Identifying and managing foreign exchange risk in your portfolio

About foreign exchange

We believe one component of Wealth Management is the art of managing risk. It is a delicate balance. For US citizens living abroad risk management needs to go beyond the classic issues of retirement planning: How much money will I need? How long do I need to work? Expats need also to ask: Do I understand the foreign exchange risk lurking in my portfolios?

Anyone traveling abroad understands what a weak dollar can do to a holiday budget: The cup of frozen yoghurt in New York that costs $4 can turn into an $8 indulgence in Geneva. For a tourist, that is a nuisance. For expats who are settling overseas for the long run, foreign exchange risk is more complex but highly manageable – if they know how to identify and then anticipate the hazards. "We typically find three areas where US citizens are likely to take on risk without always understanding the pitfalls," says James Sellon, Managing Partner, MASECO Private Wealth. "First, some investors don't always plan their investments in terms of their future liabilities. They need to be asking: 'Will my future expenses be mostly in dollars, pounds or a combination of currencies?' Second, they aren't always mindful of how they are holding cash - whether it is in dollars or euros or some other currency. Third, many don't convert currency from one currency to another to make an investment decision (because of the exchange rate costs) ignoring the eventual underlying currency exposures of the investment they make.

In this whitepaper, "Identifying and Managing Foreign Exchange Risk", we provide tips for US expats on how to take charge of foreign exchange risks.

Maintain buying power by selecting the right currency now for fixed income investing

Traditional investment portfolios generally break down into three basic categories – fixed income, stocks, and cash. Each category plays a special role. Cash is important for emergencies; stocks are the growth engine, and fixed income investments should provide the basis for daily expenses after retirement or for controlling the volatility in a portfolio. Foreign exchange risk in fixed income portfolios is singularly important to manage. "If you are planning on spending half the year in London after retirement, then think about whether a big chunk of your fixed income investments needs to be in pounds," says Sellon. "Or if you plan on retiring in London, but your children prefer to go to college in the US, you need to consider having the right mix of dollar and sterling-based fixed income investments." In practical terms, that means generally investors shouldn't put all of their fixed income investments into US Treasuries, which provide a stream of coupon payments in dollars. "US citizens living overseas need to look at matching the income from their investments to the local currency where they will be incurring most of their expenses. This will aim to protect them from fluctuations in the dollar," Sellon says. "You don't want to suddenly discover after decades of saving that the largest component of your portfolio is in dollars rather than the currency of your liabilities or vice versa." That could mean the difference between looking at that cup of frozen yoghurt mentioned earlier and thinking, "Wow, that's expensive!" - or not thinking about it at all.

Pay attention to cash - is it in a local currency?

Everyone needs to keep cash – or cash equivalents – on hand for emergencies. In our experience we sometimes find that globetrotting clients can be indifferent to the currency in which they hold cash. "Cash is cash," they might say, but that isn't strictly true. If you are living in the UK and keep cash accounts in euros as well as dollars, then you are subjecting yourself to currency risk. This is true for cash equivalents, like US Treasury bills or money market funds. If you suddenly need £30,000 to replace your car, you don't want to convert your cash hoard from another currency. The foreign exchange market is vast – $5.1 trillion trades daily. according to Reuters. But the price volatility is considerable. You could get lucky, and the currency you hold could strengthen. But in effect, you are playing roulette with your reserves.

Don't be afraid to change dollars to invest in US-based global stock funds

Stocks, real estate, commodities – these are the assets that can help to power growth in a nest egg. For US investors living abroad, buying US-based funds is typically the most efficient way to build a globally diversified portfolio of real assets. Diversifying is critical: it helps to outweigh the true risk of currency fluctuation and keep the return engine of a portfolio humming. We have found that a number of investors hesitate to swap their pounds for dollars. "They think that they will get killed on the 'tourist' exchange rates. So they don't do it; they do nothing. It's a huge behavioural issue," says MASECO's Managing Partner Josh Matthews. "If your wealth adviser has correctly set up efficient foreign exchange banking services, those transaction rates can be reduced."

Investors also assume that they are taking on dollar risk if they exchange pounds for dollars in order to invest in a US global stock fund. They are not. (Buying US funds is considered the most tax-efficient venue for expats.) "The investor needs to distinguish between the denomination of the investment and the true foreign risk exposure," says Matthews. "The currency risk for a US person permanently living in the UK, buying a dollar denominated fund, that buys stocks in Europe, is the movement between the euro and sterling - not the relationship between the US dollar and sterling. It's confusing, even for the currency sophisticated. Don't get fooled. If you exchange sterling to buy a dollar-based emerging market fund, then the foreign exchange risk is sterling vs. emerging market currencies. There is no dollar risk." (See the Q&A below for a deep dive into how this works.)

