The hedge of least regret

A balanced approach to currency risk in international equity portfolios

Executive summary

International equities remain a critical component of diversified portfolios, offering exposure to a broader opportunity set than domestic markets alone. However, investing internationally introduces an additional layer of complexity in the form of currency exposure. For U.S.-based investors, returns from international equities reflect both local market performance and movements in foreign exchange rates. While currency exposure can enhance returns in certain environments, it can also introduce meaningful volatility, often independent of underlying equity fundamentals.

Traditional approaches to managing this risk have generally focused on either fully hedging currency exposure or leaving it entirely unhedged. Each approach, however, embeds an implicit view on the future direction of the U.S. dollar—a view that is inherently uncertain and difficult to predict. In contrast, a balanced 50% currency hedge offers a neutral approach that reduces volatility without requiring investors to take a directional stance. By avoiding extreme positioning, this framework provides what can be described as a "hedge of least regret," delivering more stable outcomes over time.

International equities: A strategic, but underweight allocation

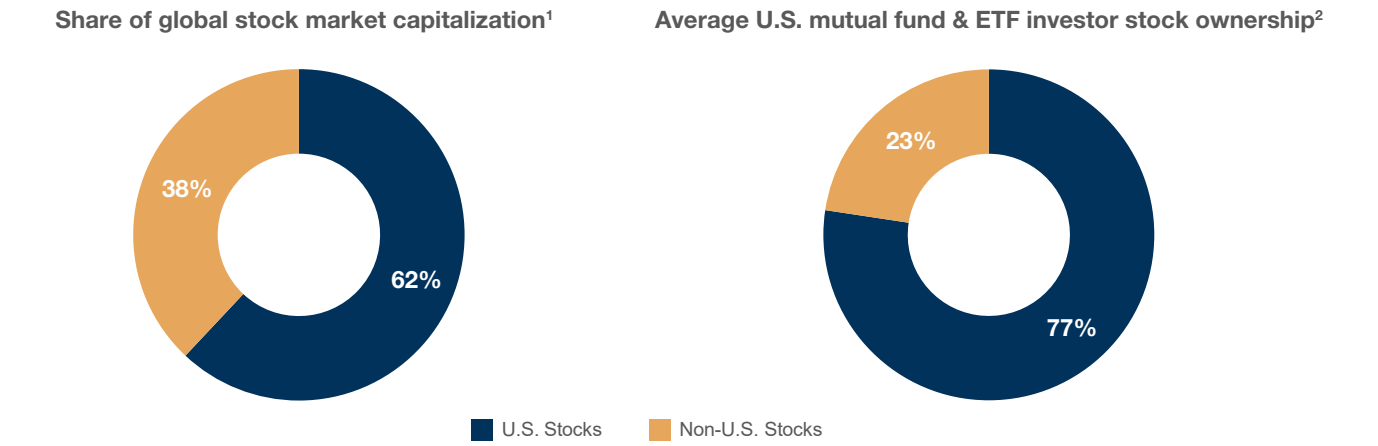
The case for international equities as a strategic long-term allocation remains compelling. A substantial share of global equity market capitalization resides outside the United States, spanning a diverse range of industries and business models. Many leading companies across sectors such as financials, industrials, healthcare, and consumer goods are headquartered outside the U.S., providing investors with exposure to economic drivers that differ meaningfully from those of the domestic market.

Despite this broad opportunity set, investor allocations remain heavily concentrated in U.S. equities. As illustrated in Figure 1, the distribution of investor portfolios diverges significantly from the global market opportunity, reflecting a persistent home-country bias. While global equity markets are more balanced across regions, portfolios often remain skewed toward domestic exposure, increasing sensitivity to U.S.-specific economic conditions and market dynamics.

This imbalance has important implications for portfolio construction. Concentration in a single market can amplify exposure to domestic policy, valuation cycles, and sector composition, particularly in periods when leadership is narrow. By contrast, international equities provide access to differentiated return streams, which can help enhance diversification and reduce reliance on a single economic regime.

Valuation differentials further support the case for global diversification. As shown in Figure 2, international equities have generally traded at a discount to U.S. markets in recent years. While part of this gap reflects structural differences in growth expectations and sector composition, it also highlights the potential for more balanced return drivers across regions. In this context, expanding international exposure may not only improve diversification but also position portfolios to benefit from evolving global market leadership.

