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Effect of Exchange Rate Volatility on Portfolio Investment
Decisions of U.S. Investors

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Abstract

Purpose: The purpose of this article was to analyze the effect of exchange rate volatility on portfolio investment decisions of U.S. investors.

Materials and Methods: This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low cost advantage as compared to a field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

Findings: Exchange rate volatility significantly affects U.S. investors' portfolio decisions by influencing asset allocation, risk appetite, and hedging strategies. High currency fluctuations increase perceived investment risk, prompting shifts toward domestic assets or the use of hedging instruments such as forwards, options, and currency ETFs. Investors dynamically adjust international equity and bond holdings based on FX forecasts, balancing expected returns

against currency-induced risk. Access to real-time analytics and predictive tools enhances portfolio resilience, though transaction costs and market inefficiencies can limit effectiveness. Overall, exchange rate movements are a critical determinant in U.S. investment strategy, requiring integration of FX risk into portfolio management and policy frameworks.

Unique Contribution to Theory, Practice and Policy: Modern Portfolio Theory (MPT), Complementing MPT and Portfolio-Balance Approach may be used to anchor future studies on the effect of exchange rate volatility on portfolio investment decisions of U.S. investors. Investment managers and individual U.S. investors should adopt structured and proactive strategies to manage currency risk. Policymakers and regulatory bodies should promote transparency and stability in foreign exchange markets to reduce systemic risks affecting cross-border investments.

Keywords: Exchange Rate, Volatility, Portfolio, Investment Decisions, Investors

INTRODUCTION

Portfolio investment decisions involve strategic asset allocation across equities, bonds, alternatives, and cash to optimize returns while aligning with an investor's risk appetite, which reflects tolerance for volatility and potential losses. In developed economies, allocation trends have shifted toward diversified portfolios emphasizing sustainable and digital assets, driven by low interest rates and technological advancements post-2020. Risk appetite has generally increased, with investors favoring equities amid economic recoveries, though geopolitical tensions have prompted hedging strategies. For instance, in the USA, pension fund equity allocation rose from 43% in 2014 to 52% in 2024, signaling heightened risk tolerance and contributing to robust market performance. Similarly, in Japan, conservative allocations persisted with bonds at 55% in 2024, down slightly from prior years, reflecting lower risk appetite amid aging demographics and yield-seeking behaviors.

In the UK, equity holdings in pension funds declined from 46% in 2014 to 30% in 2024, with alternatives surging to 27%, illustrating a trend toward risk-mitigated diversification. Overall, developed economy portfolios showed a 10-15% increase in alternative assets from 2020-2025, per global studies, underscoring adaptive risk management. These shifts highlight how central bank policies influenced appetite, boosting equity inflows by 20% annually in the USA during 2021-2023. Japan's bond-heavy strategy, stable at over 50% since 2020, contrasts with USA's aggressive stance, yielding divergent returns amid inflation pressures. Such trends emphasize the need for dynamic allocation to balance growth and stability in mature markets.

In developing economies, portfolio decisions prioritize high-growth sectors like digital infrastructure and renewables, with allocation increasingly toward emerging market equities to capture upside potential, tempered by volatility concerns. Risk appetite has fluctuated, rising post-COVID recovery but waning due to debt burdens and global tightening, leading to selective inflows. A key trend shows international project finance in developing regions declining 43% in value by 2024, reflecting cautious investor sentiment. For example, in India, FDI and portfolio inflows stabilized at \$35 billion in 2024 despite a 29% drop in China, with digital sectors attracting 107% greenfield growth since 2020. In Brazil, sustainable bond issuance doubled, supporting a 41% rise in renewables allocation, amid broader Latin American shifts toward climate-resilient assets.

Portfolio net inflows to developing Asia fell 3% to \$605 billion in 2024, yet ASEAN saw a 10% uptick to \$225 billion, indicating resilient risk tolerance in select hubs. Overall, sustainable fund flows to these economies grew 11% to over \$1 trillion in bonds by 2024, though LDCs captured only 2% of climate finance. These patterns reveal a 57% drop in M&A net sales in Asia, prompting diversified hedging. Brazil's infrastructure focus, with 30% of projects in top hosts, exemplifies allocation toward stable yields despite regional instability. Thus, developing markets' strategies blend optimism with prudence, fostering 5-7% annual growth in high-tech allocations from 2020-2025.

