Abstract

The US dollar and also increasingly the euro and in some instances the Swiss franc exhibit risk-minimizing capabilities in a wide range of international portfolios. From 1975 until the end of 2019, these currencies moved against both equity markets as well as additional asset classes such as bonds, real estate and commodities. This presents the possibility of holding specific amounts of currencies in an attempt to reduce risk in international portfolios. Given the expected return structure of an initial investment, a risk-minimizing investor can include such positions in a portfolio in order to reduce overall volatility. The financing of these long positions can be established by short selling other foreign exchange positions that are positively correlated with an investor's initial investment. This is especially the case for the Australian and Canadian dollars as well as most emerging market currencies when investing in equities and beyond. Optimal hedging demands largely depend on investor sentiment, return expectations and preferred risk exposure. Defining these metrics alongside preferred asset classes can lead to substantial risk reduction, primarily in more aggressive portfolios. In the empirical part of the work, we show that different asset classes exhibit similar hedging demands but deviate substantially in the amount of currency held. This leads to a real estate or commodities investor holding a considerably larger amount of US dollars compared to an equity or bond investor. Moreover, we demonstrate that currency demands also tend to change over time, leading to sizeably distinct optimal allocations for different time periods.