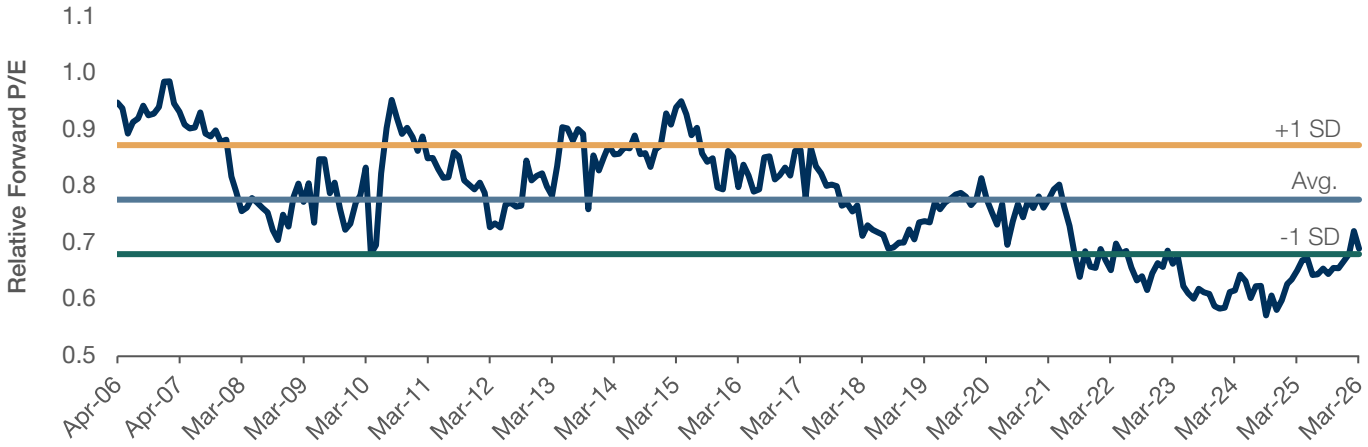
Figure 1. Global opportunity set vs. Investor allocation



Source: 1. Source: MSCI as of 12/31/25. 2. Source: Morningstar as of 12/31/25. Includes U.S. and International funds excluding world and allocation funds.

Figure 2. : Relative valuations vs. U.S.

International (MSCI EAFE Index) vs. U.S. (S&P 500 Index) valuation differential



Source: Morningstar as of 03/31/26. For illustrative purposes only. **Past performance is not indicative of future results. You cannot invest directly in an index.**

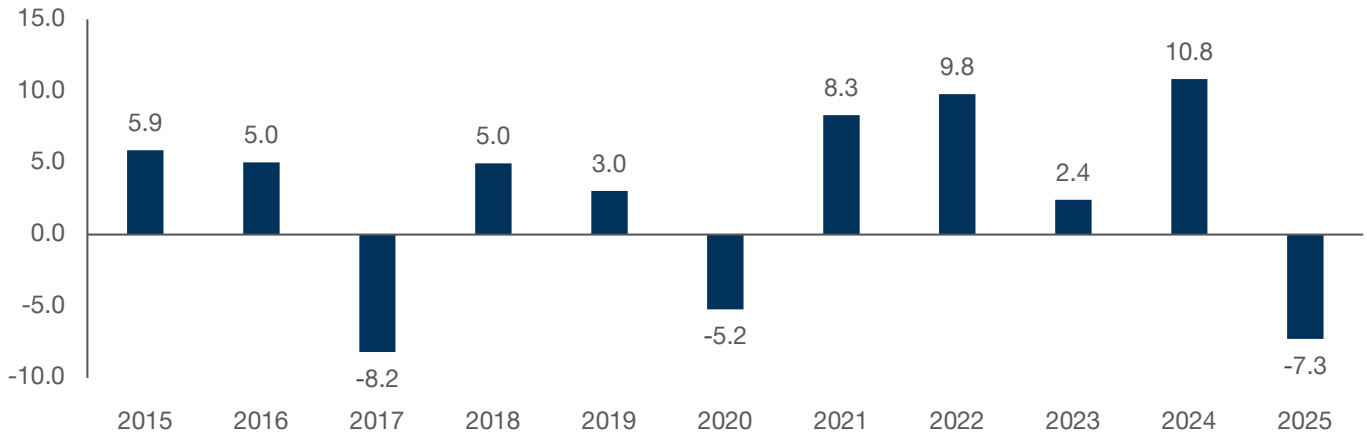
The currency conundrum

For U.S.-based investors, international equity returns are composed of both local equity performance and currency movements. While this relationship is straightforward in theory, its implications are often underestimated in practice. Exchange rate fluctuations can materially alter realized returns, particularly over shorter investment horizons, where currency movements can be rapid and unpredictable.

