

Managing Currency Risk: As an American Abroad, In What Currency Should I Save and Invest?



Introduction

Currency issues are often one of the most vexing and least well understood issues for investors. This is especially true for Americans abroad whose salaries and other income sources are often denominated in currencies other than U.S. Dollars (USD). The good news is that understanding how to properly incorporate currency considerations into a sound, long-term investment strategy is much easier than commonly understood. In this note we pull back the opaque veil of “currency risk” that clouds investment and financial planning decisions for Americans abroad. We sketch a few, easy to understand principles that all investors can use to guide choices around currency denomination of savings and investment. We then offer a practical guide on how and where investors can go to construct a globally diversified, multi-currency investment portfolio.

What is “currency risk” in investing and financial planning?

Generating good long-term investment results necessarily requires us to assume some risk. As investors, however, our goal should be to maximize investment returns without taking on more risk than is necessary to achieve those returns.

About Thun Financial Advisors

Thun Financial Advisors, L.L.C. is a U.S.-based, fee-only, Registered Investment Advisor that provides investment management and financial planning services to Americans residing in the U.S. and overseas. We maximize long-term wealth accumulation for our clients by combining an index allocation investment model with strategic tax, currency, retirement and estate planning. We guard our clients’ wealth as though it was our own by emphasizing prudent diversification with a focus on wealth preservation and growth.

Thun Financial Advisors, LLC
313 Price Place, Madison, WI 53705

608-237-1318
Skype: thunfinancial
www.thunfinancial.com

Large swings in currency exchange rates are one of the risks of investing. When we invest hard-earned savings into a portfolio of long-term investments of stocks, bonds and other kinds of investments, we expect to benefit from the anticipated long-term appreciation of those investments. Unfortunately, good investment results can be diminished or completely reversed by changes in the exchange rate between the currency denomination of our investments and the currency in which we pay our bills, educate our child, and retire. This is what we call “currency risk.”

Reducing currency risk without giving up return potential

Currency risk can be reduced or eliminated without having to settle for lower investment returns. The key to successful management of currency risk is to focus on matching what we call “life assets” and “life liabilities.” What do these terms mean?

Life Assets are financial investments and other assets that we accumulate through saving and investing (typically during our working years) with the expectation of drawing them down later in life.

Life Liabilities are the big expenses we expect to incur over our lifetimes such as buying a house, paying for a child’s education and, ultimately, retiring. We expect to pay these expenses by selling the “life assets” we have accumulated.

Both these “assets” and “liabilities” have a currency denomination. Stocks are denominated in the home country currency of

the issuer (hence IBM shares are USD denominated and Siemens shares are euro denominated). Bonds, of course, have the currency denomination of whatever currency in which they promise to pay their interest and redeem their principle. Some assets, most notably commodities and gold, are not denominated in any currency; they are freely traded in many different markets and currencies around the world and their value is not linked to any particular country’s currency.

Americans abroad are most likely to find themselves suffering under the negative impact of currency risk when “life assets” accumulated to fund “life liabilities” are denominated in different currencies. As a simple example, we might imagine an American expat family in the UK that buys a five-year CD yielding 4% compounded in USD to fund their daughter’s first year of study at a British or American university. The daughter will begin at university in five years. At that time, the USD CD will have compounded to produce a 22% return. However, if in the meantime, the British Pound (BPS) has appreciated 22% against the USD, the investment gain in terms of BPS will be zero.

The appreciation of the pound against the dollar will have no negative consequences for the family’s university savings plan if the daughter attends a U.S. university. The investment will still have generated 22% more “university expense” buying power at the end of five years. Unfortunately, if the daughter chooses a U.K. university, where tuition and other expenses will have to be paid in BPS, the appreciation of the pound over the five years will effectively offset the increase in the value of the USD CD investment. As a result, the actual buying power of the investment,

measured in BPS, will be the same at the end of the five years as it was at the beginning of the five years.

This example makes it clear that if the family had known in advance that their daughter would be attending a UK university, they would have wanted to purchase a BPS 4% 5-year CD. If they had done so, they would have made an investment that provided 22% more “university expense” buying power in the UK. The appreciation of the pound against the dollar would have had no impact on their university savings plan.

