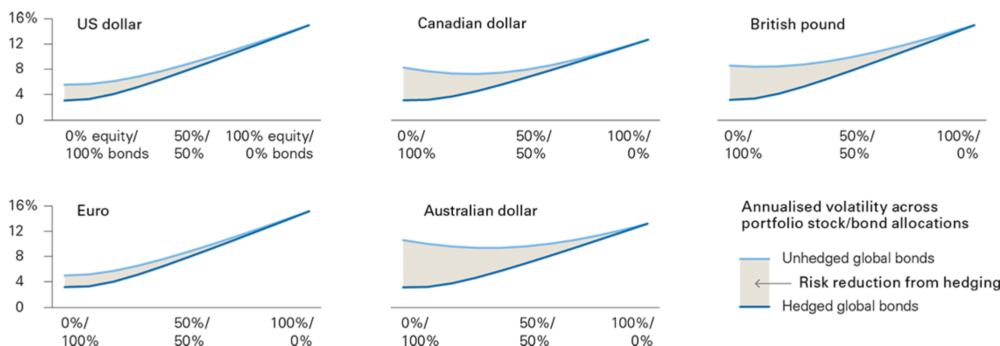
Just as currency can affect the return profile of global bonds, it can also significantly increase volatility – even in a balanced portfolio. The chart shows the historical annualised volatility for a range of global balanced portfolios of varying asset allocations. We found that regardless of the equity/bond asset allocation mix, currency-hedged global bonds provided risk-reduction benefits relative to leaving currency unhedged. The benefits were more pronounced for portfolios with higher fixed income allocations.

Of course, hedging has costs and we considered that in our analysis. Our research found that investors can expect minimal drag on their net returns relative to the significant diversification benefits that can be achieved from a global bond portfolio.

It appears going global with bonds can improve a portfolio's risk and return profile. But the key to unlocking this is hedging global bond exposure back to an investor's local currency.

To find out more, read the research paper.

Hedging the currency of global bonds reduces volatility



Past performance is not a reliable indicator of future results. These performance figures are calculated in US dollars, Canadian dollars, euros and Australian dollars and the return may increase or decrease as a result of currency fluctuations. Notes: Data cover 1 January 1988 to 30 June 2017. Global stocks are represented by the MSCI All Country World Index. For the United States, the United Kingdom, and Australia, global bonds are represented by the Citigroup WGBI to 31 December 1989 and the Bloomberg Barclays Global Aggregate Bond Index thereafter. For Canada and the euro area, global bonds are represented by the Citigroup WGBI to 31 January 1999 and the Bloomberg Barclays Global Aggregate Bond Index thereafter. Each portfolio is rebalanced on a monthly basis. Sources: Vanguard calculations, using data from Bloomberg Barclays and Thomson Reuters Datastream.

Important risk information:

The value of investments, and the income from them, may fall or rise and investors may get back less than they invested. Past performance is not a reliable indicator of future results.

Other important information:

This material is for professional investors as defined under the MiFID II Directive only. In Switzerland for institutional investors only. Not for public distribution.

This article is for educational purposes only and is not a recommendation or solicitation to buy or sell investments.

The opinions expressed in this article are those of the author and individuals quoted and may not be representative of Vanguard Asset Management, Ltd or Vanguard Investments Switzerland GmbH.

Issued by Vanguard Asset Management, Ltd, which is authorised and regulated in the UK by the Financial Conduct Authority. In Switzerland, issued by Vanguard Investments Switzerland GmbH.

Print Share

© 2021 Vanguard Group (Ireland) Limited. All rights reserved.
Issued in EEA by Vanguard Group (Ireland) Limited which is regulated in Ireland by the Central Bank of Ireland.
Your use of this site signifies that you accept our Terms and conditions of use. Important investment information | Privacy policy | Cookie policy Feedback