



From The Desk Of

Adam P. Hoffmann, CFP®
Investment & Research Analyst

The Role of Currency in a Globally Diversified Portfolio

The strength of the U.S. dollar has been a hot topic in the media throughout the global financial crisis and recovery. The dollar had been declining against many international currencies since the early 2000's before the brunt of the credit crunch in late 2008 drove global investors to flee international currency reserves to the perceived safety of the U.S. dollar and treasury securities.

At some of the most intense times, investors were willing to essentially pay the U.S. government to hold their wealth during a brief time of negative yields on short-term government bonds.

From the dollar's high point in 2008, the currency markets saw a steadily weakening dollar during the 2009 recovery. This trend has reversed in these early months of 2010 as we now see the dollar regaining strength relative to many of the world's dominant currencies.

There have been fingers pointed at both current and previous administrations, either blaming or applauding their fiscal policies that have at times promoted a weak dollar. Some analysts pointed to the dollar's relative weakness as a sign of the end of the United States' position as the dominant economy and currency, while others have seen the weak dollar as a strategic play to promote exports and business development.

I will let the politicians and pundits fight the battle to analyze the merits of a strong or weak dollar as it relates to the currency markets, political arena, or the global economy. What I intend to discuss here is what currency risk is, how changes in currency valuations impact your portfolio, and how a disciplined, globally diversified

approach to portfolio management allows you to be in a position to benefit from this volatility.

Currency risk (also known as exchange rate risk) is the risk that the value of one currency will increase (or decrease) against the value of another, and thus impact an asset's price without changing its underlying value. It most often impacts investors when they own the stock of a foreign company and receive the return in dollars. For example, if you owned shares of stock in a Japanese company and the value of the yen increased (or decreased)

against the dollar by 5%, the value of your investment would also increase (or decrease) by 5%.

Currency risk is present in a portfolio when investors own assets outside of their own domestic economic borders. In the short term, it can have dramatic impact on the performance of international assets, but in the long term, the ability of investors to move freely between markets and sound

monetary policy reduces the expected return to zero.

Investors are able to eliminate this risk within their portfolios through hedging strategies. However, given the fact there is no expected return on currency risk, the cost of doing so can adversely impact a portfolio's performance due to the added cost of implementation.

To best illustrate how changes in currency prices can impact a portfolio, let's examine what happened in 2009 (Chart A).

...a disciplined, globally diversified approach allows you to be in a position to benefit from currency volatility.

CHART A

Currency Effect Relative to Stock Market Returns 2009

	Country	Local Currency Return	USD Return	Currency Effect
Emerging	Brazil	70.9%	128.6%	57.7%
	India	93.7%	102.8%	9.1%
	Indonesia	96.2%	127.6%	31.4%
	Mexico	47.7%	56.6%	9.0%
Developed	Australia	37.0%	76.8%	39.7%
	Canada	33.6%	57.4%	23.7%
	Japan	9.3%	6.4%	-2.9%
	New Zealand	21.9%	51.7%	29.9%
	Norway	55.6%	88.6%	33.0%
	UK	27.7%	43.4%	15.7%

Past performance is no guarantee of future results and current performance may be higher or lower than the performance displayed. Chart represents calendar year 2009 data. © 2010, MSCI Barra. For informational purposes only.

The table above examines the stock market and currency returns in ten countries around the world. The first column shows the return of each market in their own currency while the second column shows the returns a U.S. investor experienced. The difference between these two figures is the increase (or decrease) of the value of the local currency against the U.S. dollar.

As the chart illustrates, a Brazilian investor would have experienced strong returns in 2009 by investing in their own stock market. However, a U.S. investor holding the same portfolio had a return that was almost 60% higher due to the strengthening of the Brazilian real against the dollar. Conversely, the Japanese market return was 2.9% lower for U.S. investors because of the relative strength of the dollar.

The benefits due to currency movements in 2009 were exceptional. The volatility in currency values that has been experienced since 2008 is roughly 40% higher than the ten year average for the same broad basket of currencies. This lopsided movement in currencies benefited your portfolio with higher returns in the asset classes of international

developed and emerging markets. This is one of the factors as to why some recent rebalancing has focused on reducing the exposure in these areas.

We are seeing a reverse in trends with these figures as we begin 2010 with the U.S. dollar strengthening against most major global currencies. Such movements will reduce international equity returns, but provide opportunities for lowered prices on international assets.

Having a globally diversified equity portfolio is the most efficient way to capture benefits from currency movements when they occur in the marketplace. By owning international equity assets, you gain exposure to global businesses, local currencies and diversification from domestic stocks all in one.

Gold and other commodities are often touted as currency hedges as the price movements are connected to fluctuations in the value of the dollar. That being said, gold and other commodities carry with them types of risk that have not predictably or consistently rewarded investors.

Rebalancing is a strategy that brings a portfolio back into alignment with its target allocations while often times leveraging opportunities to sell high and buy low. Whether the returns come from changing stock prices, currency fluctuations, or appreciating fixed income, a disciplined rebalancing approach ensures that no asset class becomes too concentrated in your portfolio just when it may begin to perform poorly. It also serves to keep your portfolio where you and your advisor have determined your allocation should be based on your risk tolerance and with the goals of your overall financial plan in mind.

In conclusion, currency risk is present in a globally diversified investment portfolio. At times it will benefit returns, and at others it will reduce them, but over the long term, the risk will dampen and provide opportunities for disciplined investors.

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CARLSON CAPITAL MANAGEMENT

NORTHFIELD

11 BRIDGE SQUARE
NORTHFIELD, MN 55057
507.645.8887

HASTINGS

12181 MARGO AVE. SOUTH, STE. 250
HASTINGS, MN 55033
651.437.2360

ROCHESTER

150 SOUTH BROADWAY, STE. A
ROCHESTER, MN 55904
507.288.9797

BLOOMINGTON

1700 W. 82ND STREET, STE. 110
BLOOMINGTON, MN 55431
952.230.6700