In this case, the two CDs were fundamentally different investments. The investment “asset” needed to be “matched” with the university expense “liability” and if this had been done correctly, currency risk would have been eliminated from the family’s university savings plan.

From this stylized education savings example we can extrapolate to an expat family’s entire financial life. Thinking through the currency denomination of all our “life liabilities” is the starting point for choosing the currency denomination of our investment portfolios. It follows, therefore, that if we expect to live in Europe for five years on an expat assignment but then return to the U.S. where we will live the rest of our lives, educate our child and retire, then our investment “assets” should be primarily USD denominated. Our investment portfolio should be heavily oriented towards U.S. stocks and bonds, even though we are temporarily living in Europe. In this way we are matching our “liabilities” with our “assets.” On the other hand, if we expect to remain permanently in Europe, then our “liabilities” will be primarily euro denominated, and we therefore need to anchor our investment

portfolio around euro denominated stocks and bonds. In both scenarios, however, a properly diversified portfolio will still include significant investments in both euros and USD.

Hedging against an uncertain geography

Of course it is quite common today for many international individuals and families to have no clear idea where they will end up or how long they will be there. In such cases, we have to make projections based on the most likely possible scenarios and then build a portfolio that is still highly diversified across a variety of currencies so that our career and retirement decisions are not constrained by large changes in relative currency valuations. We want to avoid being “tied” to one currency if our geographical future, and hence also our “life liabilities,” are uncertain.

But do I not need to protect myself from a declining dollar?

We often hear Americans abroad express deep skepticism about the outlook for the Dollar. As a result, they often seek out “currency” investment schemes that promise profit for the investor in the event that the dollar declines. When analyzing such schemes, however, it is extremely important to understand that currencies, unlike stocks or bonds, are a zero sum investment game: for one currency to appreciate, another one must depreciate. Betting on currencies, therefore, is truly akin to gambling because the random odds are that you will lose more than half the time once the middleman (the broker selling you the “currency” investment) has taken his cut. Investments in stocks and bonds, on the other

hand, all tend to appreciate over time. For one stock to go up, another one does not have to go down.

Furthermore, we caution against taking any strong view about “inevitable” outcomes in the currency market. Currency valuations are extremely hard to predict and are determined in large part by many random and unknowable future economic outcomes. It is wiser to structure your currency exposure using the framework of “assets” and “liabilities” outlined above. If the dollar does go into a period of long decline and you are planning on living in Europe, a proper euro centered portfolio of investments will protect you. On the other hand, if you are returning to the United States, then you will find that you are relatively insulated from the decline of the dollar by virtue of the fact that most of the goods and services you will be purchasing will be dollar denominated and therefore the decline of the dollar will have very little impact on your real economic circumstances.

How to build a diversified, multi-currency investment portfolio: the practical issues

So far, so good. We have identified the idea of “matching assets to liabilities” as a logical, systematic framework from which we can determine the proper currency mix needed in our investment portfolio. But are not multi-currency portfolios the exclusive realm of the ultra-wealthy who have accounts all around the globe? Do we have to open up investment accounts in the U.S. AND Europe or buy complicated currency hedging products, such as futures or swaps? Or do we need to employ the help of an expensive Swiss investment bank which can buy securities on any global exchange

and in any currency, do all the required currency conversions and simultaneously report in three or more different currencies?

The answer to these questions is categorically NO. The globalization of finance and the development of highly efficient and inexpensive investment tools such as Exchange Traded Funds (ETFs) allow us to build a fully diversified, multi-currency portfolio right in our IRA or brokerage account at any of the big U.S. brokerage firms, such as Charles Schwab, Fidelity or E*Trade. For Americans, not only is this much less costly and complex option now fully viable, but for reasons having to do primarily with U.S. tax law, it is absolutely imperative that American citizens do all their investing through U.S. financial institutions (on this point, see the Thun Research report *Six Reasons Americans Abroad Should Keep Their Money On-Shore and in the U.S.*, available at www.thunfinancial.com).