In sub-Saharan economies, investment decisions emphasize domestic resource mobilization amid external shocks, with allocations favoring short-term fixed income over equities due to governance risks and currency volatility. Risk appetite remains subdued, prioritizing stability over growth, as evidenced by persistent net outflows until recent reversals. Total external flows rebounded 7.3% to \$204.6 billion in 2023, but portfolio investments shifted from \$23.1 billion outflows in 2022 to mere \$322.9 million inflows. In Nigeria, capital market performance drove foreign portfolio investments, with equity allocations rising 15% in 2024 amid improved regulations, though sensitive to global risk sentiment. In Tanzania, pension funds allocated

70% to government securities in 2023, reflecting conservative appetite influenced by low financial literacy and high perceived risks.

FDI in the region dipped 3.4% to \$52.6 billion in 2023, with services capturing 81% of investments, signaling a shift from manufacturing. Remittances contracted 6.2% to \$91.1 billion, underscoring vulnerability to diaspora trends. These dynamics show a 2% average FDI reduction in 2024, prompting calls for policy reforms to boost appetite. Tanzania's framework, emphasizing infrastructure bonds, contrasts Nigeria's market-driven equity push, yielding varied returns. Consequently, sub-Saharan portfolios grew alternatives by 10% from 2020-2025, aiming to mitigate external dependencies.

Exchange rate volatility represents the degree of unpredictable fluctuation in currency values relative to one another, typically measured through statistical indicators such as standard deviation of returns or generalized autoregressive conditional heteroskedasticity (GARCH) models), arising from deviations in economic fundamentals, interest parity conditions, and market expectations. Conceptually, it introduces an additional layer of unhedgeable risk in cross-border investments, diminishing the correlation benefits of international diversification and amplifying total portfolio risk, particularly when currency movements covary with asset returns during crises. The four most prominent causes are macroeconomic instability (encompassing high inflation, fiscal deficits, and inconsistent monetary policies), speculative trading coupled with sudden capital flow reversals, shifts in global investor risk sentiment, and external shocks such as geopolitical events or commodity price swings. These drivers erode investor confidence by increasing the uncertainty of repatriated returns, prompting risk-averse investors to demand higher risk premiums or curtail exposure to volatile currencies. Consequently, elevated exchange rate volatility generally suppresses risk appetite, leading to conservative asset allocation with greater reliance on hedging instruments or safe-haven currencies (Adegbe & Kummer, 2025; Nenova et al., 2025).

Macroeconomic instability, through divergent inflation and interest rate paths, creates persistent currency misalignment and volatility spikes when policies adjust abruptly, causing investors to reduce allocations to affected markets and favor domestic or stable-currency assets to preserve capital. Speculative trading and capital flow reversals amplify short-term fluctuations via herd behavior and stop-loss triggers, deterring long-term portfolio commitments while encouraging tactical hedging that raises transaction costs and lowers overall risk tolerance. Shifts in global risk sentiment, often signaled by widening credit spreads or VIX surges, trigger risk-off episodes where volatility surges as capital flees emerging or commodity-linked currencies, resulting in portfolio rebalancing toward low-volatility developed-market bonds. External shocks, including geopolitical tensions or pandemic-style disruptions, induce sudden volatility spikes that overwhelm hedging strategies, prompting sharp reductions in foreign equity and bond holdings as investors prioritize liquidity and capital preservation over yield-seeking. In response, portfolio managers typically decrease emerging market exposure, increase currency overlays or derivatives usage, and exhibit home bias, and adopt lower risk appetite postures until volatility subsides (Adegbe & Kummer, 2025; Nenova et al., 2025).

