Currencies Matter

SYNOPSIS

- Investors seeking international diversification must consider the effects of currencies relative to the U.S. dollar.
- Currency movements can often wipe out substantial chunks of a large gain if the underlying currency weakens.
- Currency-hedged Exchange Traded Funds (ETFs) offer an investor the opportunity to globally diversify a portfolio without taking on the currency risk.

CURRENCY IMPACTS

Diversification is the "Golden Rule" of investing, and investors are strongly urged to seek diversification across regions, sectors, and asset classes at all times. One way to achieve this goal is to use Exchange Traded Funds (ETFs) to obtain access to foreign markets.

An ETF is a marketable security that tracks an index or a basket of stocks, bonds, and/or commodities. The fund owns the underlying assets and then divides ownership of those assets into shares. These shares of the ETF are traded on stock exchanges and are used extensively in the investment process for several reasons outlined in last week's Thought for the Week.

Investing abroad exposes an investor to a number of risks that do not exist if he/she were to simply stay here in the U.S. For example, foreign countries often have unstable governments, unfavorable policies to outside investors, or far less liquid financial markets so buying/selling can be expensive with big price swings.

Arguably the biggest and broadest risk to U.S. investors is currency risk, and extreme fluctuations in currencies can easily wipe out gains unless handled properly.

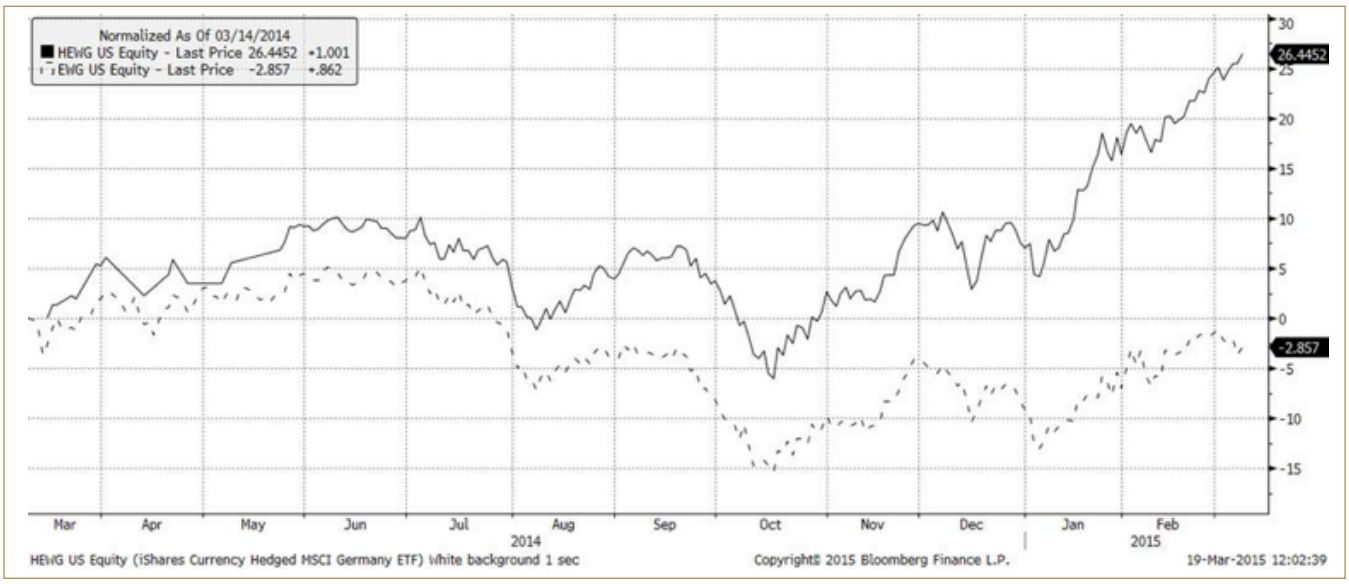
Let's say an investor were to take $1 million over to Paris and open an account with a French bank that is offering a one year CD at 5%. That investor would first be required to convert the U.S. dollars (USD) to Euros (EUR) before depositing them in the new account. Let's further assume that at the time of the conversion, one Euro could buy one dollar (1:1 conversion).

One year passes and now the investor would like to take the gains in the account and bring them back to the U.S. Now the investor earned 5% over that year, so the gain is €50,000, but the exchange rate changed over that time period to where one Euro now buys $0.80. Therefore, when our investor converts Euros back to dollars, he is left with only $40,000 (€50,000 x 0.80). The impact of the weaker EUR versus the USD has wiped out $10,000 of his profits!

Until recently, the effects of currencies were difficult to bypass. Hedging was really the only tool available, but the cost to hedge currencies can be very high and too complex for the average investor to execute. However, many ETFs now exist that

take care of the hedging for the investor for a very reasonable fee, and the impact is dramatic.

The chart below shows a comparison between a currency-hedged German ETF (ticker: HEWG) and one that does not hedge the Euro (ticker; EWG) over the last twelve months:



Source: Bloomberg

The difference in return is overwhelming because of the sharp fall in the Euro since December. The hedged ETF charges 0.53%, which is slightly higher than the non-hedged at 0.48%, but a higher fee of just 0.03% has returned over 29% to the investor.

The bottom line is that currency-hedged ETFs may cost a little more to own, but their benefits far exceed these costs in times of dramatic movements in currencies. Given the policies enacted by central banks across the globe, expect to see more interest in these products over the coming years.

Sincerely,

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