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Currencies and the U.S. investor:

SMOOTHING THE RIDE

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- In their heads, many U.S. investors realize there's a world of potential opportunity in international stocks. But in their hearts, they are often reluctant to embrace it, fearing the potential for volatility
- That's because when U.S. investors buy a non-U.S. stock, they get a package deal — exposure to the stock in its own home market, and exposure to the currency of that home market
- Isolating — and hedging — the currency component of international stock investing can meaningfully reduce its contribution to volatility. For income-driven U.S. investors, this can be especially useful

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In their heads, many U.S. investors realize there's a world of potential opportunity in international stocks. But in their hearts, they are often reluctant to embrace it, fearing the potential for volatility.

One of the concerns feeding into this is the impact of currency exchange rates on the value of their investments abroad. Shifts in the relative value of the U.S. dollar versus other currencies can indeed add volatility to the returns — and income — for U.S. investors.

That's because when U.S. investors buy a non-U.S. stock, they get a package deal — exposure to the stock in its own home market, and exposure to the currency of that home market — the euro, the Japanese yen, the British pound, or others.

U.S. investors vs. U.K. stocks in 2016: up, but down

U.S. investors in U.K. stocks learned this lesson the hard way during the first half of 2016. Whether measured in U.S. dollars or British pounds, the U.K. equity market was relatively tranquil until the beginning of June. But in spite of the unexpected outcome of the U.K. "Brexit" referendum, the U.K. market rose 9.4% in 2016.[1]

But U.S. investors have had quite a different outcome so far. Because the British pound fell markedly after the referendum, U.S. investors, whose returns are naturally measured in U.S. dollars, actually lost -2.4% during the same period. The figure below shows the results in graphic form.

Commotion between the oceans

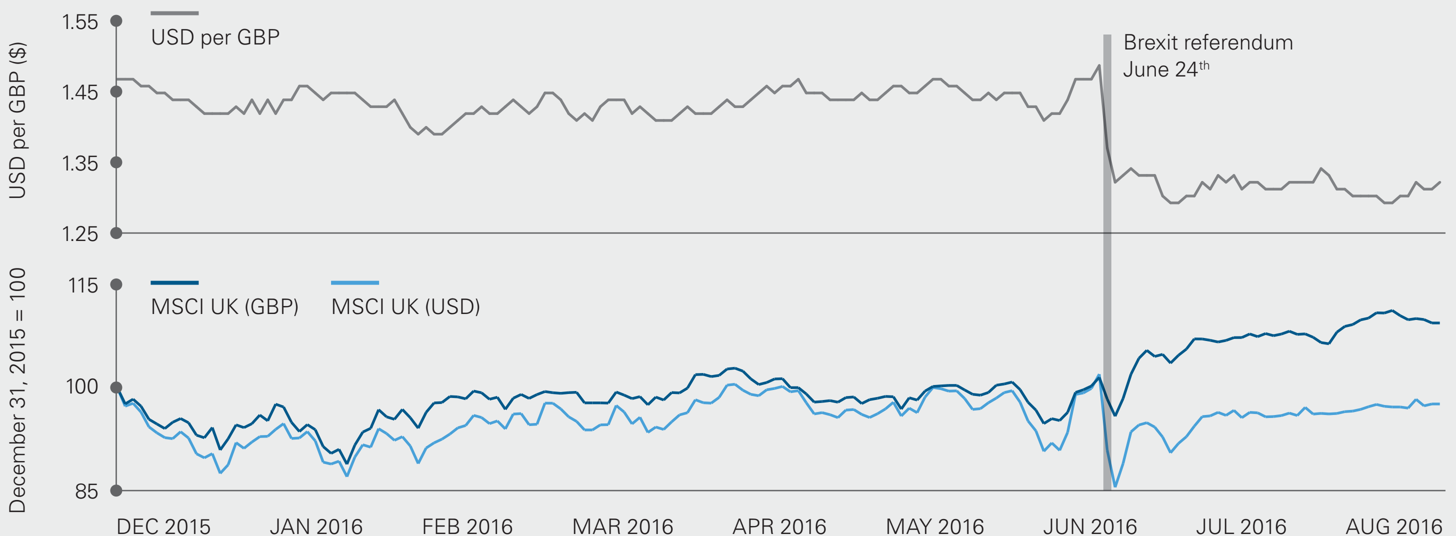
Beyond the performance differential, U.S. investors venturing abroad tend to be wary of market volatility. In fact, currency exchange rates are one important reason for this.

