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## Currency Risk: An Alternative View

### Executive Summary

- Most investors are susceptible to a decline in the value of their home currency. Even with allocations to alpha-oriented currency strategies, global/foreign equities, and global/foreign bonds the home-currency bias persists and a broader bias toward developed economies is embedded in the major indices.
- Currencies produce sufficient economic consequence to warrant independent consideration. We believe that a strategic approach to currency diversification focusing on non-major currencies and implemented through the purchase of intermediate duration bonds can provide an effective hedge against home-currency depreciation.

Most investors define currency risk as having exposure to investments denominated in a foreign currency. The alternative view is that investors have significant currency risk by default, as their assets are largely if not exclusively denominated in their home currency, exposing total return investors to the potential negative impacts of home currency depreciation. If one accepts this alternative view, then most investors have an enormous overweight to their home currency and should seek to diversify their portfolios to mitigate this home-currency bias.

To the extent that investors have foreign currency exposure, they generally obtain that exposure in one or more of the following ways:

- 1) Currency trading strategies
- 2) International or global equity (including real estate) portfolios
- 3) International or global bond portfolios

**Currency Trading strategies** are typically opportunistic, rather than strategic; therefore, investors may not get the effective diversification that they seek, as the investment objective is likely to be more focused on alpha generation rather than strategic diversification. While overall portfolio risk may be decreased and alpha may be increased through the implementation of a successful program, the portfolio as a whole will still likely retain a significant home-currency bias.

**International or global equity portfolios** do provide currency diversification, but the question arises as to whether or not this diversification is either effective or desirable. The potential problem with this approach is that currency allocations are typically not determined strategically, but are primarily the result of index selection, top-down decisions and/or issuer/sector selection. In each case, the allocation is generally not reflective of fundamental or technical views of currency performance in isolation; it is generally more significantly influenced by the equity view, or worse, a byproduct.

In the case of the MSCI All Country World Investable Market Index, the allocations are also heavily tilted toward the major industrialized countries. The Index itself has over 70% allocated to the US dollar, pound, yen and euro combined. Excluding the US dollar, the allocation to the remaining three currencies is still nearly 57% of the overall Index.

This leads to the question, "Are the best companies available in the best currencies?" One might believe that a Brazilian exporter will benefit greatly from a depreciating currency, but if the stock is priced in reais, the value of the investment will decline in dollar terms if the real depreciates, all else being equal. Recent experience also instructs that increased systemic volatility has been generally supportive of the dollar and the yen, and has had a negative impact on the real and other emerging currencies. Systemic volatility has also weighed heavily on global stock prices. This demonstrates the risk of foreign stock investing as both the currencies and the equities are susceptible to greater volatility risk when performance is measured in the investor's home currency.

If the exposure is strategic – there is an expressed intent to be short the US dollar versus the specified country exposure – then it is just the volatility of the equities that should be of concern. If the exposure is opportunistic, then one must accept that both equities and currencies are volatile sectors and one should perhaps reconsider the construct of the currency exposure. If the capital allocation is predicated mainly on bottom-up issuer selection by the manager, then currency allocation is likely to be a secondary consideration. Currencies offer sufficient economic consequence to warrant independent consideration. The true currency exposure of an equity portfolio is further complicated by the capital allocation decisions of the constituent corporations. To the extent that each corporation maintains unhedged capital balances around the globe (not repatriating earnings), the ultimate currency allocations can be muddled.

**International or global bond portfolios**, like equity portfolios, are often driven by the construct of the chosen index. These indices tend to be market cap-weighted and often focused on developed markets (Barclays Capital Global Aggregate Bond Index or Barclays Capital Global Sovereign Bond Index), or on the emerging markets (J.P. Morgan GBI-EM Global Diversified Index). In the former, the allocations are largely denominated in the currencies of the large industrialized countries (the majors). These would include the US dollar, euro, yen and pound. Collectively, these currency allocations account for roughly 91% of the Barclays Capital Global Sovereign Bond Index (Exhibit 1). Ex the euro, yen or \$, the remaining currencies would have an even greater allocation. In the latter index—the J.P. Morgan GBI-EM Global Diversified Index—the exposure is capped at 10% per currency and the top eight countries represent 78.5% of the index. This list includes Brazil, Indonesia, Mexico, Malaysia, Poland, Turkey, South Africa and Russia.