Currency hedging can help manage the risks associated with large exchange rate movements, but the choice between fully hedged and unhedged strategies introduces an inherent tradeoff. A fully hedged portfolio reduces exposure to international currencies, but may forgo potential gains when the U.S. dollar weakens. Conversely, an unhedged portfolio retains international currency exposure, which can enhance returns in periods of dollar weakness but detract from performance when the dollar strengthens. As a result, the relative performance of hedged and unhedged strategies has varied considerably over time, making it difficult to consistently identify a superior approach. Figure 3 illustrates this dynamic, showing that performance leadership has historically alternated between the two strategies depending on the prevailing currency environment.

Figure 3. Relative performance of hedged vs unhedged strategies

Calendar year net impact to return average +/- 6.5%



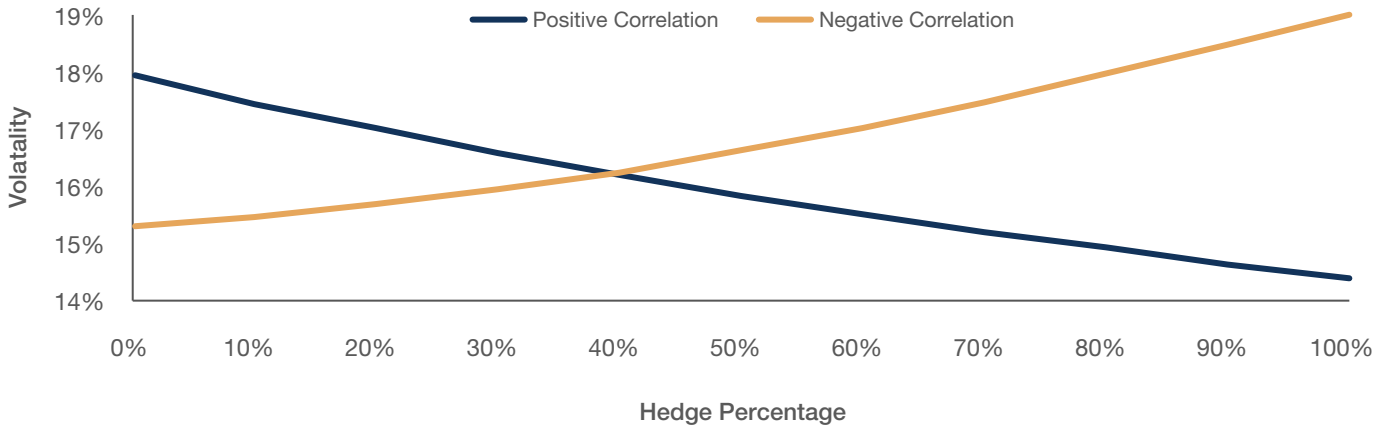
Source: Morningstar as of 12/31/2025.

A second, and often less intuitive, consideration is the impact of currency hedging on portfolio volatility. While hedging is frequently assumed to reduce risk, its effectiveness depends on the relationship between currency returns and local equity returns. As shown in Figure 4, the effect of increasing the hedge ratio is not uniform. In environments where currency and equity returns are positively correlated, higher levels of hedging tend to reduce overall volatility. However, in cases where the correlation is negative, unhedged currency exposure may provide a natural offset to equity market movements, and increasing the hedge ratio can, in fact, raise portfolio volatility.

These differing outcomes are driven by the instability of currency-equity correlations, which can vary meaningfully across regions and over time. Figure 5 highlights this variability, demonstrating that correlations are not only inconsistent but can shift regimes depending on macroeconomic conditions. For example, in markets where currencies have historically acted as a risk-off asset, unhedged exposure may dampen equity volatility. In contrast, during periods of synchronized global risk, currency movements may amplify equity fluctuations, making hedging more effective as a risk management tool.

