# Protect Your Foreign Investments From Currency Risk

**by Cathy Pareto,CFP®, AIF® (Contact Author | Biography)**

Investing in foreign securities, while a good thing for your long-term portfolio, continues to pose new threats for investors. As more people broaden their investment universe by expanding into foreign stocks and bonds, they must also bear the risk associated with fluctuations in exchange rates.

Fluctuations in these currency values, whether the home currency or the foreign currency, can either enhance or reduce the returns associated with foreign investments. Currency plays a significant role in investing; read on to uncover potential strategies that might downplay its effects. (For background reading, see *Forces Behind Exchange Rates*.)

**Pros of Foreign Diversification**

There is simply no doubting the benefits of owning foreign securities in your portfolio. After all, modern portfolio theory (MPT) has established that the world's markets do not move in lockstep and that by mixing asset classes with low correlation to one another in the appropriate proportions, risk can be reduced at the portfolio level, despite the presence of volatile underlying securities. As a refresher, correlation coefficients range between −1 and +1. Anything less than perfect positive correlation (+1) is considered a good diversifier. The correlation matrix depicted below demonstrates the low correlation of foreign securities against domestic positions. (For related reading, see *Modern Portfolio Theory: An Overview* and *Modern Portfolio Theory Stats Primer*.)

**Monthly Correlations 1988 to 2006**

| Security Type | S&P 500 Index | Russell 2000 Index | Russell 2000 Value | MSCI EAFE | International Small Cap | International Small Cap Value | MSCI Emerging Markets |
|---|---|---|---|---|---|---|---|
| **S&P 500** | 1 | – | – | – | – | – | – |
| **Russell 2000** | 0.731 | 1 | – | – | – | – | – |
| **Russell 2000 Value** | 0.694 | 0.927 | 1 | – | – | – | – |
| **MSCI EAFE** | 0.618 | 0.532 | 0.487 | 1 | – | – | – |
| **International Small Cap** | 0.432 | 0.466 | 0.414 | 0.857 | 1 | – | – |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **International Small Cap Value** | 0.41 | 0.411 | 0.414 | 0.831 | 0.97 | 1 | - |
| **MSCI Emerging Markets** | 0.59 | 0.634 | 0.586 | 0.582 | 0.53 | 0.512 | 1 |

Source: Dimensional Fund Advisors

Combining foreign and domestic assets together tends to have a magical effect on long-term returns and portfolio volatility; however, these benefits also come with some underlying risks. (For related reading, see *Broadening The Borders Of Your Portfolio*.)

**Risks of International Investments**

Several levels of investment risks are inherent in foreign investing: political risk, local tax implications and exchange rate risk. Exchange rate risk is especially important, because the returns associated with a particular foreign stock (or mutual fund with foreign stocks) must then be converted into U.S. dollars before an investor can spend the profits. Let's break each risk down.

- ***Portfolio Risk***
  The political climate of foreign countries creates portfolio risks because governments and political systems are constantly in flux. This typically has a very direct impact on economic and business sectors. Political risk is considered a type of unsystematic risk associated with specific countries, which can be diversified away by investing in a broad range of countries, effectively accomplished with broad-based foreign mutual funds or exchange-traded funds (ETFs).

- ***Taxation***
  Foreign taxation poses another complication. Just as foreign investors with U.S. securities are subject to U.S. government taxes, foreign investors are also taxed on foreign-based securities. Taxes on foreign investments are typically withheld at the source country before an investor can realize any gains. Profits are then taxed again when the investor repatriates the funds.

- ***Currency Risk***
  Finally, there's currency risk. Fluctuations in the value of currencies can directly impact foreign investments, and these fluctuations affect the risks of investing in non-U.S. assets. For example, let's say your foreign investment portfolio generated a 12% rate of return last year, but your home currency lost 10% of its value. In this case, your net return will be reduced when you convert your profits to U.S. dollars. But the reverse is also true; if a foreign stock declines but the value of the home currency strengthens sufficiently, the loss may be averted or otherwise minimized. (For more on this topic, see *Floating And Fixed Exchange Rates*.)

**Minimizing Currency Risk**

Despite the perceived dangers of foreign investing, an investor may reduce the risk of loss from fluctuations in exchange rates by hedging with currency futures. Simply stated, hedging involves taking on one risk to offset another. Futures contracts are advance orders to buy or sell an asset, in this case a currency. An investor expecting to receive cash flows denominated in a foreign currency on some future date can lock in the current exchange rate by entering into an offsetting currency futures position. (For more insight, read *Getting Started In Foreign Exchange Futures*.)

In the currency markets, speculators buy and sell foreign exchange futures to take advantage of changes in exchange rates. Investors can take long or short positions in their currency of choice depending on how they believe that currency will perform. For example, if a speculator believes that the euro will rise against the U.S. dollar, he or she will enter into a contract to buy the euro at some predetermined time in the future. This is called having a long position. Conversely, you could argue that the same speculator has taken a short position in the U.S. dollar.

There are two possible outcomes with this hedging strategy. If the speculator is correct and the euro rises against the dollar, then the value of the contract will rise too, and the speculator will earn a profit. However, if the euro declines against the dollar, the value of the contract decreases.

When you buy or sell a futures contract, as in our example above, the price of the good (in this case the currency) is fixed today, but payment is not made until later. Investors trading currency futures are asked to put up margin in the form of cash and the contracts are marked to market each day, so profits and losses on the contracts are calculated each day. Currency hedging can also be accomplished a different way. Rather than locking in a currency price for a later date, you can buy the currency immediately at the spot price instead. In either scenario, you end up buying the same currency, but in one scenario you do not pay for the asset up front.

**Investing in the Currency Market**

The value of currencies fluctuates with the global supply and demand for a specific currency. Demand for foreign stocks is also a demand for foreign currency, which has a positive effect on its price. Fortunately, there is an entire market dedicated to the trade of foreign currencies called the foreign exchange market (forex for short). This market has no central marketplace like the New York Stock Exchange; instead, all business is conducted electronically in what is considered one of the largest liquid markets in the world. (For more, see *A Primer On The Forex Market*.)

There are several ways to invest in the currency market, but some are riskier than others. Investors can trade currencies directly by setting up their own accounts or they can access currency investments through forex brokers.

However, margined currency trading is an extremely risky form of investment and is only suitable for individuals and institutions capable of handling the potential losses it entails. In fact, investors looking for exposure to currency investments might be best served acquiring them through funds or ETFs − and there are plenty to choose from. Some of these products make bets against the dollar − some bet in favor, while other funds simply buy a basket of global currencies. For example, you can buy an ETF made up of currency futures contracts on certain G10 currencies, which can be designed

to exploit the trend that currencies associated with high interest rates tend to rise in value relative to currencies associated with low interest rates. Things to consider when incorporating currency into your portfolio are costs (both trading and fund fees), taxes (historically, currency investing has been very tax-inefficient) and finding the appropriate allocation percentage.

**Conclusion**

Investing in foreign stocks has a clear benefit in portfolio construction. However, foreign stocks also have unique risk traits that U.S.-based stocks do not. As investors expand their investments overseas, they may wish to implement some hedging strategies to protect themselves from ongoing fluctuations in currency values. Today, there is no shortage of investment products available to help you easily achieve this goal.

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