Investors often confuse the currency denomination of their brokerage firm account statement or even the currency denomination of a mutual fund or ETF that they own in the account with the currency exposure of their actual investments. But the currency denomination of the account statement or even the fund itself is irrelevant. It is merely a convenience for the exchange where the ETF is traded or for the brokerage firm that does not want to report in more than one currency. The investor’s actual currency exposure is determined by the underlying investments in the account or held by the fund or ETF owned through the account.

Example: Two different currencies, two different exchanges, same investment

Let's consider the example of an American investor living in Denmark who wants to buy a basket of European stocks as a long-term euro denominated stock market investment. A European broker might advise him to buy the Dublin, Ireland listed, euro-denominated ETF, ticker symbol EUE. EUE invests in a basket of stocks based on the EURO STOXX 50 Index (50 large European companies). That would indeed give the investor solid exposure to a well diversified list of top European company shares.

However, the American investor could also have taken his money, converted it to dollars and through a U.S. broker bought a virtually identical investment: a New York listed, dollar denominated ETF, ticker symbol FEZ. FEZ is based on the same EURO STOXX 50 Index and therefore holds the same basket of European company stocks.

In this case, even though the ETFs are denominated in different currencies, the underlying investments held by the two ETFs are identical and have the same currency denomination (euro). The currency denominations of the ETFs are just a convenience for the New York or Dublin exchanges. It does not change the currency denomination or any other characteristics of the underlying investments held by the ETFs. Therefore, the performance of the investments will also be identical. To compensate for the change in exchange rate, the returns of each ETF, measured in their own currency, will differ by an amount exactly equal to the change in the exchange rate. Hence, owning either the euro denominated ETF or the USD denominated ETF will result in an equivalent investment return. (It is important to recognize that this is in

contrast to the CD example provided earlier. In that example, the underlying investments, the CDs themselves, were denominated in different currencies and hence were fundamentally different investments and had different investment outcomes.)

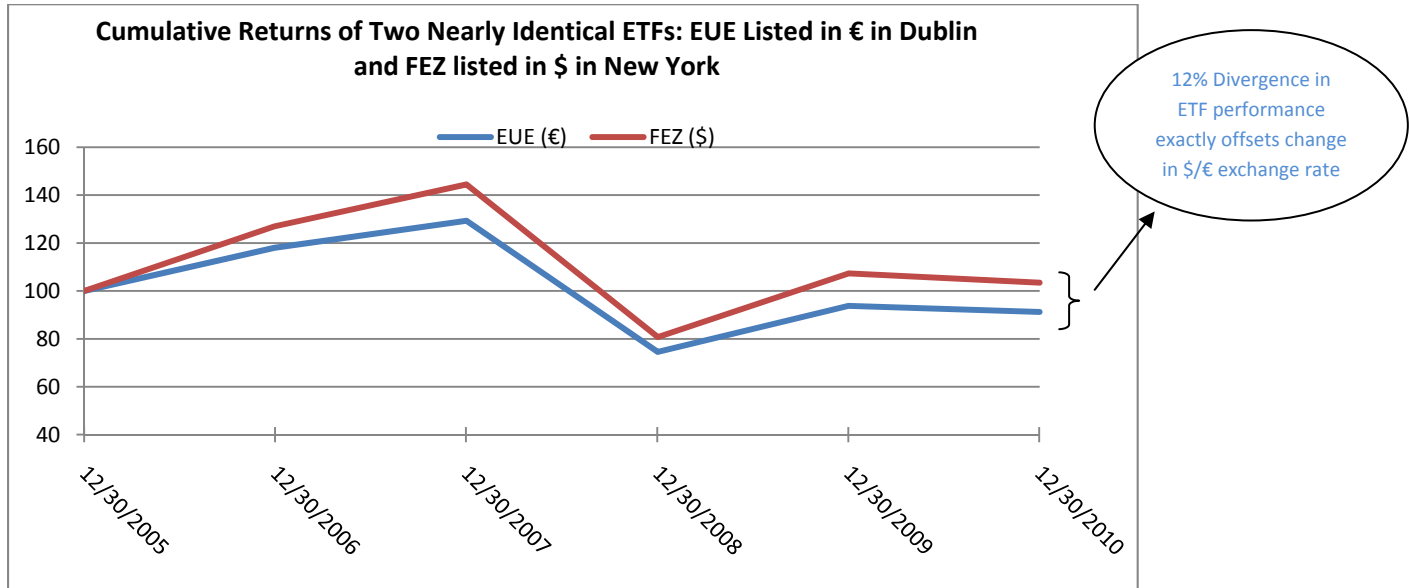
To demonstrate this conclusion, we tracked the performance of the two funds over the period December 31, 2005 to December 31, 2010. We found that FEZ (the USD ETF) gained a total of 3.4% while EUE (the Euro ETF) lost 8.7% (see figure 1). That is to say that the USD denominated FEZ outperformed its euro cousin, EUE, by 12% over the period. Over the same period, the USD declined 12% against the euro (from 1.18/€ to 1.32/€). Therefore, the investment performance difference between the two funds is exactly offset by the change in the currency over the period. At the end of the period, both investments are worth precisely the same amount, whether expressed in USD or euros. Hence, it made no difference from an investment performance point of view if the investor bought the euro ETF from a European broker or the USD ETF from a U.S. broker. This result is what we expected, for reasons discussed above. We reiterate that what matters is not the currency denomination of the ETF, but the currency denomination and nature of the investments held by the ETF.