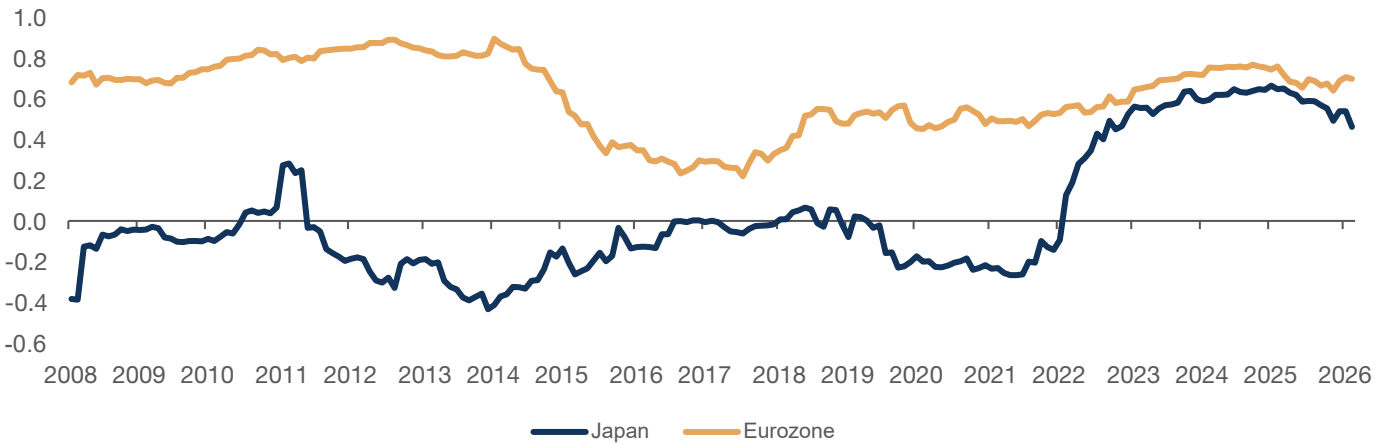
Taken together, these dynamics underscore a central challenge in currency management: the effectiveness of hedging is not constant, and both return outcomes and volatility are highly dependent on conditions that are difficult to forecast. This uncertainty complicates the case for extreme positioning and suggests that a balanced approach may offer a more consistent risk profile over time.

Figure 4. Volatility as a function of fraction hedge



Source: New York Life Investment Management. This chart is for illustrative purpose only and is meant to represent the effects of positive and negative correlation between " hedge percentage" and "volatility."

Figure 5. Rolling 36-month correlation between currency and equity returns



Source: Morningstar as of 2/28/2026.