The global indices suffer from a preponderance of major currency exposure. The emerging market index is more balanced in terms of currency exposure. What is omitted in both of these approaches is any significant way to focus on high quality currencies with strong fundamentals that could benefit from a broad depreciation of the major currencies.

Exhibit 1  
Global Treasury Statistics

	Market Value (%)		Market Value (%)
Global Treasury Universal (Statistics, Unhedged)	100.00		
Japan	32.35	Ireland	0.43
United States	25.87	S.Africa	0.40
United Kingdom	7.29	Finland	0.40
France	5.90	Malaysia	0.38
Germany	5.74	Sweden	0.38
Italy	5.71	Thailand	0.31
Spain	2.62	Singapore	0.27
Canada	1.84	Czech Rep	0.22
S.Korea	1.67	Norway	0.21
Netherlands	1.67	New Zealand	0.19
Belgium	1.59	Israel	0.19
Austria	1.11	Slovakia	0.12
Australia	0.96	Slovenia	0.07
Denmark	0.55	Luxembourg	0.03
Mexico	0.55	Chile	0.02
Poland	0.46	Hong Kong	0.01
Switzerland	0.43	Malta	0.01

Source: Barclays Capital. As of 30 Apr 12.

## A More Strategic Approach

To create effective diversification and an effective hedge against home-currency depreciation, it is necessary to allocate capital to countries and currencies that are not well represented in the traditional equity and fixed-income benchmarks and to focus on countries that have strong balance sheets and sound fiscal policies.

Alternative indices have been proposed as a potential solution to the shortcomings of cap-weighted fixed-income indices. For example, GDP-weighted indices represent an improvement conceptually, but still result in outsized allocations to the currencies of large industrialized countries with significant volumes of debt outstanding—specifically, to the yen, US dollar, euro, and pound.

In our view, there are three baskets of currencies that should be examined:

- 1) **Major currencies** – these include the US dollar, euro, yen and pound. These currencies are well represented in global indices and are the largest and most well traded currencies in the world.
- 2) **Other industrialized currencies (OIC)** – these include Canada, Australia, New Zealand, Hong Kong, Singapore, Sweden, Denmark, Norway and Switzerland. These are highly rated countries with stable fiscal policies and generally sound balance sheets.
- 3) **Emerging currencies** – These are currencies of faster growing economies that are beneficiaries of globalization, improved governance and improving fiscal policies.

Most investors have exposure to the major currencies as they are well represented in global indices. Diversification into the majors may not provide the protection that investors seek as all of the major currencies are vulnerable to persistent fiscal imbalances, aging populations, reduced expectations of future economic growth and large debt loads. We believe that strategic diversification into both other industrialized currencies (OIC) and emerging currencies can be a risk-reducing strategy for the long-term as it will reduce home currency/major currency bias(es). As investors tend to measure performance in their home currency, the addition of this exposure may increase volatility in terms of market value, but should lower volatility in terms of purchasing power and should provide incremental diversification over the long-term in a world where assets within an economy are increasingly correlated and economies are increasingly integrated.

