

CURRENCY HEDGING

# The dollar dilemma

**Currency hedging is back in focus as doubts emerge over the dollar's traditional role as a safe haven. Against a backdrop of heightened volatility, European pension funds are reviewing their exposure to foreign exchange risk and the opportunities hedging can offer. Lynn Strongin Dodds reports**

Currency hedging was always part of the toolkit, but the rolling tariffs from the Trump administration and the ongoing conflicts in the Middle East are forcing European pension funds to reconsider their strategies.

Given the diverse nature of the region, institutions are moving at their own pace but mitigating risks and enhancing performance are the common themes.

L&G co-head of asset allocation and head of macro strategy, Chris Jeffery, notes that across

Europe as a whole, pension fund assets stand at around €10 trillion although the asset allocation mix, and therefore the foreign exchange (FX) exposure, will vary hugely by country as well as type of scheme.

In general, he explains that defined contribution-(DC) based systems, such as Sweden, have a large equity share while defined benefit (DB) systems, such as Germany and France, have a bigger fixed income bias.

Unsurprisingly, the dollar, which is by far the

biggest exposure for many pension funds, is a main focus. Many institutional investors, regardless of location, relied on unhedged US dollar (USD) positions. This was due to the greenback's safe haven status as it typically gained in value during periods of stress. However, the tumultuous backdrop of the past two years has seen the greenback's traditional inverse relationship erode with falling markets.

State Street Investment Management portfolio manager, Aaron Hurd, points out that during the USD bull market, which ran from 2011 to 2022, it often seemed like a free lunch to leave global assets unhedged.

"That pattern is now less reliable," he adds. "With interest rate differentials wider and the US dollar's safe-haven role under question, unhedged currency exposure is no longer assumed to always cushion risk."

Hurd notes that while recent bouts of US dollar strength have been painful for unhedged European investors, the more meaningful impact has accumulated over time. Over the past 3.5 years, and particularly since September 2022, remaining unhedged has been costly, with euro-based investors experiencing roughly a 15 per cent currency drag versus MSCI currency composition and sterling based investors around 16 per cent.

"If the safe-haven status of the dollar diminishes further, we may see more interest in hedging it from European pension funds," says Russell Investments global head of solutions strategy, Van Luu. "One reason is that schemes that went into the period with higher hedge ratios for their US dollar assets are better off in net terms than those who are unhedged."



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### Reassessing risk

However, Schroders head of solutions, Ajeet Manjrekar, thinks that currency hedging has already become much more prominent. He says that for clients that already had established hedging frameworks in place, the recent period has reinforced the importance of disciplined FX risk management, rather than fundamentally changing strategic positioning.

For those schemes with little or no currency hedging historically, he sees them reassessing how much unrewarded FX risk they are willing to tolerate within portfolios. "It is also possible that the broad trend of US dollar weakness over the past year has been amplified by institutional investors increasing hedge ratios on dollar-denominated assets," he adds.

This is the case in the Netherlands, which is in the middle of a transition to a DC system under the Future Pensions Act. Dutch funds hold more than €500 billion in dollar-denominated assets and the losses suffered from greenback's fall from grace has prompted concerns that unhedged positions and sudden drops in funding ratios would disrupt their transition valuations.

Meanwhile, Etablissement de Retraite Additionnelle de la Fonction Publique (ERAFP), France's supplementary pension fund for civil servants, managing approximately €50 billion, launched a hefty €3 billion foreign currency hedging tender earlier this year. This operational mandate was deployed to drastically increase protection against currency swings across its expanding global asset portfolio.

Swiss pension funds, on the other hand, are carefully mulling over their options. For example, Federal Pension Fund PUBLICA, one of the country's largest funds, with €45 billion in assets under management, said that it was contemplating a small increase in the hedge ratio to take into account the large exposure its portfolio has to the US dollar.

Decisions taken may also depend on the maturity of the scheme. Hyman Robertson partner and head of DC investment, Alison Lee, notes that often over a long-time horizon, such as that available for many young savers, the cost doesn't pay off.

There are market positions where, however, a level of hedging is beneficial particularly for equities especially where it is justified over the medium to long term when markets are expected

to be more volatile for a longer period of time.

“Fixed income typically is always hedged as you don’t want the large falls and fluctuations close to retirement so hedging these out is always preferred,” she explains.

### Divergent paths

DC and DB schemes will also take divergent paths. For example, “as a rule of thumb, DB schemes will typically adopt a version of the mantra to ‘diversify rewarded risks, hedge unrewarded risks,’” says Jeffrey.

He adds: “That implies relatively heavy use of FX and interest rate derivatives to mitigate currency and rates risk on their fixed income holdings.”

He notes that, like banks and insurers, they will typically lock down that risk through FX hedges in the forward market. The strategy creates a set of portfolio management challenges given the potential for large currency movements to trigger significant collateral calls in the event of a sharp depreciation in the base currency.

Aside from the transaction and execution expenses of implementing the derivative, the carry is also a factor. It is driven by central bank interest rate differentials and can increase the cost.

Although it varies significantly across Europe, depending on the specific currency pair, research from Allianz Global Investors shows that the annual performance drag is around 2 per cent to 2.3 per cent for the primary EUR/USD exposure.

The cost helps explain why European pension funds have adopted less expensive passive, systematic, and rules-based frameworks. This usually involves hedge ratios being set with reference to long-term investment objectives, according to Manjrekar.

However, he says under a fiduciary or outsourced chief investment officer (OCIO) arrangement, it is possible to supplement these frameworks with more dynamic decision-making, for example, adjusting hedge ratios opportunistically where conditions are appropriate.

Hurd has also seen some interest for active hedges against unhedged benchmarks. In this case investors retain their policy to leave currency exposure within equity portfolios unhedged but allow tactical hedges to mitigate expected downside.

“This is consistent with a broader trend we’re seeing among active hedgers to focus more on active risk reduction rather than the go-anywhere alpha strategies that were more common 10-20 years ago,” he adds.

RESERVE NOTE

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According to Hurd, some alpha funds appear to favour dynamic hedging frameworks that offer a rules-based way to adjust hedge ratios

over time. The idea is to raise hedge levels when a currency looks expensive, and reduce hedging when a currency is cheap, aiming to both manage risk and add value over the currency cycle.

Although the approach remains relatively niche, he believes it aligns with a trend that is seeing pension funds wanting efficient hedging that can adapt to changing conditions.

### Boosting returns

Protection, albeit key, is not the only goal. A robust currency management and hedging programme can also help enhance performance. For example, figures from Denmark’s National Bank shows that the country’s insurance and pension sector’s DKK 225 billion in 2025 total return was not only driven by foreign equities – particularly US technology stocks – but also the DKK 88 billion gain from the currency hedging of dollar denominated investments.

On the micro level, this was the case for SBB, the corporate pension fund for the Swiss Federal Railways. It attributed part of its 4.8 per cent performance last year to currency hedging, which provided a 2.2 per cent increase against the Swiss franc due to the depreciation of the US dollar.

Alecta, Sweden’s largest occupational pension manager, also benefitted from a significant currency hedging programme, which helped deliver a 9.6 per cent boost. The Swedish krona surged by more than 20 per cent against the US dollar over the course of 2025, almost double the euro’s gain against the US currency, according to *Reuters* market data.