Problem Statement

Exchange rate volatility poses a critical challenge to U.S. investors' portfolio management, as unpredictable currency fluctuations introduce substantial unhedgeable risks that distort expected returns, elevate portfolio variance, and compel reactive adjustments in asset allocation away from foreign exposures toward safer domestic alternatives. This phenomenon is particularly acute during periods of U.S. dollar appreciation, which not only erodes the dollar-

denominated value of international holdings but also amplifies duration-related losses in emerging market bonds, triggering procyclical outflows from mutual funds—the primary conduits for such investments—and exacerbating global financial spillovers. Empirical analyses reveal that a 1% broad dollar appreciation can reduce inflows into emerging market local currency bonds by up to 2.46%, underscoring how volatility curtails risk appetite and fosters home bias in portfolio decisions, thereby limiting the diversification benefits essential for long-term yield optimization. Furthermore, the interplay between exchange rate swings and monetary policy shocks intensifies these effects, as investors face heightened Value-at-Risk constraints, leading to widened credit spreads in target markets and persistent reductions in cross-border allocations that hinder economic resilience in recipient economies. Addressing this issue is imperative, as unchecked volatility risks perpetuating a cycle of capital flight and market instability, ultimately undermining U.S. investors' ability to achieve balanced, high-return portfolios in an increasingly interconnected global landscape.

THEORETICAL FRAMEWORK

Modern Portfolio Theory (MPT)

Modern Portfolio Theory (MPT), originally developed by Harry Markowitz in 1952 but continually refined in contemporary finance research, remains one of the most influential foundations for understanding how investors manage risk under conditions of uncertainty. The core essence of the theory is that investors construct portfolios by balancing expected returns against variance, using diversification to minimize exposure to unsystematic risk while acknowledging the unavoidable presence of systematic factors. Recent scholars continue to emphasize how external macro-financial shocks, especially exchange rate movements, alter expected covariances among assets and shift the efficient frontier that investors rely on for rational allocation decisions (Steiner, 2021). In the context of U.S. investors, the relevance of MPT is substantial because exchange rate volatility directly affects the relative attractiveness of foreign-denominated assets, complicates risk forecasting, and forces investors to reassess whether international diversification still enhances expected returns. As exchange-rate swings widen, the risk contribution of currency exposure increases, pushing investors either to adopt hedging strategies or to rebalance portfolios away from markets with high foreign exchange uncertainty.

Complementing MPT

Complementing MPT is the Intertemporal Capital Asset Pricing Model (ICAPM), advanced by Merton in 1973 but expanded in recent empirical finance literature to incorporate global risk factors, including foreign exchange risk. The central argument of ICAPM is that investors do not only care about current-period returns; they also value assets for their ability to hedge adverse shifts in future investment opportunities, meaning that multiple sources of systematic risk become priced in equilibrium. Contemporary findings show that exchange-rate volatility acts as one such systematic risk, influencing discount rates and altering the risk premiums investors require to hold internationally diversified portfolios (Han & Li, 2020). For U.S. investors, this framework is vital because foreign exchange uncertainty can affect consumption patterns, retirement planning, and long-term wealth accumulation, prompting them to react not only to short-term currency shocks but also to expected long-horizon volatility. Under ICAPM, U.S. investors may reduce exposure to foreign assets with unstable currency regimes or increase holdings in assets that provide natural hedges against domestic economic fluctuations, thereby using international markets as a shield against future shocks.

Portfolio-Balance Approach

Portfolio-Balance Approach, widely used in open-economy macro-finance and recently re-emphasized in studies exploring how global capital flows interact with exchange rate movements. The theory argues that exchange rates are not merely determined by trade flows or interest rate differentials; rather, they respond dynamically to investors' portfolio allocation decisions across domestic and foreign assets. Recent literature demonstrates that when U.S. investors adjust their international equity or bond positions because of heightened exchange-rate volatility, these capital flows influence currency demand and can induce further fluctuations, creating feedback loops that link investor behavior and exchange rate dynamics (Kanda, 2019). This approach is particularly relevant for understanding the bidirectional relationship between U.S. investors' portfolio decisions and FX volatility: investors respond to currency shocks, but their responses also shape the evolution of currency values. Thus, the Portfolio-Balance Approach helps explain why U.S. investors may withdraw from foreign markets during volatile periods, why they may pursue currency hedges to stabilize expected returns, and how their collective decisions contribute to broader macro-financial stability or instability.

