Making Sense of the Currency Effect in Foreign Equities Investing

Todd Wax, CFA | Portfolio Specialist

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In the long run, fluctuating currency exchange rates have a negligible effect on investors participating in international markets; however, in the short and intermediate terms, exchange-rate movements have a material impact on the returns for U.S. investors in international stocks. U.S. investors in international markets would be well advised to understand the impact that currency fluctuations have on their international portfolio, especially when translated back into U.S. dollars.

Executive Summary

- Investing internationally brings diversification benefits for U.S.-based investors, including currency effects.
- Currency movements have a significant impact for U.S. investors in overseas equities in the short to intermediate terms.
- Multinational companies have exposure to currency fluctuations as well, a key input that investors should consider when making decisions.
- Currency hedging can be a tool to mitigate volatility.

Nowadays, the primary benefit of international exposure for a U.S.-based investor should be widely known: portfolio diversification. But one component of it—currency exposure—isn't always given sufficient consideration.

The impact—positive or negative—of foreign exchange movements on portfolio performance can be significant. It largely depends on the time frame and whether exchange-rate volatility is mitigated with currency hedges, which can cushion the effects of swings in value of one currency against another.

In finance theory, an asset class, which is defined as a group of assets with similar attributes, is additive to portfolio construction if including it enhances the risk profile of the portfolio. When asset classes exhibit different return characteristics at different times, the empirical correlation between them is less than 100%; hence, when added together, the volatility of returns, or "risk" in finance, is reduced. That's how diversification benefits a portfolio.

For a U.S. investor, domestic stocks and international (foreign) stocks represent different asset classes. The returns characteristics of each differ, so diversification benefits are realized when the two asset classes are combined into a single portfolio.

One key component investors often overlook when investing overseas is currency. When U.S. investors buy foreign stocks, they are essentially making two investments, often without realizing it: the obvious investment in the stock itself, and secondly, the less obvious investment in the currency in which the foreign stock is denominated. In other words, the local shares that trade on the other country's stock exchange and the local currency in which those shares are denominated.

The U.S. investor will receive the stock returns: the share price movement from purchase coupled with dividends paid, as well as the local currency exchange rate movement vis-à-vis the U.S. dollar. This currency return via exchange rate movement represents an important component of investing internationally.

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Take a look at the returns data in ***Table 1*** for periods of relative outperformance between a standard international benchmark (MSCI EAFE Index) and a standard U.S. benchmark (S&P 500 Index) showing total excess return performance and how much of that excess return was driven by exchange rate movements (currency returns).

Point-to-point over the almost 45-year period, currency return ended up not making a large difference for the U.S. investor, with alternating periods of favor for both the local currency and the U.S. dollar. However, currency return via exchange-rate movements clearly matters in the short- to medium-term periods.

Investors Can Draw Several Conclusions

1. Domestic and international markets tend to go through multi-year periods of relative favor.
2. Because there are clear periods of favor, the diversification benefit of owning both is evident.
3. Currency movement is a significant driver of the relative favor trends in the medium term (such as the periods above).
4. Over the long term, currency movement has less impact.

Long-run Currency Effect a Wash

Many factors affect currency exchange rates, including inflation and interest rate differentials between countries, and terms of trade as well as countries' respective balance of payments, government debt and fiscal balance, political stability, and economic resources and robustness. Many academics argue that all of these can help forecasters project long-run currency equilibrium exchange rate trends. In reality, in the short to medium term, exchange-rate movements can be extremely difficult to predict.

Prudent investors understand this, and the reality that the short- and medium-term exchange-rate movements affect domestic currency-based returns when investing in foreign stocks.

Currency and Companies with Cross-Border Transactions

Not only do exchange-rate dynamics affect the end investor in foreign stocks, it also affects the multinational companies in which we invest.

For example, a multinational manufacturing company headquartered in Germany, where the economy is largely driven on exports, is listed on the

Table 1 | MSCI EAFE vs. S&P 500 Index Return Data

FROM	TO	OUTPERFORMER	BY	CURRENCY COMPONENT	OUTPERFORMANCE FROM CURRENCY
4/30/71	3/31/73	MSCI EAFE	62.2%	29.8%	48.0%
3/31/73	10/31/76	S&P 500	30.5%	7.9%	26.0%
10/31/76	10/31/80	MSCI EAFE	90.0%	58.1%	64.6%
10/31/80	10/31/82	S&P 500	34.1%	30.4%	89.1%
10/31/82	2/28/89	MSCI EAFE	409.2%	251.7%	61.5%
2/28/89	8/31/00	S&P 500	493.9%	25.7%	5.2%
8/31/00	11/30/07	MSCI EAFE	60.5%	47.0%	77.7%
11/30/07	12/31/16	S&P 500	80.9%	23.1%	28.5%

Data Source: Morgan Stanley and Morningstar Direct

The performance data quoted represents past performance; it does not guarantee future results.

