The Rennie Quarterly Return

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Currency Exposure In Investment Portfolios

If you are like most people, you consider the impact of currency exchange rates only when planning your next foreign vacation. However, exchange rates directly impact our daily lives in many ways.

For example, a strong US Dollar can have a material effect on the US economy, making US exports less attractive to foreign consumers and dampening GDP growth. Conversely, US consumers snap up foreign goods at discounted prices.

Portfolio Effects

Less obvious are the effects that currency exchange rate changes have on investment portfolios. The last twelve months provide an excellent example of how exchange rate fluctuations can obfuscate underlying market returns.

During 2014, the US Dollar strengthened 11.5% against the Euro and 12.3% against a global currency basket. How does this change impact US investors?

Remember that most foreign securities are denominated in local currency. European stocks are priced in Euros, not Dollars.

When a US investor buys a mutual fund that holds foreign securities, they naturally pay US Dollars. Those Dollars must be exchanged into the local currency by the fund company before they can purchase foreign securities.

Subsequently, when the fund company computes the daily fund value, the value of each security it holds must be converted back to US Dollars at the current exchange rate. **<u>Thus, daily foreign fund value changes represent the combination of local security returns and currency fluctuations.</u>**

Fund	Symbol	YTD Return
Vanguard European Stock Index	VEURX	-5.24%
WisdomTree Europe Hedged Eq ETF	HEDJ	<u>5.03%</u>
Imputed VEURX Return From Currency:		-10.27%
PIMCO Foreign Bond (Unhedged)	PFBDX	0.02%
PIMCO Foreign Bond (USD Hedged)	PFODX	<u>10.14%</u>
PFBDX Return From Currency:		-10.12%

Returns through 12/29/14

Fund Currency Returns

It is difficult to break out a foreign fund's return from securities versus currency. However, the currency effect becomes obvious when comparable funds are offered in both local currency and US Dollar hedged (eliminating foreign currency exposure) formats.

PIMCO, for example, offers US Dollar hedged and unhedged versions of the PIMCO Foreign Bond Fund. On the stock side, The Vanguard European Stock Index Fund (unhedged) can be compared to the WisdomTree Europe Hedged Equity ETF.

As the table above shows, the strong US Dollar more than offsets positive YTD euro-denominated European stock returns, and fully offsets stellar foreign local bond returns through 12/29/14. Currency was a larger determinant of returns in these asset classes than equity or bond market fundamentals. **<u>In general, for unhedged US investors, a strong US Dollar lowers foreign investment returns. Conversely, a weak US Dollar increases foreign investment returns.</u>**

Take A Global Perspective

It is important to realize that a European investor will have quite a different perspective on 2014's investment returns than his/her US counterpart.

To a typical US investor, foreign stock and bond returns were poor while US stock and bond returns were solid. However, to a European investor, European stocks and bonds did well, however US stocks and bonds did even better due to devaluation of their home currency. The difference in perspective simply has to do with the local currency of each investor.

What to do?

Currency exchange rates do not lend themselves to accurate prediction. In theory, however, the currency-hedged and unhedged returns should equal out—over the long-term.

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Our Two

"The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists."

Ernest Hemingway

Quarterly Trivia:

What is the cost of production of the Treasury's new $100 note?

12.5 cents