Wariness about exchange rates is particularly important for two types of investors: seekers of income and avoiders of volatility. For income investors, currency swings can lower the amount of U.S. dollar income as the U.S. dollar appreciates vs. other currencies. That's particularly important because income investors may find the higher dividends available in certain European sectors such as telecoms and utilities to be the primary appeal of investing abroad. At the same time, retirees can ill afford any loss of income due to currency fluctuations.

Currencies present a special challenge to investors seeking lower volatility. A successful low-volatility strategy, when applied to non-U.S. equities, can potentially reduce overall portfolio volatility to the point that it's lower than the volatility of currency markets. But unless currency volatility is also reduced by hedging, currency volatility can more than cancel out the potential benefit of reduced volatility in the underlying equities.

Taking a pounding: U.S. dollars per British pound

January 1, 2016–August 22, 2016



Source: Bloomberg, as of August 22, 2016. **Past performance is no guarantee of future results.** An investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

[1] Source: Bloomberg, as of August 22,2016.

A special risk: the flight to safety

U.S. investors in non-U.S. markets face a unique risk — paradoxically — thanks to the relative stability and reliability of the U.S., its government bonds, and its currency. In times of crisis, the world's investors have flocked to U.S. Treasuries and other U.S. dollar assets, including real estate, and private investments, thereby boosting the U.S. dollar. This means suffering a double blow for U.S. based investors with non-U.S. assets during a global market drawdown, due to both local share price drops and to the rise of the U.S. dollar in times of crisis.

This global "flight to quality" isn't new, but it's been felt acutely in recent years during the 2008 financial meltdown, and via European crises triggered by Greece, Cyprus, Russia, Italy, Spain and other so-called "peripheral" economies. Capital even flowed toward the U.S. following the downgrade of U.S. sovereign debt — Treasuries themselves — during the 2011 budget crisis. The figure below shows the movement of the trade-weighted U.S. dollar during several major market-related events over the past ten years.

For U.S. investors, this special status suggests that hedging away the risk of non-U.S. currencies could open the door to participating in economic recovery elsewhere in the world without taking on this additional risk. This means sometimes missing out on unexpected gains. For instance, currency hedging would have deprived U.S. investors of the returns to be had by the recent appreciation of the Japanese yen against the U.S. dollar. For those with tactical views on currencies, or who believe in a potential long-term secular decline of the U.S. dollar, there are certainly strategies designed to take advantage of these kind of changes. However, for those simply looking to benefit from the potential appreciation and income available in non-U.S. stocks, the ability to limit risk can potentially outweigh the possible windfalls from currency shifts that can arise along the way.

Conclusion: the risk not taken

One of the most important decisions facing U.S. investors looking to capitalize on the world beyond its borders is how to understand the risks as well as the potential rewards of "going global." Some of those risks could be well worth taking for certain types of investors — who are willing to face the prospect of volatility as a cost of doing business abroad. But for investors seeking to minimize volatility while still participating in the rest of the world, seeking out strategies that invest in the expertise needed to hedge the volatility of currencies could well be worthy of consideration.

The flight to safety: The trade-weighted U.S. dollar and financial crises

Dollar strengthens in response to bad news — U.S. dollar index, January 2006–August 2016

Source: Bloomberg, as of August 29, 2016. **Past performance is no guarantee of future results.** An investor cannot invest directly in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges. This information is provided for illustrative purposes only and does not reflect the performance of an actual investment.

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