



Global Investing, Local Returns

A Look into Currency Hedging Across Asset Classes

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In global markets, performance isn't just about picking the right assets, it's also about managing the risks emanating from currencies behind the assets. From equity portfolios to infrastructure projects, effective currency hedging safeguards value, enhances predictability, and allows investors to focus on what matters most: long-term strategy, not short-term swings.

The Silent Swing Factor in Global Returns

Global investing opens doors to growth, diversification, and access to sectors unavailable domestically. But global investing also comes embedded with the risk from currencies. For investors allocating across equities, fixed income, and alternative assets such as real estate and infrastructure, foreign exchange (FX) risk is the silent swing factor, capable of amplifying or eroding returns.

A Canadian investor in European equities, for instance, may find portfolio gains wiped out by a weakened euro. In lower yielding foreign bonds, where both yield and volatility are generally lower, small currency shifts can overwhelm the return experience. For infrastructure, these long-term, income-oriented assets can have decades of planning and ongoing work undermined by unfavourable FX trends.

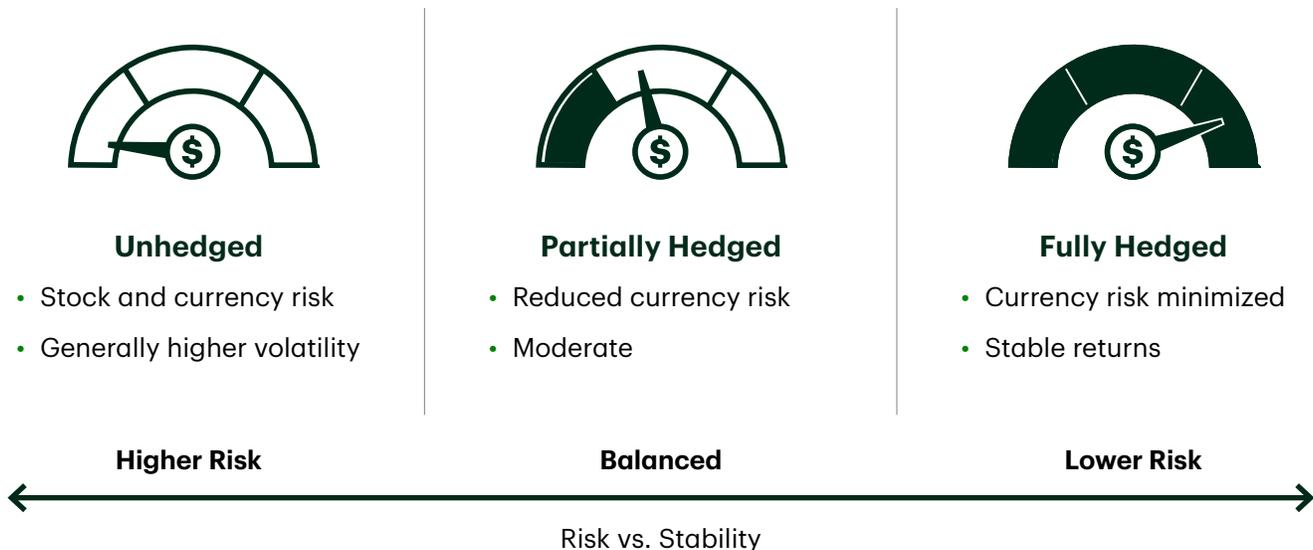
The solution? Currency hedging. Not as a one-size-fits-all exercise, but as an asset-class-specific discipline that integrates risk management within an investment portfolio.

Equities: Harnessing Growth, Taming Volatility

When you invest in international stocks, you are managing two distinct sources of return: the stock's performance and the currency's performance. While equity growth often outpaces currency moves over decades, short-term exchange rate swings can significantly impact returns.

To help manage currency value swings, investors can choose from a spectrum of hedging levels depending on their risk tolerance and market outlook:

Hedging Foreign Equities Impact of Currency Movements on Returns



For illustrative purposes only.

- **Unhedged (0%):**

A conscious and active decision to let currency move freely. This captures potential gains if the foreign currency rises but leaves you vulnerable if it falls.
- **Full Hedge (100%):**

Uses financial contracts such as currency forwards or currency futures¹ to “lock in” the return of the stock in investors’ home currency. This eliminates currency risk but incurs cost of carry, which is a debit cost or a credit based on the interest rate differential between the home country and the foreign counterpart. Despite the name, cost of carry can be a net cost (that hedger pays to hedge) or a net credit (the hedger gets paid to hedge).
- **Partial Hedge:**

Uses currency forwards or futures to continuously hedge a constant percentage of FX exposure. Many investors choose 50% hedge ratio, often called the least regret hedging ratio that allows some participation in currency gains if the foreign currency rallies, and some hedge in case foreign currency falls.
- **Dynamic Hedge:**

A disciplined approach where hedges are adjusted based on an investment process that considers asset and currency volatility and correlation, or other factors such as interest rate differentials, valuation and the mean reversion tendencies of currency pairs.

