What You Need to Know About Currency Risk

Given the current weakness of the U.S. dollar, it is critical that U.S. investors understand the risks (and potential rewards) involved in foreign currency diversification -- and take steps to protect their portfolios.

The U.S. dollar continues to fall against other major world currencies -- and the consensus among economists and analysts is that the greenback's downward spiral may likely continue over the long term.

General investment wisdom states that to hedge a portfolio against the falling dollar, investors should diversify into foreign currency holdings. One of the easiest ways to do that is to acquire shares of U.S. companies with multinational operations, such as Microsoft and Exxon. Yet recent research suggests that this strategy may not be as effective at providing adequate currency diversification as many investors think. A study found that roughly 80% of the international income of multinational companies is hedged back to U.S. dollars.[1] Furthermore, the larger the company, the more completely hedged those earnings tend to be.

So where does this leave investors who think they are gaining global currency exposure through purchases of global U.S. firms? According to the study, many investors are getting only about one-fifth the diversification effect they assume -- perhaps much less.

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Currency Risk 101

Strategies for managing a portfolio's foreign currency exposure fall into three broad categories.

1. **No hedge.** The simplest approach used by international portfolio managers and investors is to not hedge the currency risks at all. Proponents of this approach say that not hedging foreign currency exposure helps diversify a portfolio. Others believe that currency fluctuations tend to wash out over an extended period of time.

2. **100% hedge.** Some go to the other extreme and hedge 100% of their currency exposures. This group believes that foreign exchange rates are highly unpredictable and that currency risks in

non-dollar securities should always be fully hedged. But hedging costs tend to reduce overall returns over time, compared with an unhedged portfolio.

3. **Actively managed hedging.** The third strategy falls somewhere in between. Those who use an actively managed hedging approach hedge selectively: sometimes no hedge, sometimes a partial hedge, and sometimes a full hedge. The selective approach is gaining in popularity. Most investment firms now offer some kind of currency service, and some firms with substantial international investments even appoint a separate manager to handle currency as a distinct asset class.

Currency risk is an essential element of international investing and is only one risk of investing across borders. Others include possible increased taxation as well as political uncertainties. Your financial advisor can explain the pros and cons of international investing in more detail.

Source/Disclaimer

[1]Source: Merk Investments LLC, "U.S. Investors Overexposed to U.S. Dollar Risk," June 2011.

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