Frankfurt Stock Exchange. Its shares are denominated in euros. Assume its manufacturing and administrative expenses both occur in Germany; therefore, a large portion of costs are euro denominated. The company sells its products globally, with a revenue base comprised of the euro, U.S. dollar, Japanese yen, British pound, Canadian dollar, and Chinese yuan, all driven by the economics of the non-local customer. So it has revenue exposures to foreign currencies, which are translated back into its reporting currency, the euro. Therefore, the company is exposed to exchange-rate movements in its business operations.

Say the euro depreciates versus the U.S. dollar. The company's goods just became more affordable for dollar-based customers, driving revenue higher from U.S. dollar customers on revenue exposure to the strengthening greenback. That increases the company's earnings. Investors generally understand that exporting companies benefit from a weakening local currency, while the opposite is true for importing companies, as their purchasing costs increase, and negatively affect earnings.

Conversely, assume the euro appreciates versus the dollar. The company's products are now more expensive for its dollar-based customers, resulting in lower dollar sales and a negative earnings impact.

What can a company do to smooth the risk of this currency exposure? Multinational companies often dampen this risk by employing business operations exposed to the same currencies or financially via currency hedges.

In the example, the company knows that it has revenue coming from U.S. dollars and can choose to lock in future exchange rates by hedging to decrease the risk of adverse exchange-rate shifts.

We have found that placing partial, cost-effective hedges on local currency when we view near-term vulnerability aids in the risk-return profile of our strategy.

Many companies choose to hedge currency exposure, and many do not.

Investing in Foreign Companies

Now the perspective of the dollar-based investor of the foreign company, such as U.S. investors in mutual funds. In the first scenario, the company's earnings (and theoretically its stock price) were positively affected by the weakening euro. However, recall the foreign shareholder was making two investments: one in the stock of the foreign company and another in the company's local currency. This investor benefits from the increasing share price of the company but is negatively affected from the currency investment when translated back into the investor's home currency (U.S. dollar).

In the second scenario, the opposite was true: the investor was negatively affected by the share price performance and positively affected by the currency return.

The phenomena that stock prices do not move in lock step with exchange rates adds to the diversification benefit of investing in international stocks. Owning stocks in many different currencies implies that diversification benefits further improve.

How Do We Do It in Thornburg International Value Fund?

We run an international portfolio primarily for U.S. investors who are looking for international diversification, including non-U.S.-dollar currency exposure. We are, however, mindful that our investors are primarily U.S. dollar based, carrying U.S. dollar liabilities.

Just as some companies might hedge their currency exposure, we do as well.

We build a portfolio of international companies from the bottom-up via fundamental research. Part of our analysis includes the company's currency exposure: what currency exposure does the company have in the nature of its costs and revenues? What are the company's hedging policies? Finally, do we have a short- to medium-term view on the company's reporting currency vis-à-vis the U.S. dollar?

Due to the fact that currency is part of the investment in international stocks, we typically employ partial hedges in dynamic fashion—i.e., not as a matter of course, but when we believe foreign currency depreciation risks in relation to the U.S. dollar are present. We have found that placing partial, cost-effective hedges on local currency when we view near-term vulnerability aids in the risk-return profile of our strategy.

In Summary

There is more to international investing than simply researching and buying international stocks. Currency is an integral part of the overseas investment outcome, especially in shorter-term periods. We incorporate currency dynamics into our analysis and portfolio construction to help our clients build a robust, diversified portfolio that can offer attractive returns and a smoother ride. ■

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The MSCI EAFE (Europe, Australasia, Far East) Index is an unmanaged index. It is a generally accepted benchmark for major overseas markets. Index weightings represent the relative capitalizations of the major overseas developed markets on a U.S. dollar adjusted basis. The index is calculated with net dividends reinvested in U.S. dollars.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

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