When it comes to stocks, the ups and downs of foreign exchange can indeed enhance or hurt returns in the short-run. Some managers may use fancy techniques to hedge – or protect - investors from the vagaries of the foreign exchange market. In the long-term, however, academic studies show that hedging isn't all that effective when it comes to stocks. Rather global diversification is seen as the best friend for savers. When investors understand just where currency risk lies, they can make choices about how to manage that risk. A misunderstanding of these risks can result in investors not being able to achieve their goals.

Questions & Answers
Foreign exchange is one of the most confusing topics for investors and professionals to discuss. Below, MASECO shares the most common questions that US investors living abroad have about their portfolios and currency risk.

Q: I have a US stock mutual fund with the word 'global' in it. But I've noticed that sometimes US stocks account for the vast majority of the assets. Does that matter?

A: Yes, it matters. When reviewing equity mutual fund portfolios, you need to think strategically about just how diversified the holdings are. Allocating a small percentage of emerging market stocks, and then pasting the name "global" on the equity fund isn't good enough. You may need a blend of exposures to achieve true diversification. Of course, a mindful wealth manager may prefer certain exposures to another to help rev the growth engine in a portfolio. The weightings need to be understood and reviewed regularly.

Q: If I am an American in the UK and have British pounds and want to invest in European equities, shouldn't I invest directly in euro funds rather than US funds that invest in European equities? Doesn't the US fund build in an extra layer of foreign exchange risk or expense?

A: This is one of the trickiest ideas to master. The short answer is no, in this case you are not building in an extra layer of currency risk. Think of the US dollar fund as a middleman. The foreign exchange risk resides with the relationship between the British pound (the currency of your liabilities) and the euro (the core investment). The dollar simply is a medium to exchange. You will also have very marginal transaction costs around exchanging your foreign currency to dollars and then back again. This small friction over the life of the investment should be meaningless.

An example:
Suppose you are a US person living in the UK and want to buy 100 shares of the euro stock fund denominated in dollars. At the time, the fund is priced at $1.50 – or a total $150. Before buying the fund, you need to swap your British pounds for dollars. Let us say £1 can buy $1.50. So you will need to exchange £100 to buy 100 shares of the fund.

Finally, you should also consider the underlying value of the stocks in the euro stock fund in euros. Let us assume that it is worth €1.20 /share or €120 for 100 shares.

An example continued:
Here are the basic foreign exchange rates so far:
£1 = $1.50
£1 = €1.20

Based on these values, how many dollars can a euro buy?

It's a simple ratio. Divide the value of the dollar ($1.50) by the value of the euros (€1.20) - or 1.50/1.20. That equals $1.25. The euro/dollar exchange rate is therefore €1:$1.25.

Fast-forward a year later and the euro stock fund has appreciated 20% in local currency: The underlying investment has gone from €120 to €144.

But the dollar hasn't stood still; in fact, it has shrunk miserably against the sterling, the currency of your adopted new home. One pound can now buy $2.00, up from $1.50 a year earlier.

In this case, the relationship between sterling and the euro remains unchanged. £1 is still worth €1.20. (Of course, in real life, currencies are constantly changing relative to one another. But the point here is that the risk remains between the steling and the euro.)

Bad news for you? Sharpen your pencil.
Euro stock fund value = €144, up 20% from a year earlier.

How much is that worth in weakened dollars? Remember, this is a ratio.

If £1 = $ 2.00 and £1 = €1.20
then
€1 = 2.00/1.20 = $1.67

Can you guess whether the US investor who will convert his dollar investment back into sterling has lost anything by using a dollar vehicle for a euro-based stock fund?

First convert the value of the euro stock fund into sterling.

Remember £1 = $1.20

To calculate the new value of the fund in sterling, divide by 1.20

€144/1.20 = £120

Finally, let's convert Sterling into dollars. Remember, sterling can now buy $2.00, up from $1.50 earlier; Again, we just multiply the values:

£120 x 2.00 = $240

...which turns out to be the exact same result you would have achieved if you had invested directly into the Euro fund with your dollars:

$144 x 1.67 = $240

You can clearly see that investors receive the same return whether they invest in the local currency investment or an investment vehicle investing in the same underlying investments but denominated in a different currency. Using investment vehicles denominated in dollars reduces the regulatory, transaction and operational costs and does not change the investment risk.

It does add marginally to the transaction costs as you will convert currency at the beginning and the end of the investment but if the investment is held, like it should be, for an extended period of time then this cost should be immaterial.

Q: My global bond mutual fund invests in fixed income securities in the local currencies. Will that help protect me from foreign exchange risk? We plan on retiring in the UK in 15 years.

