CIO Brief

FX Hedging Beyond the Roll

A practitioner's framework for designing FX overlays that behave.

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Executive Summary

FX hedging is routinely treated as a single problem with a single solution.
It isn't.

Most portfolios combine **indefinite FX exposures** with **finite hedging instruments**, then rely on convention – typically rolling short-dated FX forwards – to bridge the gap.

Operationally, this works. Economically, it often fails.

Rolling FX forwards persist not because they are optimal, but because they are liquid, familiar, and governance friendly. Cross-currency swaps are often dismissed as expensive or complex, despite being the correct tool for genuinely long-dated exposures. Options are frequently excluded altogether, even though they are the only instruments that introduce convexity and control into FX overlays.

The result is predictable:

- FX risk that is shaped in the short term but uncontrolled over time
- Carry costs that quietly compound
- Path dependency that surfaces only after years of underperformance
- Governance frameworks that reward comfort over coherence

This paper reframes FX hedging as **multiple distinct problems**, not one:

1. **Hedging** indefinite, evolving exposures**, where flexibility matters more than precision**
2. **Hedging** genuinely long-dated exposures**, where certainty matters more than liquidity**

Each requires a different structure.

The objective is not to eliminate FX risk. It is to **match the hedge to the nature of the exposure**.

Any numerical examples are illustrative and intended to reflect realistic market conditions, not precise forecasts.

FX Hedging Is Not One Problem

FX exposure is often discussed as if it were homogeneous. It isn't.

Some FX exposures are **finite**. Others are **indefinite**. Some terminate naturally. Others persist for as long as the portfolio exists. Treating them all the same is the root cause of most FX hedging failure.

A portfolio holding a five-year USD bond faces a fundamentally different FX problem to a portfolio holding offshore assets with no defined exit date. One has a maturity. The other doesn't. One can be hedged to a known endpoint. The other cannot.

Yet in practice, both are often hedged using the same structure: rolling short-dated FX forwards.

This is convenient. It is also structurally incoherent.

FX risk is path dependent. What matters is not just where the currency ends up, but **how it gets there**. Short-dated hedges reset that path repeatedly. Long-dated hedges fix it. Options reshape it.

The first step in any FX hedging programme is not instrument selection.
It is **exposure classification**.

Why Rolling FX Forwards Dominate

Despite years of criticism, rolling short-dated FX forwards remain the default hedging tool for institutional portfolios. This is not accidental, nor is it evidence of collective incompetence.

Rolling forwards dominate because they optimise for **operational survival**.

They offer deep liquidity, tight bid–offer spreads at short tenors, simple hedge accounting treatment, minimal termination risk, and easy resizing as portfolios evolve.

From a governance perspective, they are hard to argue against. They are familiar. They are auditable. They fit neatly into committee-driven risk frameworks.

For portfolios with uncertain holding periods, active rebalancing, and evolving mandates, rolling forwards are robust.

That robustness, however, is often mistaken for optimality.

Rolling forwards survive because they are resilient.
Not because they solve the right problem.

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What Rolling Forwards Actually Do

To evaluate FX hedging properly, we need to be precise about what rolling forwards deliver – and what they don't.

Rolling short-dated FX forwards:

They do:

- Reduce short-term FX volatility
- Smooth periodic reporting outcomes
- Limit drawdown amplification during acute FX shocks

They do not:

- Neutralise long-term FX risk
- Lock in base-currency returns
- Remove FX path dependency
- Control cumulative carry drag

Each roll resets the hedge at prevailing spot and forward points. Over time, this introduces compounding uncertainty rather than certainty.

If the mandate is to stabilise quarterly returns, rolling forwards do exactly what they are meant to do.

If the mandate is to deliver currency-neutral returns over multi-year horizons, they don't – and never will.

Rolling forwards shape volatility.
They do not eliminate FX exposure.

Hedge Ratios and the Myth of Neutrality

There is no universally "correct" FX hedge ratio.

Observed institutional practice spans a wide range, often driven more by governance comfort than economic logic. A static 100% hedge ratio is rarely an economic decision. It is usually an optical one.

The problem is not that full hedging exists. It is that full hedging is often implemented **without reference to carry, duration, or path dependency**.

FX hedging is asymmetric:

- Expected long-run FX return ≈ 0
- Expected hedge cost ≠ 0

That asymmetry compounds over time.

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A portfolio can be “fully hedged” and still experience material FX-driven underperformance relative to expectations. When this happens, the hedge is blamed for “not working”, even though it did exactly what it was designed to do.

The mistake was upstream.

