

Jakub Jurek: “Crash-neutral Currency Carry Trades”

Abstract:

High interest rate currencies tend to appreciate relative to low interest rate currencies. This finding, often referred to as the forward premium anomaly, is one of the most prominent empirical features of exchange rate data. In the period from 1999 to 2007, an equal-weighted (spread-weighted) strategy aimed at exploiting this anomaly within G10 currencies delivered a Sharpe ratio of 1.26 (1.46). I show that the returns to the carry trade cannot be interpreted as a risk premium for bearing the risk of rapid devaluations (currency crashes) of high interest rate currencies. Returns to crash-neutral carry trades in which exposure to devaluations has been hedged by combining positions in currencies with currency options are positive and highly statistically significant. An equal-weighted (spread-weighted) strategy which buys protection against a depreciation of more than 5% in the high interest rate currency continues to deliver a Sharpe ratio of 1.08 (1.30).