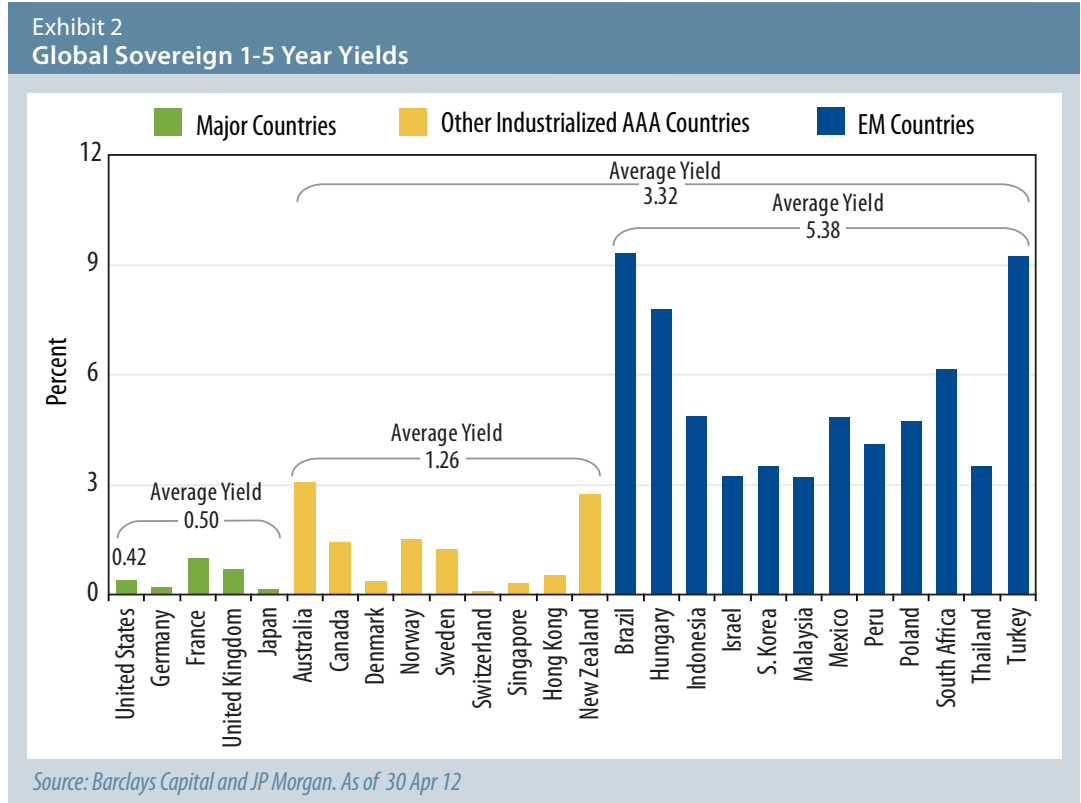
In summary, most investment allocations and the resulting currency allocations rely heavily on market benchmarks. To the extent that an investor has diversified the portfolio, it is likely still heavily exposed to the home currency and, to the extent that there has been an attempt to diversify globally, to other major currencies that share a common weakness: large fiscal imbalances. Currency trading strategies are just that: trading strategies offering a potential source of alpha, but little strategic diversification. Strategic diversification targets specific currencies that tend to be underrepresented in the major indices and does so based on fiscal and fundamental strength rather than volume of debt or equity outstanding.

## Other Considerations

The discussion above applies primarily to investors whose objective is total return. Embedded in that objective is not just an attractive return but also preservation of purchasing power. To the extent that we witness deterioration in the value of the home currency, strategic currency exposure can provide an attractive hedge against both home currency depreciation and the resulting inflationary pressures. It is our opinion that the only investors who needn't concern themselves with currency diversification are those who are managing a portfolio versus a liability denominated in their home currency and with no exposure to inflation, such as cost of living adjustments. These investors should consider currency allocations as an opportunistic tool rather than a strategic one.

## Defining the Universe

Below, we provide a chart that segregates the currencies into the three groups we have identified: majors (green), other industrialized countries (yellow) and emerging (blue). As can be seen in the chart, the latter two currently offer higher yields than the most prevalent basket, the major currencies.



## Attaining Strategic Currency Exposure

As stated above, we believe that traditional approaches to currency diversification are flawed. We believe that the best way to construct currency exposure is to select countries that:

- A) Are fundamentally sound and that are supported by sound fiscal policies,
- B) Do not have an overly easy monetary policy,
- C) Have net capital inflows and
- D) Are not well represented in traditional market benchmarks.

Once the universe of countries/currencies has been identified, one must determine how to obtain the exposure. The choices can include currency derivatives (forwards, futures, options, etc.), equities, bonds, and/or cash holdings/deposits. While currency derivatives capture the change in currency values, they provide little in the way of income as they have an implied yield equal to the local short-term rate minus the cost of financing. It is important to note that equity and bond derivatives do not provide currency exposure as there is an implicit financing transaction embedded in the contracts that effectively hedges the risk back into one's home currency. Only profit and loss are exposed to currency fluctuations.