A: Investing in global bond funds should be considered as a key part of an investor's portfolio – not because it can potentially help to minimise foreign exchange exposure. If you are planning to retire in the UK, you will need an income stream in sterling. A dollar denominated global fixed income fund won't provide that for you. Investing in global fixed income is the path for those who wish to have exposure to global interest rate markets and are truly global citizens. It is important for those who wish to protect their purchasing power over the long-term and not be at the mercy of having all one's fixed income eggs in one currency especially when they are unsure of their potential future retirement/liabilities.

Q: Is there a fixed income mutual fund that provides an income stream in sterling or euros? That would make the most sense, wouldn't it?

A: That may make perfect sense, depending on individual needs and circumstances, for UK nationals and US citizens living in the UK who expect to retire in the UK. Typically, US asset managers do not offer fixed income products that provide non-dollar income streams as the universe of potential customers is small. US citizens should also be wary of investing in offshore (non-US regulated) fixed income instruments as this will result in potentially onerous tax consequences if not understood correctly.

Q: Does it matter if the exchange rate fluctuates when I buy and sell different investments?

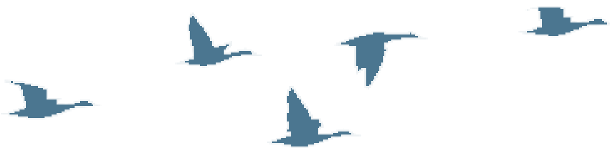
A: Yes. You want to be sure that your wealth manager has the ability to keep precise records on the prices of all assets and the exchange rates at the time of purchase and sale. The regulators and tax administrators require this. The wealth manager also needs to keep tabs on dividend and fixed income interest rate payments, even if they are re-invested immediately and you do not pocket any of the payments.

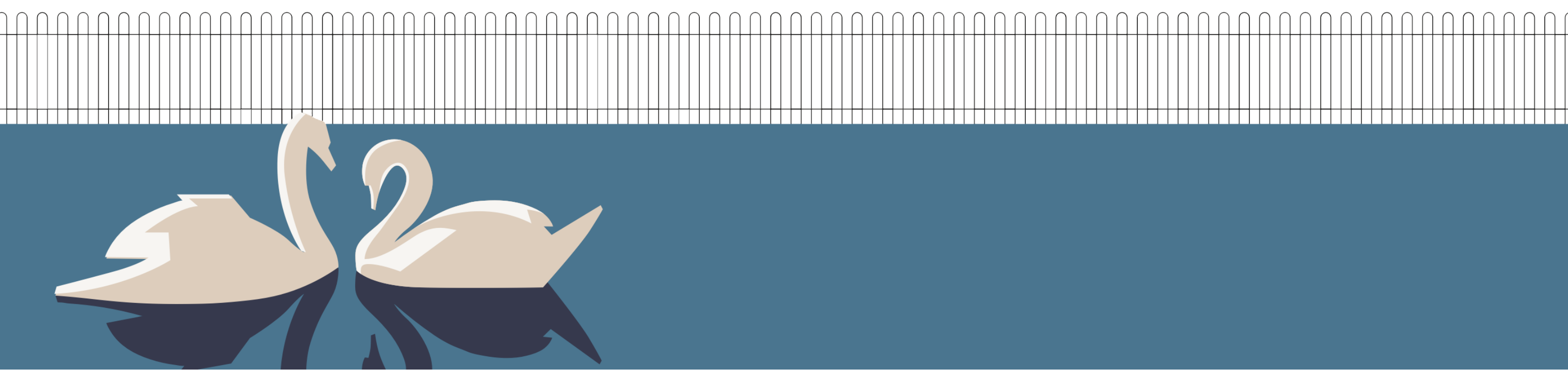
Q: Can we invest in individual bond offerings directly, without the help of funds?

A: Yes absolutely. You must take care to avoid buying bonds that would be deemed a "remittance" from a UK perspective. It is also challenging sometimes to get execution and diversification on individual bonds if your portfolio is not of significant size.

Q: What else can I do if I am a US person living abroad?

A: If you have more that $5 million in liquid assets (excluding your home) then you may be eligible to invest in funds that offer unique tax advantages for U.S. expats - Qualifying Electing Funds.





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- Your capital is always at risk.
- Currency exchange rates may cause the value of an investment and/or a portfolio to go up or down.
- Alternative strategies involve higher risks than traditional investments, such as speculative investment techniques, which can magnify the potential for investment loss or gain.
- Certain products, such as US Mutual Funds, used within a portfolio are not regulated in the UK and therefore clients will not have the benefit of the protections afforded by the UK regulatory regime.

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