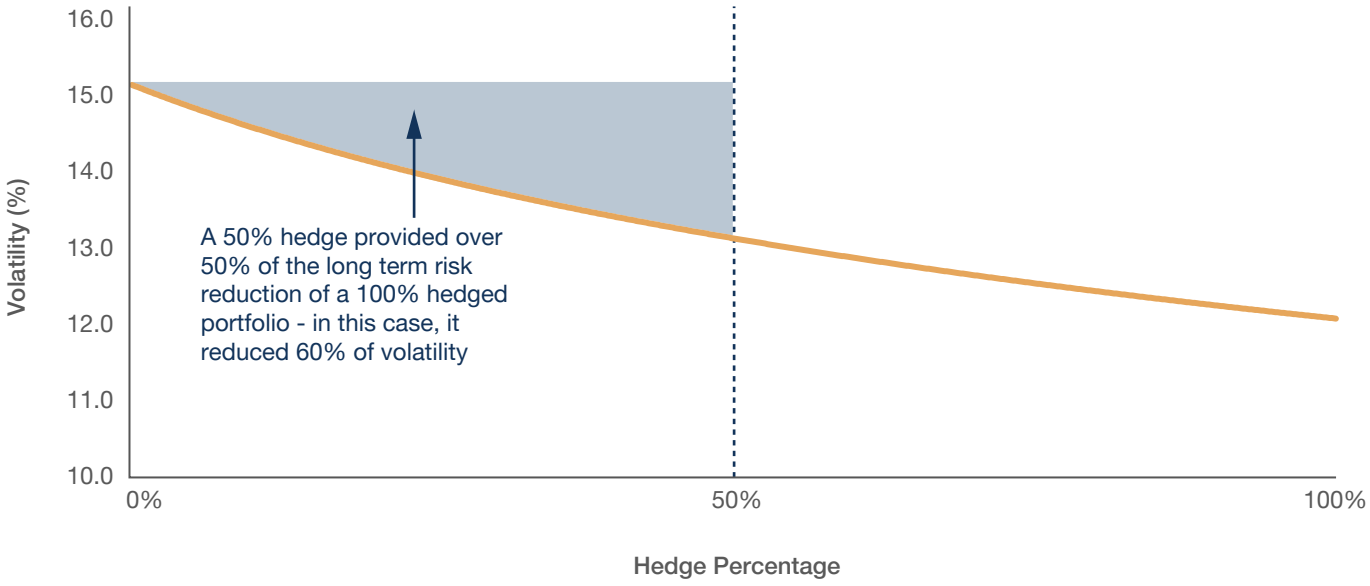
The hedge of least regret

Given the limitations of extreme approaches, a balanced hedging strategy may offer a more robust solution. A 50% hedge represents a midpoint between fully hedged and unhedged positions, creating a neutral exposure to currency movements. This approach allows investors to retain partial participation in currency-driven returns while reducing the overall impact of exchange rate volatility.

Importantly, the relationship between hedging and risk reduction is not linear. A substantial portion of the volatility reduction associated with currency hedging can be achieved without fully eliminating currency exposure. As a result, a partial hedge can provide meaningful risk benefits while avoiding the trade-offs associated with extreme positioning. Figure 6, for example, shows that a 50% currency hedge has historically reduced risk associated with currency exposure by 60%.

By maintaining exposure to both potential dollar strength and weakness, a balanced hedge avoids the need to take a directional view on currency markets.

Figure 6. Risk reduction from partial hedging



Source: Morningstar data - 15 Year Standard Deviation of the FTSE Developed ex North America Inde, FTSE Developed ex North America 50% Hedged Index and FTSE Developed ex North America Hedged Index as of 2/28/26.

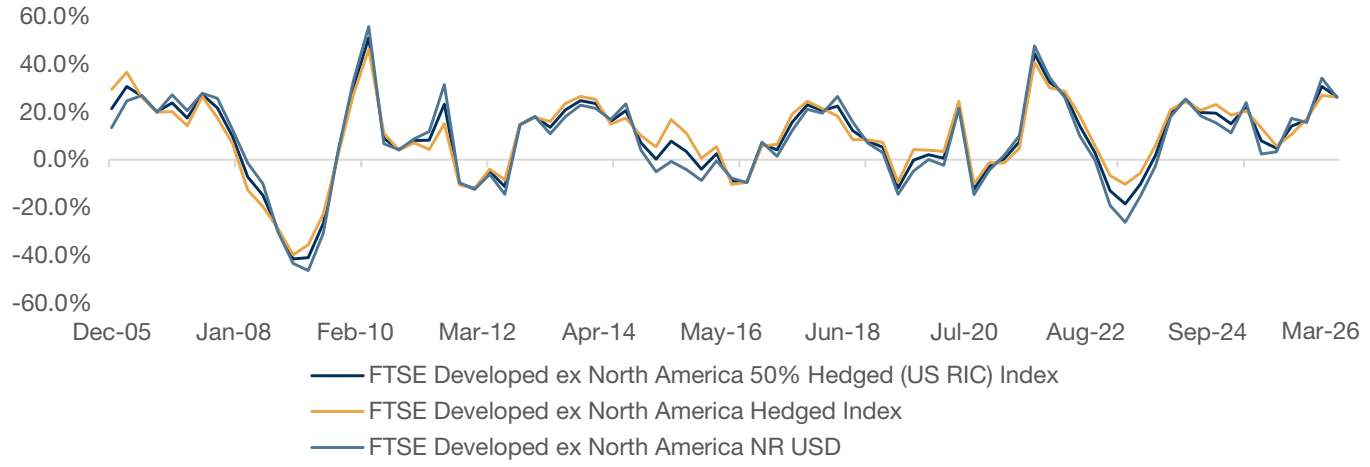
Currency decisions often carry a behavioral dimension. Investors are prone to regret when outcomes diverge sharply from expectations, particularly when those outcomes are driven by factors perceived as unpredictable. Currency markets are a frequent source of such outcomes.

A fully hedged portfolio may underperform significantly during periods of dollar weakness, while an unhedged portfolio may suffer during periods of dollar strength. These outcomes can lead to reactive decision-making, with investors adjusting their hedging approach in response to recent market movements rather than long-term strategy.

