EXECUTIVE BRIEF

FX Hedging Beyond the Roll

Matching the Hedge to the Exposure

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Executive Summary

FX hedging is routinely treated as a single problem with a single solution. It is not.

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

FX Hedging Is Not One Problem

FX exposure is often discussed as if it were homogeneous. It is not. Some 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 does not. 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.

> *FX risk is path dependent. What matters is not just where the currency ends up, but how it gets there. The first step in any FX hedging programme is not instrument selection. It is exposure classification.*

Why Rolling FX Forwards Dominate

Rolling short-dated FX forwards remain the default hedging tool for institutional portfolios. This is not accidental, nor is it evidence of collective incompetence. They 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. For portfolios with uncertain holding periods, active rebalancing, and evolving mandates, rolling forwards are genuinely robust.

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

What Rolling Forwards Actually Do

Rolling short-dated FX forwards reduce short-term FX volatility, smooth periodic reporting outcomes, and limit drawdown amplification during acute FX shocks. They do not neutralise long-term FX risk, lock in base-currency returns, remove FX path dependency, or 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 do not and never will.

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

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.

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

Cross-Currency Swaps: The Right Tool for Long-Dated Exposures

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

Cross-currency swaps appear expensive because they are compared to the wrong benchmark. A single three-month FX forward looks cheap. Forty of them over a decade are not. Cross-currency

swaps concentrate cost upfront. Rolling forwards distribute it invisibly over time. When the full economics are annualised, cross-currency swaps are often cheaper.

Instrument fit	Conditions
Cross-currency swaps are the right tool	Stable, long-dated exposure. Clear intent to hold. Meaningful size. Tolerance for mark-to-market noise.
Cross-currency swaps are the wrong tool	Uncertain holding periods. Active portfolio turnover. Governance frameworks intolerant of MTM volatility.

Options: The Missing Dimension

Forwards and cross-currency swaps 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.

Most portfolios avoid options not because they are unsuitable, but because they require judgement. That discomfort is often mislabelled as prudence. Options are not a replacement for forwards or cross-currency swaps. They are a control layer.

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

A Unified FX Overlay Framework

A coherent FX overlay recognises three layers. Structural FX uses cross-currency swaps for genuinely long-dated, stable exposures. Flexible FX uses rolling forwards where exposure is indefinite. Convexity and control uses options to manage path risk and carry timing.

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

> *FX hedging fails not because portfolios choose the wrong instruments, but because they expect one instrument to solve every FX problem. Match the hedge to the exposure. Match the structure to the intent. Everything else is optics.*

About This Brief

This Executive Brief is a companion to the Para Bellum Advisors practitioner paper: Designing FX Overlays That Behave. The full paper covers exposure classification frameworks, instrument mechanics, carry modelling, and a structured approach to building FX overlays across asset classes.

Available at **www.parabellumadvisors.com/insights/**

About Para Bellum Advisors

Para Bellum Advisors is an independent advisory firm specialising in derivatives, structured finance, and balance sheet efficiency for institutional investors, family offices, and corporate treasury teams.

The firm focuses on hedge framework design, overlay mechanics, collateral efficiency, and portfolio resilience across FX, rates, credit, equity, and volatility exposures. Its work is practitioner-led, drawing on three decades of experience across trading, structuring, and portfolio management in APAC and globally.

Para Bellum Advisors is independent of product distribution and transaction mandates. Its objective is durable improvement in capital efficiency and liquidity resilience.

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