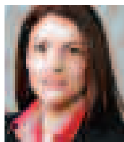
Coin tossing



ANNE-SOPHIE GIRAULT INVESTIGATES WHETHER CURRENCY MATTERS.

Executive summary

- The track record for currency-exchange forecasting is poor, as can be seen by the recent consensus view of the dollar's prospect.
- Asset allocation to currency-exchange forecasting is likely to be a waste of time, or worse.
- Myths surround currency hedging. Companies need to assess how vulnerable assets and earnings are to exchange volatility.

Treasurers can realistically enhance value for their companies in two areas: balancing the benefits of reserving debt capacity for future financing needs against associated costs, and understanding when risks are worthwhile to hedge.

Should currency issues influence your asset allocation or the way you invest? Recent currency volatility has had a significant impact on portfolio performance and, in some cases, can help to explain the difference between outperformance and underperformance. Is it time to call the currency strategist?

IT'S A TOUGH JOB TO BE A CURRENCY STRATEGIST In December 2004, the consensus view was that the US dollar would weaken against the euro (to 1.32 by the end of December 2005[1]) primarily as a result of the US's large current account and budget deficits. The past 12 months have proved this consensus forecast completely wrong. Instead, the US dollar actually strengthened against the euro, reaching 1.18 by the end of 2005 (see *Chart 1*).

However, since the beginning of 2006, the dollar has weakened significantly – from 1.18 to 1.24 (as at 24 April). Furthermore, the dollar is expected to continue on a downward trend and fall further to reach 1.27 against the euro by April 2007[2]. This belief reflects several factors weighing on the US currency: these include the usual suspects, such as the US's twin record deficits, but also the anticipated end of the monetary tightening cycle by the US Federal Reserve and the declining GDP growth differential between the US and Europe.

So how much weight should investors give to currency calls? In

fact, the track record for currency-exchange forecasts looks poor. On average, such forecasts have tended to be inaccurate. Furthermore, the direction of the call is often also wrong.

This phenomenon was summarised by Alan Greenspan during his speech on the US current account in March 2004. He said: "Despite extensive efforts on the part of analysts, to my knowledge, no model projecting directional movements in exchange rates is significantly superior to tossing a coin. I am aware that of the thousands who try, some are quite successful. So are winners of coin-tossing contests." He then concluded: "My experience is that exchange markets have become so efficient that virtually all relevant information is embedded almost instantaneously in exchange rates to the point that anticipating movements in major currencies is rarely possible."[3]

In the light of Greenspan's comments, allocating assets according to currency-exchange forecasts is likely to be a waste of time at best, a costly mistake at worst. So if predicting currency movements is virtually impossible, should investors aim at least to neutralise the impact of exchange volatility on the performance of their investments?

MYTHS AND REALITIES OF CURRENCY HEDGING Investing outside local markets offers investors the well-known benefits of diversification but also introduces a currency risk. Indeed, the return on an international asset is equal to the return of the asset plus or minus the currency impact.

One of the market's strongest beliefs is that currency risk evens itself out and, as such, currency hedging may not only be unnecessary but also costly. However, over the short term, currency volatility can have an undeniable impact on investment's performance. To take a recent example, since the beginning of the year, the MSCI Europe (a benchmark for global index providers) has risen by 9.0%, 10.0% and 14.2% in euro, sterling and dollar terms respectively[4].

A study by ABN Amro and the London Business School looking at 106 years of investment showed that over the short term, for investors concerned with volatility, there may be scope for hedging currency exposure[5]. However, this would be an entirely different matter when investing in assets that require a longer investment horizon (such as property or equities, for example). Indeed, this study showed that for long-term investors, foreign exchange hedging mitigates downside risk by no more than a small margin.

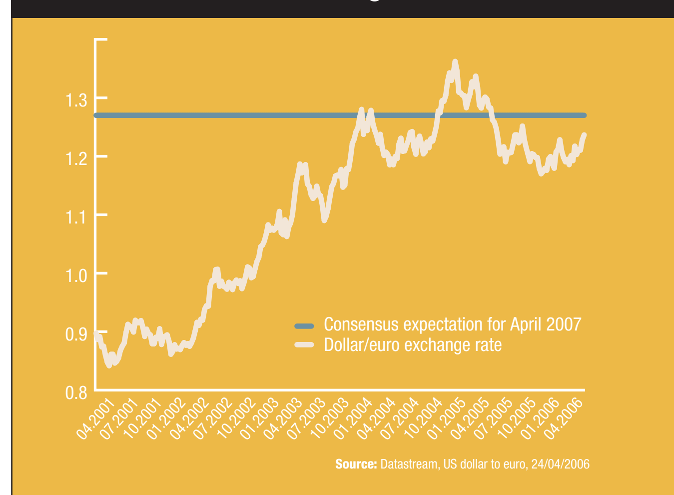
Steve Buller, Portfolio Manager of Fidelity's Global Property Fund, says: "We would argue investors should own property for a long period of time, and, if you do, the currency pros and cons to any particular period should negate themselves over this period of time."

Overall, in the long run, stock-market risk is reduced more effectively through international diversification than by currency hedging.

Finally, currency hedging is often considered to be a costly practice. Although this may have been true several years ago, transaction costs are now low as a result of the greater liquidity and transparency in these markets, leaving a forward premium/discount (the result of interest rate differentials) that can be either positive or negative. In fact, some fund managers hedge currency exposure back to the base currency of their portfolios. This ties in with the fact that the investment horizon for fixed-income assets tends to be shorter than for equities or property.

So while currency hedging makes sense for fixed-income investors, and more generally speaking for short to medium-term investors, without costing too many performance basis points, it does not add significant value for long-term investors, in particular for those investing in equity or property.

Chart 1. Dollar/Euro Exchange Rate



Source: Datastream, US dollar to euro, 24/04/2006

EQUITY INVESTORS: KNOW WHAT YOU OWN While the long-term equity investor has little incentive to hedge currency exposure, the performance of underlying stocks may be affected by currency issues. How much are anticipated movements in the exchange rate encapsulated in equity valuations and stock performances? For instance, European equities tend to do better when the dollar strengthens. This is partly because European exporters benefit from the currency effect. Additionally, currency volatility also affects companies' balance sheets and profits through the transaction costs that arise when a company generates revenues and has costs in different currencies. Indeed, only a few companies have 100% of their cost-base and 100% of their turnover generated in their own domestic market.

Fortunately, analysts covering individual companies are in a good position to understand a company's currency exposure and risks, and the impact that changes in exchange rates can have on the company's assets and earnings. For example, how much of the production is sold outside the domestic market? How vulnerable are the earnings or the value of the company's assets to volatile currency rates? How does the company hedge its currency exposure?

These are some of the questions the analyst takes into account when assessing the risk/opportunity of individual stocks. During times of currency volatility, these issues can make a significant difference in the earnings published and, ultimately, in the stock performance. After all, as much as 60% of FTSE 100 earnings are generated outside of the UK[6].

1 Consensus Forecasts, 6 December 2004
2 Consensus Forecast, 10 April 2006
3 Remarks by Chairman Alan Greenspan to the Economic Club of New York, 2 March 2004
4 RIMES, MSCI price index, 24 April 2006
5 Global Investment Yearbook 2006, Elroy Dimson, Paul Marsh and Mike Staunton, London Business School, and Rolf Elgeti, ABN Amro
6 www.aitc.co.uk/press_centre, 13 July 2005

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