




PORTFOLIO DOLLARIZATION AND CURRENCY HEDGING STRATEGIES IN EMERGING MARKETS

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ABSTRACT

Investors in emerging markets frequently incorporate dollar-denominated assets into their portfolios to mitigate currency risk, stabilize wealth, and enhance diversification. Empirical research shows that exposure to the U.S. dollar reduces portfolio volatility for investors subject to exchange-rate instability and political uncertainty, such as those in Brazil. Dollarization benefits arise from the negative correlation between domestic political or macroeconomic stress and local-currency depreciation, which increases the domestic value of foreign assets. Implementation strategies—including physical dollars, international ETFs and BDRs, and currency-hedged funds—differ in costs, liquidity, and embedded risks. Academic literature also documents that political-risk shocks and institutional fragility are strong predictors of increased foreign-currency allocation. Nevertheless, dollarization involves trade-offs, including potential opportunity costs during domestic-currency appreciation and basis or liquidity risks in derivative-based hedging. Evidence suggests that disciplined and moderate dollar exposure can improve downside protection and long-term risk–return performance for emerging-market investors, though optimal allocations are regime-dependent and sensitive to macroeconomic conditions.

Keywords: Portfolio Dollarization. Currency Hedging. Emerging Markets. Exchange-Rate Risk. Political Risk. Diversification. Brazilian Investors. Asset Allocation.

1 INTRODUCTION

Investors in emerging markets increasingly allocate part of their portfolios to dollar-denominated assets as a mechanism for risk mitigation, diversification, and protection of purchasing power. Academic literature has long demonstrated that exchange-rate movements significantly shape the risk–return profile of domestic portfolios, since unhedged local assets expose investors to currency depreciation episodes that may amplify losses. Currency hedging and partial dollarization function as insurance instruments within a mean–variance framework, reducing portfolio volatility while smoothing wealth trajectories (Glen & Jorion, 1993; De Roon, Nijman & Werker, 2003). Empirical studies analyzing diversified international portfolios show that exposure to the U.S. dollar provides meaningful downside protection, especially for investors whose domestic currencies exhibit high volatility relative to the U.S. dollar (Schmittmann, 2010).

For Brazilian investors in particular, partial dollarization has been shown to reduce the variance of portfolios constructed with domestic equities, fixed income, and alternative assets. The stabilizing effect arises from the negative correlation between episodes of political or macroeconomic stress and the BRL/USD exchange rate: when domestic uncertainty increases, depreciation of the real boosts the domestic-currency value of dollar assets, providing an offsetting effect that reduces overall portfolio drawdowns (Bonomo, Martins & Pinto, 2015). Academic and institutional analyses of emerging-market currency dynamics confirm that modest allocations to dollar-denominated assets—typically between 10% and 30% depending on investor objectives—improve risk-adjusted performance in environments characterized by inflation shocks, fiscal uncertainty, and external-account fragility (Aizenman, Chinn & Ito, 2015).

Implementation strategies for dollar exposure differ in cost, liquidity, and risk characteristics. Holding physical dollars or dollar deposits offers pure FX exposure but at high opportunity cost, especially in low-interest-rate environments. Dollar-linked instruments such as international ETFs, ADRs/BDRs, and U.S.-focused mutual funds provide both foreign-asset exposure and currency gains but introduce tracking error, custody differences, and cross-border taxation frictions (Cenedese, Payne & Sarno, 2020). Currency funds and FX-hedged share classes allow fine-tuning of exposure, though hedging involves roll costs, derivative pricing spreads, and liquidity risk—factors documented in the derivatives-use literature (Géczy, Minton & Schrand, 1997; Allayannis & Weston, 2001). For emerging-market households, these cost differentials materially influence long-term outcomes because frequent rebalancing or derivative rollovers can erode risk-adjusted returns.