Empirical Review

Smith and Alvarez (2021) investigated how short-term exchange-rate volatility influences the foreign-equity allocation decisions of U.S. institutional investors. The purpose of the study was to assess whether volatility in major currency pairs prompts measurable shifts in portfolio composition and hedging strategies. Using a panel regression approach applied to monthly holdings of 120 U.S. mutual funds from 2015 to 2020, the researchers modelled FX volatility through a GARCH(1,1) framework while controlling for fund-specific effects. Their findings indicated that a one-standard-deviation rise in FX volatility led to a 2.8% reduction in foreign-equity exposure and a 4.1% increase in the uptake of currency-hedged investment products. The authors recommended that institutional investors integrate dynamic currency overlays and adopt regular FX stress testing to cushion portfolios against sudden volatility spikes. Chen, Patel and Green (2019) examined how U.S. retail investors respond to persistent exchange-rate volatility, particularly during extended periods of dollar fluctuations. The purpose of the study was to establish whether prolonged FX uncertainty triggers reallocations toward domestic assets. Employing a difference-in-differences design on over 50,000 U.S. brokerage accounts during the 2017–2018 episodes of heightened dollar volatility, complemented by propensity score matching for robustness, the study uncovered significant behavioral shifts. Findings revealed that retail investors increased domestic equity allocation by 3.5 percentage points while reducing inflows into foreign ETFs, with more pronounced effects among less-experienced investors. The authors recommended enhanced brokerage disclosures on currency risks and promoted wider access to low-cost hedging ETFs.

Okoye and Thompson (2022) focused on the stabilizing role of currency hedging for U.S. pension funds exposed to exchange-rate risk. The purpose was to evaluate how different hedge ratios balance return and volatility in internationally diversified pension portfolios. Using an event-study approach on pension portfolios between 2014 and 2020, the authors generated synthetic hedged and unhedged portfolios and optimized hedge ratios using mean-variance models. Results showed that partial hedging strategies between 40–60% reduced annual return volatility by about 12% with minimal impact on long-term returns, whereas full hedging often underperformed during strong-dollar cycles. The researchers recommended that pension trustees adopt adaptive, valuation-informed partial hedging strategies instead of rigid hedge policies.

Rivera and Huang (2020) studied the link between exchange-rate volatility and risk-budgeting decisions among U.S. wealth managers. The purpose was to understand whether currency uncertainty alters wealth managers' risk appetite, advisory communications, and portfolio construction. Through a mixed-methods design combining a survey of 200 wealth managers with 25 in-depth interviews, the study employed ordered probit models to analyze quantitative responses. Findings showed that managers significantly tightened client risk budgets during FX-volatile periods and increasingly adopted currency-linked structured products to stabilize expected returns. The authors recommended that wealth managers strengthen client education on the long-term benefits of global diversification and provide tailored guidance on currency-risk tools.

Gupta (2023) explored the micro-level effects of intraday FX volatility on algorithmic portfolio-rebalancing behavior in U.S. quantitative funds. The main purpose was to determine whether real-time currency shocks cause excessive trading and reduce net performance. Using high-frequency trade-and-quote data from 15 quantitative funds between 2018 and 2022, the study applied hazard models to estimate the likelihood of rebalancing under different volatility regimes. Findings revealed that intraday spikes in FX volatility increased rebalancing frequency by 18%, inflating transaction costs and reducing net alpha, while funds with FX-sensitive trading rules achieved superior efficiency. The study recommended incorporating FX volatility filters into algorithmic triggers and using more disciplined limit-order execution to reduce slippage.

Morales, Lee and Johnson (2024) investigated whether exchange-rate shocks trigger safe-haven portfolio shifts among U.S. and global balanced funds. The purpose was to quantify how FX volatility affects flows into U.S. Treasury securities and related adjustments in portfolio duration. Using vector autoregressive (VAR) models on monthly data from 2010 to 2023, including FX volatility indices, foreign-equity flows, and U.S. Treasury flows, the study mapped dynamic responses. Findings showed that FX-volatility shocks produced sustained inflows into Treasuries and shortened duration exposure as fund managers sought liquidity and stability, especially when global volatility was simultaneously elevated. Recommendations included integrating FX-sensitive macro indicators into duration-management frameworks and monitoring cross-asset spillovers more frequently.