For Canadian investors, the decision to hedge often depends on the specific region and its relationship with the Canadian Dollar (CAD). Hedging costs vary with interest rate differentials. Hedging into a lower-yielding currency can generate positive carry, while hedging into a higher-yielding currency can erode returns. For example, in regions like Europe and Japan, interest rates have historically been lower than in Canada. This creates a positive cost of carry, meaning investors can earn a small “bonus” for hedging.

TD Asset Management Inc. (TDAM) research shows that fully or partially hedging Europe, Australasia and the Far East (EAFE) equities has historically delivered slightly better returns for Canadian investors compared to leaving them unhedged². On the other hand, emerging markets (EM) generally have higher interest rates resulting in higher costs from FX hedging. As such leaving the EM equity exposure unhedged is common as historically unhedged returns were similar to marginally better with similar volatility.

For U.S. equities, unhedged returns have been historically better for Canadian investors due to the countercyclical nature of the U.S Dollar (USD). Over the long run, U.S. equities and USD/CAD were

negatively correlated. This means when equities experienced drawdowns, USD strength could offset some of the negative experience. The negative relationship between the U.S. equities and USD/CAD stems from the status of the USD as the de-facto safe-haven currency during weaker equity market periods. This relationship has historically allowed unhedged U.S. equity exposure as a natural source of diversification for equities. In addition, the cost to hedge the USD could at times significantly detract from returns. As a result, historically, unhedged U.S. equity exposure has performed better than the full hedged equity portfolio².

In the future, U.S. political actions aimed at devaluing the dollar may make it harder to predict the strength of the U.S. dollar, which has previously been driven by American exceptionalism. It becomes more necessary for Canadian investors to consider dynamic currency strategies with their U.S. stock investments.

Overall, the optimal FX hedging ratio should depend on the strategy and goals of the equity portfolio. Ultimately the degree of hedging should smooth the portfolio’s volatility over time and avoid unexpected returns driven by currency swings. This helps give investors peace of mind for the intended return to achieve their objective.



Fixed Income: Where Hedging Becomes More Critical

Bonds are typically the “ballast” of a portfolio—they provide steady income and stability during market turbulence. However, when an investor invests in international bonds, currency volatility can be significantly higher than the volatility of the bond itself. For example, a high-quality global bond may yield 4%, but if the currency it is denominated in drops by 5%, the total return becomes negative. For an asset class meant to provide safety, this “currency drag” is often unacceptable.

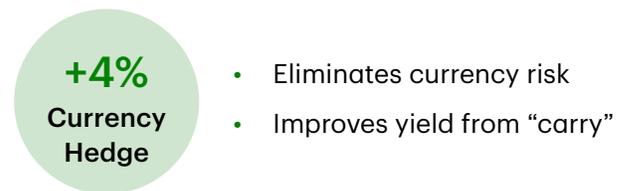
Currency Hedging in Fixed Income Why Hedging Matters for Foreign Bonds

Unhedged Foreign Bonds



Currency swings often overwhelm bond returns. Hedging neutralizes this risk.

Currency Hedged Foreign Bonds



Hedging converts “noisy” bonds into stable, income-producing assets.

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Like equities, hedging approaches vary from not hedging at all, to partial or dynamic hedging, to fully hedging.

For high quality bonds, the conventional practice for investors is to fully hedge because currency swings can easily overwhelm the bond’s yield. In some cases, currency hedging can sometimes even boost the effective yield due to interest rate differentials. When foreign short-term rates are lower than those in the home currency, the hedging mechanics can pay the investor a premium. In this scenario, investors capture the stability of the foreign government bond plus a positive “carry” from the hedge.

However, there are exceptions. If the foreign country’s short-term interest rates are significantly higher than the home currency’s, hedging will result in an unattractive yield after the cost of subtracting the foreign bond yield. In this case, some managers may choose to leave the position unhedged or only partially hedged, depending on their outlook for the foreign currency. For example, if the U.S. dollar is expected to hold its value or appreciate, a Canadian investor might accept the currency risk rather than paying to hedge it.

When it comes to EM bond investments, currency hedging can vary widely across investment strategies. For total return-seeking strategies, managers may leave investments unhedged to capture both the bond’s yield and any potential currency gains, especially if they are optimistic about the region’s prospects. Alternatively, some managers choose to hedge their currency exposure tactically when they anticipate increased risk of significant currency declines or heightened volatility. If the manager has no strong conviction on the direction of the currency, they may prefer a fully hedged currency position—provided that, after hedging, the investment still offers a more attractive yield compared to other alternatives in their opportunity set.