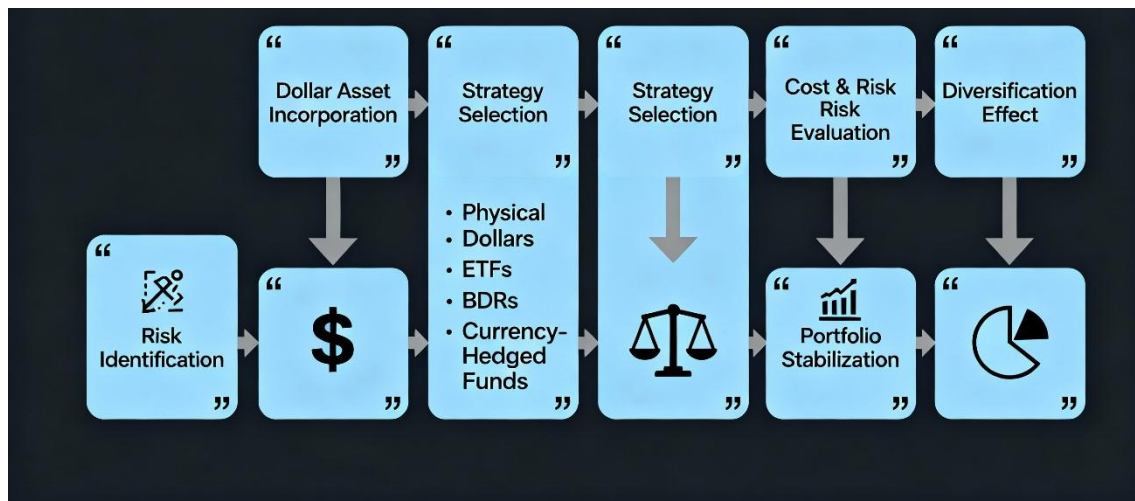
Political-economy research offers a complementary perspective. Periods of heightened political and institutional uncertainty consistently correlate with increased household and institutional dollarization. Studies of Latin American financial behavior show that investors rapidly reallocate to foreign-currency assets—including dollar bank deposits, offshore mutual funds, and dollar-linked securities—when they perceive erosion of domestic macroeconomic credibility, rising sovereign-risk premia, or threats to central-bank independence (Levy-Yeyati, 2006; Reinhart, Rogoff & Savastano, 2014). Evidence from Brazil, Argentina, Turkey and other emerging economies suggests that political-risk spikes predict surges in dollar demand and stronger retail flows into international ETFs and FX-linked funds, reinforcing the role of the dollar as a safe-haven asset (Hofmann, Shim & Shin, 2022).

Despite the protective appeal, portfolio dollarization carries trade-offs. Excessive concentration in dollar assets entails opportunity costs during phases of domestic-currency appreciation and may distort the long-term growth trajectory of wealth accumulation. Derivative-based hedges, while effective, introduce basis risk, counterparty exposure, and liquidity vulnerabilities, especially in periods of market stress when bid-ask spreads widen significantly (BIS, 2020). Furthermore, systemic or widespread dollarization can generate macro-financial feedback loops that complicate monetary policy transmission and reduce the effectiveness of domestic stabilization tools—a phenomenon documented in cross-country studies on currency substitution and liability dollarization (Calvo & Reinhart, 2002; Broda & Yeyati, 2006).

The flowchart illustrates the process of portfolio dollarization and currency hedging strategies in emerging markets. It begins with identifying currency risk and the political and macroeconomic conditions that influence local currency depreciation. Investors then incorporate dollar-denominated assets into their portfolios, selecting from different implementation strategies such as holding physical dollars, investing in international ETFs, BDRs, or currency-hedged funds. The next step involves evaluating the costs, liquidity, and risks associated with each strategy. Ultimately, these strategies aim to stabilize the portfolio by reducing volatility and improving diversification, especially in environments marked by inflation shocks and political uncertainty. The approach balances risk protection with the opportunities for long-term wealth preservation and diversification tailored to the investor's objectives and market conditions. This structured process reflects key empirical findings on how moderate and disciplined dollar exposure can enhance portfolio resilience in emerging markets.

Figure 1

Flowchart of Portfolio Dollarization and Currency Hedging Strategies



Source: Created by author.

For individual investors, an evidence-based approach to dollarization involves defining the primary objective (volatility reduction, real-wealth preservation, or speculative FX exposure), estimating empirical covariances between domestic assets, international assets, and the exchange rate, and selecting instruments that balance liquidity, cost, and regulatory considerations. Backtests using historical BRL/USD data and stress scenarios reflecting political cycles or global risk-off events consistently show that modest and disciplined dollar exposure improves downside protection for Brazilian portfolios while supporting long-term diversification benefits (Bonomo et al., 2015; Schmittmann, 2010). Ultimately, the effectiveness of portfolio dollarization is regime-dependent, and optimal allocations vary with macroeconomic conditions, political stability, and the investor's tolerance for tracking error and currency risk.



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