Ahmed and Rosen (2020) explored how repeated exposure to FX-volatility episodes influences long-term foreign-allocation behavior in U.S. taxable retail investors. The purpose was to test whether investors learn and adapt over time or whether they permanently retreat from foreign markets. Using a panel dataset of brokerage accounts from 2010 to 2019 and employing random-effects models with state-dependence adjustments, the authors traced how past volatility episodes shaped future decisions. Findings indicated that investors initially reduced foreign exposure after FX shocks but gradually reverted toward diversification after about two years, especially when guided by financial advisors. The study recommended strengthening investor education programs and promoting advisor engagement to counteract emotionally driven allocation shifts.

MATERIALS AND METHODS

This study adopted a desk methodology. A desk study research design is commonly known as secondary data collection. This is basically collecting data from existing resources preferably because of its low-cost advantage as compared to field research. Our current study looked into already published studies and reports as the data was easily accessed through online journals and libraries.

FINDINGS

The results were analyzed into various research gap categories that is conceptual, contextual and methodological gaps.

Conceptual Gaps

Although existing studies explore how exchange-rate volatility influences portfolio allocation, hedging behavior, risk appetite, and algorithmic trading, several conceptual gaps remain. First, most studies treat exchange-rate volatility as a uniform shock, yet they do not differentiate between *expected* versus *unexpected* FX volatility or between *short-term* and *structural* currency uncertainty—leaving a gap on how U.S. investors respond to different volatility types. Second, while individual studies address allocation shifts, hedging choices, or behavioral responses, few integrate these dimensions into a single conceptual model that explains how cognitive, macro-financial, and algorithmic factors interact to shape investment decisions. Third, existing evidence focuses heavily on direct reactions (e.g., reducing foreign exposure), but there is limited conceptual work on *mediating mechanisms* such as financial literacy, institutional policy constraints, algorithm design, or advisory influence. Fourth, no study sufficiently explores how exchange-rate volatility interacts with emerging asset classes—such as cryptocurrency ETFs, global tech indices, or ESG-themed international funds—creating a gap in understanding modern portfolio dynamics. Overall, there is a need for a comprehensive conceptual framework that captures the multi-layered and evolving nature of U.S. investor behavior under FX volatility.

Contextual Gaps

Contextually, prior studies focus on specific market segments—mutual funds, retail investors, pension funds, wealth managers, or quantitative funds—but very few integrate findings across these categories to build a holistic understanding of the entire U.S. investment landscape. Most studies analyze isolated behaviors (e.g., hedging, risk reduction, rebalancing) without considering broader institutional contexts such as regulatory changes, monetary policy cycles, or shifts in global liquidity. Additionally, the behavior of *emerging investor categories* such as robo-advised portfolios, AI-driven trading systems, and environmentally oriented global investors remains largely unexplored. There is also limited contextual analysis of how FX volatility interacts with periods of geopolitical stress, inflation surges, or supply-chain disruptions, yet these conditions increasingly shape modern currency markets. Finally, most existing studies rely on historical datasets ending before 2024, failing to account for the recent post-pandemic economic realignments, increased algorithmic participation, and heightened geopolitical currency shocks. This creates a contextual gap requiring updated and real-time evidence.

Geographical Gaps

Geographically, the reviewed studies focus exclusively on U.S. investors and their reactions to global currency shocks, but they rarely compare these behaviors with investors from other major economies such as the EU, Japan, the UK, or emerging markets. This limits understanding of whether U.S. investor responses are unique or part of broader global patterns. Additionally, none of the studies examine how U.S. investors behave differently across foreign regions for example, comparing their reactions to volatility stemming from developed markets (euro, yen, pound) versus emerging markets (yuan, rupee, rand). There is also a geographical under-exploration of how U.S. investors respond to volatility in frontier markets where currency risk is significantly higher. Another gap is the absence of studies linking U.S. offshore investment behavior with region-specific policy changes or currency-management regimes.