A balanced hedging approach reduces the likelihood of such extreme outcomes. Figure 7 highlights that the 50% hedged route produces a more stable return profile across different currency environments. While it may not deliver the highest return in any single scenario, it avoids the most unfavorable outcomes, thereby reducing the potential for regret.

Figure 7. Performance dispersion across hedging strategies

Rolling 1-year returns



Source: Morningstar as of 3/31/2026.

Implementation considerations

The practical implementation of currency hedging strategies has evolved over time. ETF innovation has allowed for a more streamlined approach, enabling investors to access a neutral currency exposure within a single product offering. Historically, achieving a partial hedge required combining multiple investment products, introducing additional transaction costs, complexity and operational burden. Figure 8 highlights some of these drawbacks and the benefits of a single-ETF strategy. Plus, investors still benefit from the liquidity, transparency, low cost, and tax efficiency of ETF investing.

Figure 8. Implementation approaches

	Single 50% currency-hedged ETF	Equally splitting assets between a fully hedged ETF and a fully unhedged ETF
Initial transaction costs	• Required for one ETF	• Doubled
Annual trading costs	• Lower	• Higher due to ongoing reallocations
Rebalancing tax implications	• Automatic rebalancing within a single portfolio	• Potentially higher due to ongoing need to sell shares of one ETF to buy shares of the other
Statements	• Streamlined single line item	• Multiple line items
Efficient allocation across hedging strategies	• Professionally managed, automatically ongoing, and completely transparent	• Potentially inefficient due to limited investor research resources • Potential to make a wrong call if not allocated properly at any given time

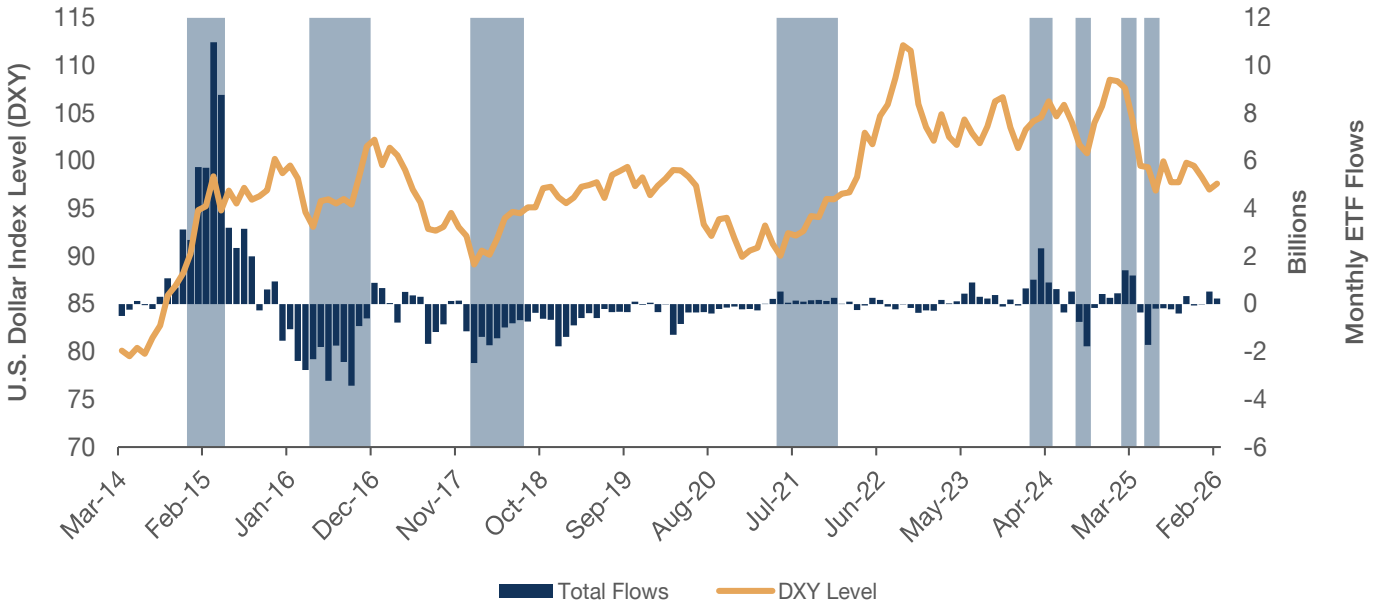
Timing currency positioning

Currency markets are inherently complex and influenced by a wide range of economic and financial forces. Monetary policy, inflation differentials, capital flows, and changes in global risk sentiment all play a role in shaping exchange rate movements. These factors evolve over time and often interact in ways that are difficult to anticipate, contributing to periods of both stability and volatility in currency markets.