Equities bring idiosyncratic risk as well as systemic risk unique to the equity market, and that risk is comparable in magnitude to the embedded currency risk. Cash securities are very effective at capturing currency risk and provide a source of income: the local short-term rate. We believe that the most effective tool for obtaining currency exposure is intermediate bonds as they typically provide more income than cash with

little or no incremental risk. This incremental accumulation of income can provide some degree of protection against positive (upward) moves in the home currency, which would represent negative performance for the currency positions. Additionally, the liquidity of sovereign debt and the lack of correlation between bond returns (measured in local currency terms) and currency performance (in dollar terms) make intermediate bonds an even more compelling tool.

## Exhibit 3

**Historic Returns for Other industrialized Countries (equal weight)**

1-5 Year Sovereigns	Annualized 10-Year Returns			10-Year Monthly Volatility Measures		
	(1) Total	(2) Bond	(3) Currency	(4) Total St. Dev.	(5) Bond St. Dev.	(6) Currency St. Dev.
Australia <sup>1,2</sup>	13.3%	6.1%	6.8%	3.8%	0.7%	4.0%
Canada <sup>1,2</sup>	9.3%	4.3%	4.7%	2.8%	0.6%	2.9%
Denmark <sup>1,2</sup>	8.4%	4.3%	3.9%	3.2%	0.6%	3.2%
Norway <sup>1,2</sup>	9.4%	5.3%	3.9%	3.5%	0.7%	3.6%
Sweden <sup>1,2</sup>	8.9%	4.4%	4.3%	3.6%	0.6%	3.7%
Switzerland <sup>1,2</sup>	8.8%	2.7%	5.9%	3.5%	0.5%	3.4%
Hong Kong <sup>1</sup>	3.8%	3.7%	0.1%	0.8%	0.8%	0.2%
New Zealand <sup>1,2</sup>	13.4%	6.7%	6.2%	3.9%	0.6%	4.1%
Singapore <sup>1,3</sup>	6.5%	2.5%	3.9%	1.8%	0.5%	1.7%
<b>Equal Weight Return</b>	<b>9.3%</b>	<b>4.5%</b>	<b>4.7%</b>	<b>2.5%</b>	<b>0.5%</b>	<b>2.6%</b>

**Local bond returns are not correlated with currency returns**

10-Year Return Correlation	Currency Returns
Bond Returns	-0.11

Source: Sources: <sup>1</sup>Bloomberg, <sup>2</sup>Barclays Capital, <sup>3</sup>Citigroup. As of 30 Apr 12

\*Assumes Monthly Rebalancing

Note that portfolio risk drops slightly when moving from cash currency exposure to intermediate bond-based currency exposure (column 4 versus column 6). Also note the returns that bonds have contributed over the last 10-years (column 2). While interest rates are not likely to decline by the same magnitude over the next 10 years, they still typically provide an incremental yield versus overnight cash positions.

**Conclusion**

Most investors have an inherent home-currency bias. While many investors do seek global diversification through global and/or international equity and fixed-income allocations, these allocations are often skewed toward the large developed economies. It is our view that capital allocation away from the home currency should be strategic and should have the ultimate goal of preserving purchasing power. Stated another way, global diversification should seek to mitigate the impact of a significant decline in the value of the home currency. This approach, when coupled with commodity investing and inflation-linked securities, can improve the overall effectiveness of inflation-hedging.

A bond portfolio can provide the opportunity for income as well as diversification. By focusing the portfolio on either "other industrialized currencies," as previously defined, and/or on emerging currencies, an investor can reduce the long-term risk inherent in being heavily invested in one's home currency.

This alternative view—home currency exposure as a risk and foreign bond exposure as a hedge—is one that we believe is of value to both consumers and total return investors as it provides the opportunity for both positive carry and a hedge against the depreciation of the home currency.

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