ROBECO
The Investment Engineers

Share class hedging explained

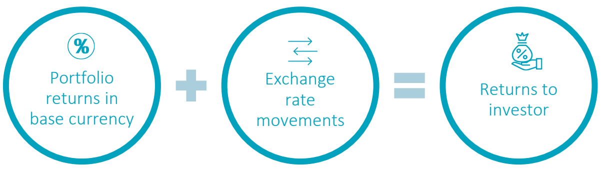
Currency-hedged share classes

Sustainable Investing Expertise by ROBECOSAM

Exchange rates can have a significant impact on investors' returns. The aim of currency-hedged share classes is to engage in currency hedging transactions to reduce exchange rate risk. This minimizes the undesired performance impact due to fluctuations in the exchange rate between the currency of the share class and other currencies.

For example, if a European investor wishes to capture the investment performance of the US equity market, the portfolio returns will be affected by the movements in the EUR/USD exchange rate. The European investor could decide to invest in the EUR-hedged share class of a US fund, with the aim of capturing the performance of the US equity market without being exposed to the currency risk of moving EUR/USD exchange rates.

Figure 1 | Exchange rate movements affect investors' returns



Source: Robeco. For illustrative purposes only

Hedged share classes offer the convenience of dealing in the investors' preferred currency and offer exposure to the asset category, with minimal impact from currency movements. It should be noted that it is impossible to achieve a perfect hedge, and there is therefore no guarantee that currency hedging will fully eliminate investors' exposure to currency risks.

How are the currency hedges implemented?

When an investor purchases shares of a hedged share class, the following actions are taken:

- The investor's subscription in the hedged share class is converted at the spot rate, typically to the base currency of the fund;
- The investor's currency exposure in the share class is hedged through a currency forward;
- The hedge is monitored daily and adjusted based on changes to the net asset value of the hedged share class, subject to certain thresholds;
- The hedges are rolled on a periodic basis, typically monthly, realizing any gain or loss on the hedge. The gain or loss offsets the impact of the movement of the other currencies.

Robeco applies different types of hedging methodologies to its hedged share classes. These methodologies are described in Table 1.

Table 1 | Hedging methodologies

	NAV hedge	Portfolio hedge	Benchmark hedge
Description	Hedges the value of the assets, as expressed in the base currency of the fund, into the currency of the hedged share class	Hedges the different currency exposures of the fund into the currency of the hedged share class	Hedges the currency exposures of the fund benchmark into the currency of the hedged share class
Purpose	Receive similar returns to those in unhedged share classes in the base currency of the fund, adjusted for hedging costs	Receive a return that mitigates the impact of foreign exchange movements in the fund	Receive a return that mitigates the impact of foreign exchange movements in the fund, minimizing currency risks relative to the benchmark
Typical usage	Funds with a cash benchmark and single-currency funds	Multi-currency equity funds	Multi-currency fixed income funds
Preservation of active currency positions*	Yes	No	Yes

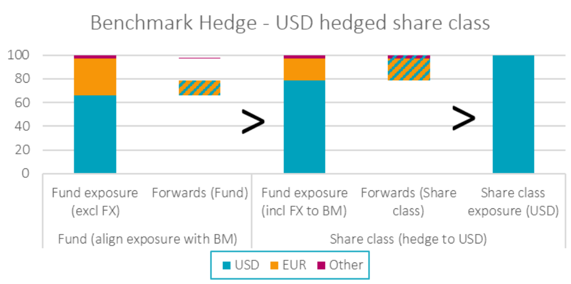
Source: Robeco

** Some funds employ an active currency policy. This means that the fund can take active currency positions resulting in positive or negative currency exposures. The treatment of these active currency positions at the share class level depends on the hedging methodology.*

Example of a benchmark hedge

We provide an example of a benchmark hedge for a fixed income fund with a USD hedged share class and a total allocation of US dollar-denominated bonds and cash of around 67%, versus around 80% in the benchmark. The currency policy of the fund is to align the currency exposures with the benchmark. Hence, the US dollar exposure of 67% in the fund will be increased to 80%, by using currency forwards. At the share class level, the remaining EUR and other currency exposure, 20% in total, is hedged to the share class currency USD.

Figure 2 | Example of a benchmark hedge



Source: Robeco. For illustrative purposes only

Why can hedged share classes still have exposures to other currencies?

The currency-hedged share classes aim to mitigate exchange rate risk. Several factors can affect the results:

- **Short-term interest rate differential** between the currency of the share class and the currencies being hedged (the pricing of currency forwards takes into account the interest rates that investors would earn holding the different currencies) and the **cross-currency basis** (the price of currency forwards are influenced by supply and demand).
- **Transaction costs**, including the costs for the hedging agent. Note that to avoid unnecessary transaction costs, opportunities are identified for offsetting transactions or for combining transactions where possible.
- **Unrealized gains and losses on the currency forward contracts** are not invested in underlying assets until the hedge transactions are rolled and the gain or loss is realized.
- **The timing of the hedge transaction and the fund's valuation point**. Note that hedging transactions are in general executed as close as possible to the fund's valuation point to limit this impact.
- **Settings of the hedging program**: the size of the forward currency contracts can differ from the NAV of the share class due to practical limitations or to avoid transaction costs (e.g., avoid small transactions).

Because there is no such thing as a perfect hedge, investors may still be exposed to currencies other than the currency of the hedged share class.

What are the costs of the currency hedging program?

The hedging activities for the hedged share classes incur transaction costs. These transaction costs include a charge for the hedging agent. The charge for the hedging agent is maximum 3bps per annum over the hedged assets on the periodic roll date. All gains, losses and transaction costs of the hedging program are borne solely by the investors in the hedged share class.

What are the risks of currency hedges for investors?

There are a few risks related to the currency hedges that should be considered by investors:

- Achieving a perfect hedge is not possible and it is therefore not guaranteed that the currency hedging will fully eliminate investors' exposure to currency risks. Investors may still be exposed to currencies other than the currency of the hedged share class.
- Investors in hedged share classes elect to gain exposure to the currency of the hedged share class. This currency may strengthen or weaken relative to other currencies. By investing in the hedged share class, the investor will not be exposed to the negative impact from the currency movements, but will also not benefit from any favorable currency movements.
- There is no segregation of liabilities between share classes.

Conclusion

As exchange rates can have a significant impact on investors' returns, currency-hedged share classes aim to engage in currency hedging transactions to reduce exchange rate risk. This minimizes the undesired performance impact due to exchange rate fluctuations between the currency of the share class and other currencies.

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