As a result, forecasting the direction of currencies, particularly over shorter investment horizons, has proven to be challenging. Even in environments where broader economic trends appear clear, exchange rates can deviate from expectations for extended periods, making it difficult to consistently identify when a hedged or unhedged approach is likely to be advantageous.

As Figure 9 shows, investor flows in and out of currency hedged ETFs have tended to be ill-timed, with investors often employing a currency hedge after a period of dollar strength and vice versa, or failing to hedge prior to large moves (e.g., 2021).

Figure 9. Currency hedged ETF flows vs. Dollar movements



Source: Morningstar as of 2/28/2026.

CONCLUSION

Currency exposure is an inherent feature of international investing and a meaningful driver of both returns and risk. While fully hedged and unhedged strategies offer clear outcomes, both require investors to take a view on the direction of the U.S. dollar.

Given the inherent uncertainty of currency markets, such views are difficult to form with confidence. A balanced approach, such as a 50% currency hedge, offers a practical alternative. By reducing volatility, moderating outcomes, and avoiding extreme positioning, it supports more consistent performance potential across a range of market environments.

For investors seeking to maintain international diversification while managing currency risk, this approach represents a disciplined and resilient framework—a hedge of least regret.

This material is provided for educational purposes only and should not be construed as investment advice or an offer to sell or to buy any security.

ABOUT RISK:

All investments are subject to market risk, including possible loss of principal. Currency exchange rates can be very volatile and can change quickly and unpredictably. Therefore, the value of an investment may also go up or down quickly and unpredictably, and investors may lose money.

Foreign securities can be subject to greater risks than U.S. investments, including currency fluctuations, less liquid trading markets, greater price volatility, political and economic instability, less publicly available information, and changes in tax or currency laws or monetary policy. These risks are likely to be greater for emerging markets than in developed markets.

DEFINITIONS:

Correlation is a measure of the linear relationship between two random variables.

Standard deviation measures the dispersion of a fund's returns over a specified time period. A higher standard deviation implies greater potential for volatility.

Price/Earnings ratio (PE Ratio) is a measure of the share price relative to the annual net income earned by the firm per share.

Volatility in finance is a measure of how much the price or return of an asset fluctuates over time.

Positive correlation: is a relationship where two variables move in the same direction. In Figure 5, it means the underlying asset returns and currency movements tend to rise and fall together.

Negative correlation is a relationship where two variables move in opposite directions. In Figure 5, it means the underlying asset returns and currency movements tend to move inversely—when one goes up, the other tends to go down.

Hedge percentage refers to how much of the portfolio's foreign currency exposure is being neutralized (hedged) back into the investor's base currency (typically USD).

DXY Level" shows how the dollar's strength has moved over time, while the bars show flows into currency-hedged ETFs—often used to manage exposure to those currency movements.

The MSCI EAFE® Index: Is an equity index which captures large and mid cap representation across 21 developed markets countries around the world, excluding the U.S. and Canada. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The S&P 500® Index: Is the widely recognized benchmark for large-cap U.S. stock market performance.

The FTSE Developed ex North America Index: Is comprised of large-and mid-cap stocks in Developed markets, excluding the US and Canada. The index is derived from the FTSE Global Equity Index Series (GEIS), which covers 98% of the world's investable market capitalization. The FTSE currency hedging methodology allows exposure to the returns of the foreign assets in the index without being exposed to the volatility of the exchange rates against the US dollar. The index uses the WM Reuters one month (16:00 hrs. London Time mid price) forward rates in the currency hedging calculation.

The FTSE Developed ex North America 100% Hedged to USD Index and FTSE Developed ex North America 50% Hedged to USD Index: are the FTSE Developed ex North America Index with 100% and 50% of their exposure hedged to U.S. dollars, respectively. The FTSE currency hedging methodologyallows exposure to the returns of the foreign assets in the index without being exposed to the volatility of the exchange rates against the US dollar. The index uses the WM Reuters one month (16:00 hrs. London Time mid price) forward rates in the currency hedging calculation.

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