Carry Is the Dominant Driver

Most FX hedging discussions fixate on volatility. This is the wrong variable.

Over long horizons, carry dominates outcomes.

Currencies do not offer persistent directional returns. Interest rate differentials do. Forward points compound relentlessly, whether or not anyone is paying attention.

For low-rate base currencies, FX hedging is structurally expensive.
For high-rate base currencies, it can be accretive.

Same exposure. Same hedge ratio. Same instruments.
Completely different outcomes.

If carry is not discussed explicitly in governance forums, it is still being paid – quietly and indefinitely.

Ignoring carry does not make it disappear.
It just makes the outcome surprising later.

Tenor Matching – When It Works, When It Fails

Tenor matching is conceptually appealing. Hedge the exposure for as long as it exists.

It works extremely well for instruments with **defined cashflows and maturities** – bonds, loans, and project finance assets.

It fails when applied indiscriminately to exposures that do not terminate naturally.

Long-dated hedges introduce termination risk, larger mark-to-market volatility, balance-sheet consumption, and reduced flexibility if the exposure changes.

This is why many portfolios avoid long-dated FX hedges even when they appear theoretically sound. The real risk is not FX. It is being forced to unwind a hedge at the wrong time for the wrong reason.

Tenor matching is not wrong.
It is **context dependent**.

FX Forwards vs Cross-Currency Swaps

Cross-currency swaps are often described as “expensive” or “complex”. In reality, they are simply misapplied as often as they are underused.

What CCS Actually Do

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A cross-currency swap converts a foreign-currency asset into a synthetic domestic-currency asset for the life of the swap.

It locks FX conversion, fixes funding spread, aligns hedge and asset cashflows, and removes FX path dependency.

For genuinely long-dated, stable exposures, this is exactly what is required.

Why CCS Look Expensive

CCS appear expensive because they are compared to the wrong benchmark.

A single 3-month FX forward looks cheap.
Forty of them over a decade are not.

CCS concentrate cost upfront. Rolling forwards distribute it invisibly over time. When the full economics are annualised, CCS are often cheaper, not more expensive.

When CCS Are the Right Tool

- Stable, long-dated exposures
- Clear intent to hold
- Meaningful size
- Tolerance for mark-to-market noise

When CCS Are the Wrong Tool

- Uncertain holding periods
- Active portfolio turnover
- Governance frameworks intolerant of MTM volatility

CCS are not superior.
They are **specific**.

Options – The Missing Dimension

Forwards and CCS are linear instruments applied to non-linear portfolios.

Options introduce convexity. They protect against tail events, reduce forced re-hedging, and allow timing flexibility around carry and path dependency.

Option economics are highly regime-dependent. Structures that appear cheap in low-volatility environments can become prohibitively expensive or unavailable during stress.

They are not a replacement for forwards or CCS.
They are a **control layer**.

Most portfolios avoid options not because they are unsuitable, but because they require judgement. That discomfort is often mislabelled as prudence.

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Mandatory FX Hedging Regimes

When hedging is compulsory, economics take a back seat.

The objective shifts from optimisation to damage control.

In these regimes, options become more valuable, not less. They are often the only remaining lever to reduce pro-cyclicality and manage carry without breaching policy.

Pretending mandatory hedging is economically optimal helps no one. Documenting the trade-offs does.

A Unified FX Overlay Framework

A coherent FX overlay recognises three layers:

- **Structural FX** – CCS for genuinely long-dated, stable exposures
- **Flexible FX** – rolling forwards where exposure is indefinite
- **Convexity & control** – options to manage path risk and carry timing

Most portfolios run only the second layer – and then wonder why outcomes disappoint.

Closing Thoughts

FX hedging fails not because portfolios choose the wrong instruments, but because they expect one instrument to solve every FX problem.

The objective is not elimination.
It is alignment.

Match the hedge to the exposure.
Match the structure to the intent.
Match governance to reality.

Everything else is optics.

Further Reading and Practitioner Resources

Para Bellum Advisors publishes practitioner papers and CIO Briefs:
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The firm works with lean investment teams managing complex, long-dated portfolios across FX, rates, credit, equity, and volatility risk. Its focus is not on product distribution or transaction volume, but on structure: how hedges are designed, how capital is consumed, and how portfolios behave under stress.

Para Bellum Advisors is practitioner-led. Its work draws on decades of experience across trading, structuring, and portfolio management in banks, asset managers, and insurance balance sheets. The objective is not theoretical optimisation, but durable improvement in capital efficiency, liquidity resilience, and realised outcomes.

For more information, visit **www.offers.parabellumadvisors.com**

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