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PRIVATE WEALTH

the tortoise & the hare

# Managing foreign exchange risk for international investors: Some do's and don'ts

For the past two years, my town in Germany has been flooded with Swiss nationals crossing the border nearby to go grocery shopping. Why? A decision by central bankers in Zurich sent the Swiss franc surging against the Euro. In plain English: Everything went on sale for anyone with Swiss francs in their pockets.

Many MASECO clients and advisors ask us about foreign exchange (FX) risk in their portfolios. What can be done to protect against or exploit unexpected swings in Euro, the British pound, or the US dollar – the currencies most commonly in their portfolios? In my monthly commentary, I lay out a few do's and don'ts for individual investors and professionals.

**Betting on price movements of single currency pairs (eg EUR/USD or GBP/USD) is a losing strategy. Invest in a mix of asset classes to find an advantage.** I was managing billions of dollars in tactical currency overlays for many years until 2009. So I should be able to predict, if people ask me, where the US Dollar will trade in 12 months' time versus the GB Pound. Right? Wrong. Betting on the price action of any single currency pair is an insanely high risk endeavour.

From experience, even the very best currency managers only get six out of 10 ideas right. They have advantages most investors do not: They can easily take long as well as short positions using derivatives. They trade at very, very low cost given the size of their assets. And most importantly, they take positions in many different currency pairs at the same time. Even so, it has arguably become harder to make money in currency markets: Political events like Brexit are driving prices and are obviously very hard to predict. For that reason, I would not invest in currency-only products these days, but instead in a mix with other asset classes to find advantages, whether by exploring price momentum or other areas where you can find return premia from cross asset class phenomena.

**Match your major liabilities and your currency.** Everyone has major fixed costs: A mortgage, life insurance, tuition. Look at your major fixed costs and then work out a program to ensure that you have the right currency in hand with minimal foreign exchange risk.

Risk management has always been at the core of my work. Back in my currency heyday, my team refused to manage billions of dollars from pension funds because they did not allow us to go short and restricted the investment universe to fewer currency pairs. Private individuals are advised to accept that they will not succeed in predicting the price change of a single currency pair. They should also not believe that their financial advisor can do any better. This is the inconvenient truth. If they don't act accordingly and instead follow their emotions (usually greed or fear) by placing what is nothing but a very, very big bet, they will experience the same outcome as throwing a dice: they are either lucky or not. If private individuals have regular positive cash flows in a different currency to their outflows, there is little they can do to protect themselves from currency swings, other than to perform what is essentially cost averaging: Stick to a schedule of transfers, identical amounts at regular intervals. Ultimately, any extra savings should be transferred into the currency of the country you expect to live in for the long-term. Of course there are also investment tax consequences to consider, which your MASECO wealth manager will provide expert guidance on.

**Keep an eye on the cost of currency trades; they vary tremendously.** Spreads are the differences in price quoted by a third party to either buy or sell an asset. The commission is always easy to find out and some FX dealers even offer no commission. But they make a profit on the spreads, which in some cases are multiple percentage points. Just check out one of the providers next time you are at an airport. Unfortunately, even some of the banks offer prices that consist of spreads that are unnecessarily high. So, if you have large sums of money to transfer, make sure you shop around on the internet and seek your financial advisor's help. There are substantial cost savings up for grab.

**Learn to read statements to understand where any currency risk lies.** Investment statements are typically reported in one currency. This is called your reporting currency. Your investments, however, are likely in multiple currencies. There could be lots of risk tucked away – but you need to know where to look for it. Let's take the example of someone living in the UK who has two portfolios, one with a US financial advisor broker and the other with a UK

| Product | US Broker | | UK Wealth Manager | |
|---|---|---|---|---|
| | Reporting Currency | Risk Exposure | Reporting Currency | Risk Exposure |
| XYZ US Stock | US Dollar | US Dollar | GB Pound | US Dollar |
| Cash Deposit in local currency | US Dollar | US Dollar | GB Pound | - |
| UK Equity ETF | US Dollar | - | GB Pound | - |
| EMU Equity Fund | US Dollar | Euro | GB Pound | Euro |
| Global Fixed Income (hedged to GBP) | US Dollar | - | GB Pound | - |