Likewise we would find the exact same result if we compared a European stock that lists both in Europe and the U.S., as most major stocks do. For example if we look at the shares of British Petroleum (BP) we will see that the difference in performance between London listed BP shares and the New York listed BP shares exactly matches the change in the value of the pound versus the dollar over the period examined. Again, we see that it does not

matter whether you pay BPS to buy a British stock on a UK exchange or pay USD to buy the same British stock on an American exchange.

The investment outcome is identical because the underlying investments are identical.

Figure 1



Data source: Ishares and State Street Global Advisors

Enter tax considerations and investment expenses

While ETFs that invest in the same underlying securities will generate the same return on investment no matter what the currency denomination of the ETF itself is, the tax and compliance costs make the purchase of the euro-denominated European stock ETF a much worse investment choice for American investors. For better or for worse, U.S. tax and reporting rules make the *after-tax* return on investment of the Dublin listed ETF much lower for American citizens than the *after-tax* return on the New York listed EFT. Furthermore, investment costs (fund expenses and brokerage

commissions) associated with buying the European ETF will be higher or much higher in Europe than American, depending on from which country the investments are made.

Conclusion

These examples are intended to demonstrate that fully diversified, multicurrency portfolios can be easily constructed using standard U.S. investment or retirement accounts and investing in widely available, cost-efficient and liquid ETFs. Furthermore, almost all investments, no matter where the issuer is located, can be bought and sold in New York for lower cost than those same investments can be purchased in the issuer’s home country. This surprising fact is another important reason that

Americans abroad should do their investing through U.S. financial institutions, no matter what their currency exposure needs. Remember, what matters is not the fact that a

U.S. account statement lists the value of investments in USD. Rather, what matters is the nature and currency denomination of the underlying investments.

David Kuenzi, CFP®, Thun Financial Advisors
June, 2011

Copyright © 2011 Thun Financial Advisors

DISCLAIMER FOR THUN FINANCIAL ADVISORS, L.L.C., THE INVESTMENT ADVISOR

Thun Financial Advisors L.L.C. (the "Advisor") is an investment adviser licensed with the State of Wisconsin, Department of Financial Institutions, Division of Securities. Such licensure does not imply that the State of Wisconsin has sponsored, recommended or approved of the Advisor. Information contained in this brochure is for informational purposes only, does not constitute investment advice, and is not an advertisement or an offer of investment advisory services or a solicitation to become a client of the Advisor. The information is obtained from sources believed to be reliable, however, accuracy and completeness are not guaranteed by the Advisor.

The representations herein reflect model performance and are therefore not a record of any actual investment result. Past performance does not guarantee future performance will be similar. Future results may be affected by changing market circumstances, economic and business conditions, fees, taxes, and other factors. Investors should not make any investment decision based solely on this presentation. Actual investor results may vary. Similar investments may result in a loss of investment capital.