Overall, the geographical scope remains narrow, leaving opportunities for comparative, cross-market, and region-specific research.

CONCLUSION AND RECOMMENDATIONS

Conclusion

The effect of exchange rate volatility on portfolio investment decisions of U.S. investors is both significant and multifaceted, shaping how individuals and institutions allocate assets, manage risk, and pursue long-term financial goals. Evidence from recent empirical studies demonstrates that heightened currency instability consistently triggers shifts toward safer domestic assets, increased use of hedging instruments, and more cautious risk budgets across investor categories. These behavioral responses highlight the central role that exchange-rate movements play in influencing both short-term tactical decisions—such as rebalancing and hedging—and long-term strategic decisions, including diversification into foreign markets. At the same time, the studies reveal that investor reactions are not uniform; they are shaped by factors such as financial literacy, institutional constraints, advisory influence, and level of exposure to global markets. Furthermore, exchange-rate volatility is shown to not only alter returns directly through currency translation effects but also indirectly influence asset demand, cross-border capital flows, and perceptions of market stability.

Overall, the literature underscores that U.S. investors operate within an increasingly interconnected financial environment where currency movements can amplify or dampen portfolio performance. The dynamic nature of modern currency markets—driven by geopolitical tension, shifting monetary policy, and global economic disruptions—makes it essential for investors to adopt more sophisticated risk-management tools, flexible allocation strategies, and informed decision frameworks. Consequently, understanding exchange rate volatility is not merely an academic exercise; it is a practical necessity for optimizing portfolio resilience in a volatile global investment landscape.

Recommendations

Theory

Future theoretical models should extend beyond conventional portfolio theories by explicitly integrating exchange rate volatility as a dynamic, systematic risk factor rather than treating it as a peripheral variable. This framework should combine Modern Portfolio Theory (MPT), International CAPM (ICAPM), and portfolio-balance approaches to better capture the interplay between currency fluctuations and cross-border investment behavior. Researchers are encouraged to develop models that account for investor behavioral responses to short-term and long-term FX volatility, such as risk aversion shifts, hedging preferences, and strategic allocation adjustments. Longitudinal studies tracking U.S. investors' portfolio performance under varying exchange rate regimes would strengthen causal inference and allow for observation of evolving decision-making patterns. Comparative research across different economic and regulatory contexts such as developed versus emerging markets—could refine theoretical models, ensuring they are generalizable across global investment environments. These recommendations push for hybrid theoretical frameworks that integrate macroeconomic, behavioral, and financial market dynamics, providing a more comprehensive understanding of portfolio investment in the context of currency risk.

Practice

Investment managers and individual U.S. investors should adopt structured and proactive strategies to manage currency risk. Establishing dedicated FX risk committees within investment firms can enhance decision-making by combining expertise from portfolio

managers, currency analysts, and risk officers. Firms should implement dynamic hedging policies, scenario-based stress testing, and periodic portfolio rebalancing that explicitly account for projected currency volatility. In addition, investors should leverage real-time FX analytics, predictive models, and volatility indices to inform allocation decisions and optimize risk-adjusted returns. Structured educational programs, including reverse mentorship for younger, data-savvy analysts to train senior portfolio managers on emerging FX modeling tools, can improve organizational capabilities in currency risk management. These recommendations provide a practical blueprint for integrating exchange rate considerations into everyday portfolio management rather than treating them as ad-hoc or secondary concerns.

Policy

Policymakers and regulatory bodies should promote transparency and stability in foreign exchange markets to reduce systemic risks affecting cross-border investments. Targeted policy interventions could include guidelines for derivative and hedging instruments, incentives for the adoption of FX risk management tools, and investor education programs emphasizing currency risk awareness. Regulatory support for market infrastructure, such as centralized platforms for currency derivatives trading and real-time FX reporting, would enhance market efficiency and investor confidence. Furthermore, fiscal incentives such as tax credits or rebates for firms that demonstrate formal, board-approved FX risk management strategies could encourage adoption of best practices in currency exposure mitigation. These recommendations advocate for evidence-driven interventions that strengthen market stability, facilitate informed decision-making, and foster resilient investment practices in the face of exchange rate volatility.

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