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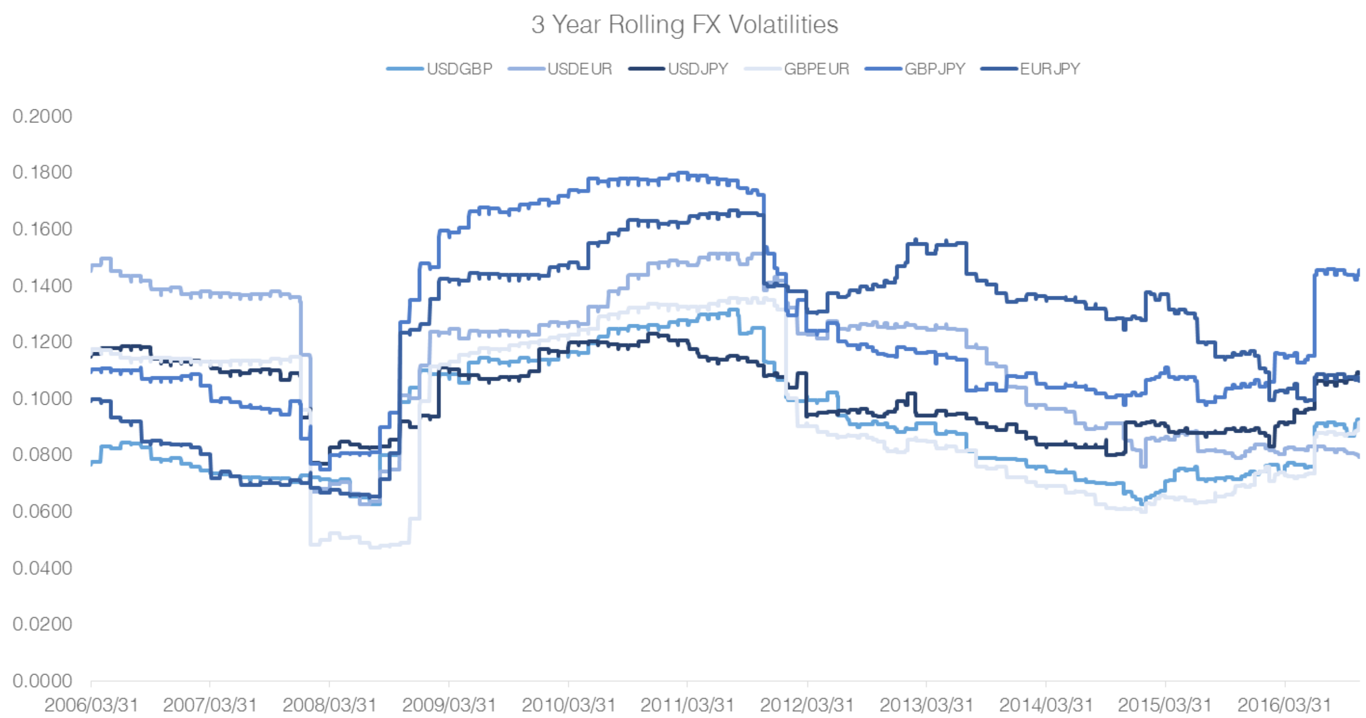
Are these the currency risk exposures you expected? Let me explain.

Holding the currency of your country/region of residence, is not risky because the return of an asset is not impacted by FX price moves. As such, a UK equity ETF, no matter where it is held – whether in a UK or US account -- does not expose a UK-based investor to currency risk.

Look at the holdings XYZ US Stock and the EMU Equity Fund -- they carry currency risks, no matter which account they are held in. Even a cash deposit in local currency of the financial intermediary, if it is held in an account abroad, bears FX risk.

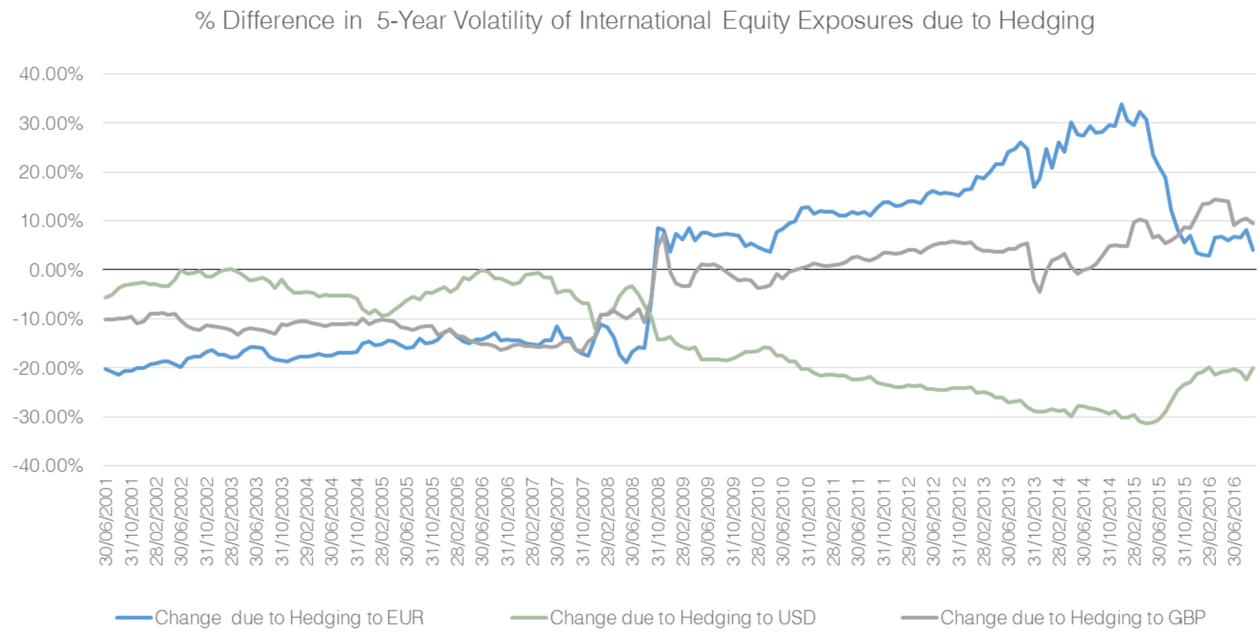
Only products that have all international currency exposures hedged back to GB Pound with the help of FX derivatives[1], such as the Global Fixed Income ETF (hedged to GBP), do not need to be worried about from a currency risk angle.