Overall, for low-volatility, income-focused fixed income, like developed-market government or investment-grade bonds, full currency hedging is generally recommended to preserve the ballast role of this asset class. For higher-yielding, return-seeking fixed income, such as EM debt, unhedged or active hedging approaches are more common.

Alternative Assets: Real Estate & Infrastructure Hedging is Nuanced and Strategic

When considering alternative assets such as real estate and infrastructure, the currency hedging decision often becomes a longer-term, strategic choice rather than a tactical one. These assets typically have lower liquidity and very long investment horizons, meaning that short-term currency fluctuations are less of a concern as investors focus on the long-term potential.

Hedging decisions typically depend on firm wide investment philosophy, overall strategic goals, geographical exposure and hedging cost financially and operationally. Due to the long-term nature, liquidity constraints and operational complexity characteristics of real estate and infrastructure investments, FX hedging could be more bespoke among investment firms compared to equities and bonds.

Often, Canadian real estate and infrastructure funds invested in developed regions such as the U.S., Europe and the United Kingdom (UK) tend to opt out of hedging the FX exposure. This stems from the mean reversion assumption in FX, that over the long run these regions tend to be politically and economically comparable to the home country over decade long horizons. As such, currency returns that are mean reverting over time are expected to match the long-term total return objective. In addition, hedging could add operational cost without meaningful benefit over the long run.

On the other hand, funds invested in regions with less economic stability and high currency fluctuations may have a stronger desire to hedge the income generated to secure a more stable distribution stream, especially in the near term (e.g. 12-24 months) expected income distribution. Investment tools like FX forwards, FX options and cross-currency swaps¹ are commonly used for such hedging. Another common hedging implementation in real estate and infrastructure is natural hedging, with projects being financed in local currency to match local revenue to reduce residual FX exposure and therefore reduce hedging need.

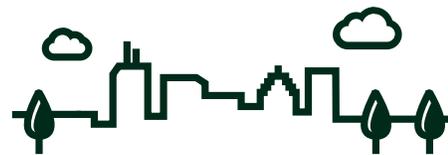
Overall, hedging decisions on alternative assets like real estate and infrastructure investment is a nuanced and strategic decision, less standard than the liquid asset classes due to the unique characteristics of these investments. Its strategic decision cascaded from the alternative asset management team's philosophy, long term geopolitical views and operational priorities. The ideal strategic hedging framework should have a long-term mindset, balancing the view on the foreign currency trend over the asset's investment time frame and shorter-term income stability required, as well as the operational and financial costs to implement hedging.

Currency Hedging in Alternative Assets Strategic Foreign Currency Hedging for Real Estate & Infrastructure



Developed Economies

- Long-term, inflation-linked cash flow
- Predictable operations
- Hedging often costly, pays limited benefit



Emerging Markets

- Higher yield, unstable currency
- Income Stabilization priority
- Currency swings far bigger than yield

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Cross-Asset Integration: Designing a Holistic Hedging Approach

For multi-asset solutions, hedging considers total portfolio level return and risk objectives, rather than an asset-by-asset basis. The holistic approach looks at the total portfolio on an aggregate basis, considering the interplay between various asset classes and their currency exposures, allowing multi-asset fund managers to optimize hedging by evaluating overall portfolio risks and synergies.

Typically, multi-asset managers determine the strategic and tactical currency exposure on the

total portfolio and use currency overlay to achieve the desirable currency targets through FX forwards or FX option overlays¹. Scenario analysis is often used to evaluate whether the currency exposure is adequate given the managers' market view, and whether neutralizing or tilting the foreign exposure is necessary considering the return and risk on the total portfolio. Such a holistic hedging approach ensures efficient risk management and meeting the overall return and risk objectives tailored to the multi-asset solution mandates.

Turning a Risk into a Strategic Advantage

In summary, currency hedging is not always a technical adjustment at the margins, but a dynamic and strategic tool that empowers investors to navigate the uncertainties of global markets. By actively evaluating FX exposure across asset classes and tailoring hedging strategies to the unique characteristics of equities, fixed income, and alternatives, investors transform currency risk from a silent swing factor into a source of resilience and opportunity.

As market conditions evolve and correlations shift, integrating flexible and context-driven FX management ensures portfolios remain aligned with the investment objective and time horizon, helping investors capture global returns while confidently managing local risk. With thoughtful implementation, currency hedging becomes an essential lever—one that safeguards yield, smooths volatility, and supports stable income, ultimately turning currency risk into a strategic advantage in global investing. ■

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¹ An FX forward contract, also known as a currency forward, is an agreement between two parties to exchange a specific amount of one currency for another at a set exchange rate on a future date. A cross-currency swap is a financial contract where two entities exchange an equivalent amount of principal in different currencies. Then each entity makes interest payments on the currency they received, with rates that can be fixed or floating. ² Bloomberg Finance L.P. Data from January 1, 2005 to December 31, 2025.

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