**FX is an unrewarded risk. Eliminate it within fixed income exposures.** If a private investor pools his or her assets with other investors, the asset pool is often sufficiently large to consider taking on the cost of hedging[2] FX exposures from different developed markets. These hedging cost need to be weighed up with the potential benefits. Let's compare FX volatility[3] itself with that of other asset classes versus any diversification benefits FX exposures might bring to a portfolio (examining correlations[4]). Below are some examples of FX volatility from our most recent review, showing volatility of monthly returns over three-year rolling windows:



Currency volatility levels, though different by currency pair as well as fluctuating over time, is always substantially higher than the volatility of government bonds. Therefore, even if currency return patterns are different from the ones of government bonds (low correlations), keeping currency risks in a global government bond portfolio does not reduce risk. That is why developed market government bond portfolios are almost always hedged.

Developed market equity markets are modestly more volatile than FX rates. The value add of hedging international equity is not obvious. The argumentation is not quite as straightforward on the equity side. Standalone FX volatility is usually lower than the volatility of developed equity markets. That fact by itself leads one to hypothesize, that keeping currency exposures within a global equity portfolio is beneficial, and hedging them is not. We examined volatility levels of three international equity indices from the currency perspective of US Dollar, GB Pound and the Euro, comparing the alternative of hedging all FX exposures with the one, where all FX exposures stay unhedged. Perhaps surprisingly, the annualised volatility over a 20-year time frame was lower for the hedged alternatives in all three cases. However, drawing conclusion from only one data point is not wise. We therefore dove deeper, breaking down our data history into rolling five-year intervals:




Source: Morningstar; Calculations are based on MSCI World ex EMU, MSCI World ex USA and MSCI World ex UK

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Before, the Global Financial Crisis, we find hedging reduced risk for all three currency perspectives consistently, albeit modestly for US-based international equity investors. Post 2008, that consistency evaporates. Looking in the rear-view mirror, hedging resulted in significant risk reduction only for US-based international equity investors. On the contrary, the same policy would have created substantially more risk for EU-based investors; UK-based investors would have had to cope with a slight increase in risk as well.

Framing an expectation given this lack of robustness is difficult to say the least. While the jury is still out, we believe it is prudent, once hedging costs enter the decision, to avoid these costs and not hedge currency exposures for international equity portfolios.

**Footnotes:**

1 - Derivatives are contracts whose values is derived from the value of an underlying asset, such as the spot rate of a currency pair. Examples of derivatives are options, futures or forwards.

2 - Hedging is the activity of buying or selling an asset to reduce the risk of undesired price movements in a different asset.

3 - Volatility describes the variability of the return of an asset or a portfolio. It is usually measured by calculating the standard deviation or variance.

4 - Correlation describes how the returns of two assets fluctuate together. A positive correlation indicates the extent to which those increase or decrease in parallel; a negative correlation indicates the extent to which one increases as the other decreases.

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Neither asset allocation nor diversification assures a profit or protects against a loss in declining financial markets. Currency fluctuations may increase or decrease the returns of any investment.

Bonds are affected by a number of risks, including fluctuations in interest rates, credit risk and prepayment risk. In general, as prevailing interest rates rise, fixed income securities prices will fall. Bonds face credit risk if a decline in an issuer's credit rating, or creditworthiness, causes a bond's price to decline. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

The prices of real assets (for example, precious metals) tend to fluctuate widely and unpredictably, and have historically experienced periods of flat or declining prices. Prices are affected by global supply and demand, investors' expectations with respect to the rate of inflation, currency exchange rates, interest rates, investment and trading activities of hedge funds and commodity funds, and global or regional political, economic or financial events and situations.

REITs investing risks are similar to those associated with direct investments in real estate: lack of liquidity, limited diversification and sensitivity to economic factors such as interest rate changes and market recessions.

The indices are unmanaged, are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include expenses, fees or sales charges, which would lower performance.

International investing entails greater risk, as well as greater potential rewards compared to investing in your local stock market. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets, since these countries may have relatively unstable governments and less established markets and economics.

Investing in smaller companies involves risks not associated with more established companies, such as business risk, significant stock price fluctuations and illiquidity.

Interest on municipal bonds is generally exempt from US federal income tax; however, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax exemption applies if securities are issued within one's state of residence; if applicable, local exemption applies for issues within one's city of residence.

The initial interest rate on an inflation-linked security may be lower than that of a fixed rate security of the same maturity because investors expect to receive additional income due to future increases in CPI. However, there can be no assurance that these increases in CPI will occur.

Changes in exchange rates may have an adverse effect on the value, price or income of foreign currency denominated securities.

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