Sankala Group

Currency Impacts

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Some conventions are so ingrained in our lives that we don't really notice how silly they are until we view them from a bigger perspective. For example, all investors know their return on investment in stocks and bonds has two primary components—changes in market value and cash flows. In stocks the cash flow is called a dividend, and in bonds it's called interest. Conspicuously, most brokerage houses only show investor's price gains and losses in the primary account view. They rarely show cumulative (life-to-date) dividends and interest, and almost never show us our total returns in the position:

Total Return = Capital Gain/Loss + Cumulative Dividends/Interest

I'm not really sure why that is the convention for brokers because it makes little sense for investor transparency. It would be very easy to do correctly from a technology standpoint.

My viewpoint may be jaded, but perhaps since brokers are paid on commission they only want you to look at the gain/loss component (which moves every second) as that drives the greed and fear emotions which then drive unneeded trading and hence commissions. Heaven forbid your broker shows you how much dividend and interest income you receive by doing nothing, the very action that makes the most sense for the investor most of the time.

Taking this fundamental observation further, when we invest internationally there is a third component of total return that adds more complexity: currency exchange rates. As currencies change value against one another, the total return equation becomes:

Total Return = Capital Gain/Loss + Cumulative Dividends/Interest + *Currency Gain/Loss*

This currency gain/loss figure is almost always hidden also, especially for U.S. investors who are generally using an index fund or mutual fund priced in $USD, or American Depository Receipts (ADRs) priced in $USD.

When U.S. investors buy investments directly on international exchanges, they must first obtain the currency, buy the investment, eventually sell the investment, and finally convert back into $USD. In that time the exchange rate has often changed materially. Adding further complexity, practicality and brokerage house policy differences often result in the size of the currency transaction not matching exactly the size of the investment transaction. Basically, the investment price changes in the time it takes you to settle your currency transaction, so you end up with a stub currency position or an investment of slightly different size than originally intended. While small, this figures back into the currency gain/loss component.

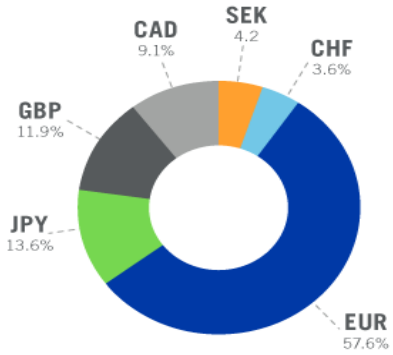
Depending on the market conditions each component has very different attribution to total returns. Dividends tend to provide backbone to returns over time, while capital gains and losses are volatile around those core cash flows, often changing dramatically from positive to negative attribution. Currency on the other hand tends to have a slightly subtler impact (baring rare but consequential currency revaluations) and it also tends to contribute in the same direction, either positive or negative, for years at a time.

Having currency become a profitable tailwind to investment requires the newly acquired currency to appreciate relative to the investor's base currency. That opens the door to macroeconomic analysis that incorporates rates of inflation in each country as well as a

range of other economic variables. A few generalizations can guide us however. Buying stocks abroad is generally less risky currency-wise than buying bonds as inflation generally feeds back into the prices companies get for their products and services, so they remain profitable regardless of the monetary environment. On the other hand, when buying foreign bonds a spike in inflation won't feed back into the price of nominal assets like a bond, and in fact it undermines it. Just as in the U.S., stocks tend to be a decent inflation hedge and bonds are better to own in stable currencies and during deflation.

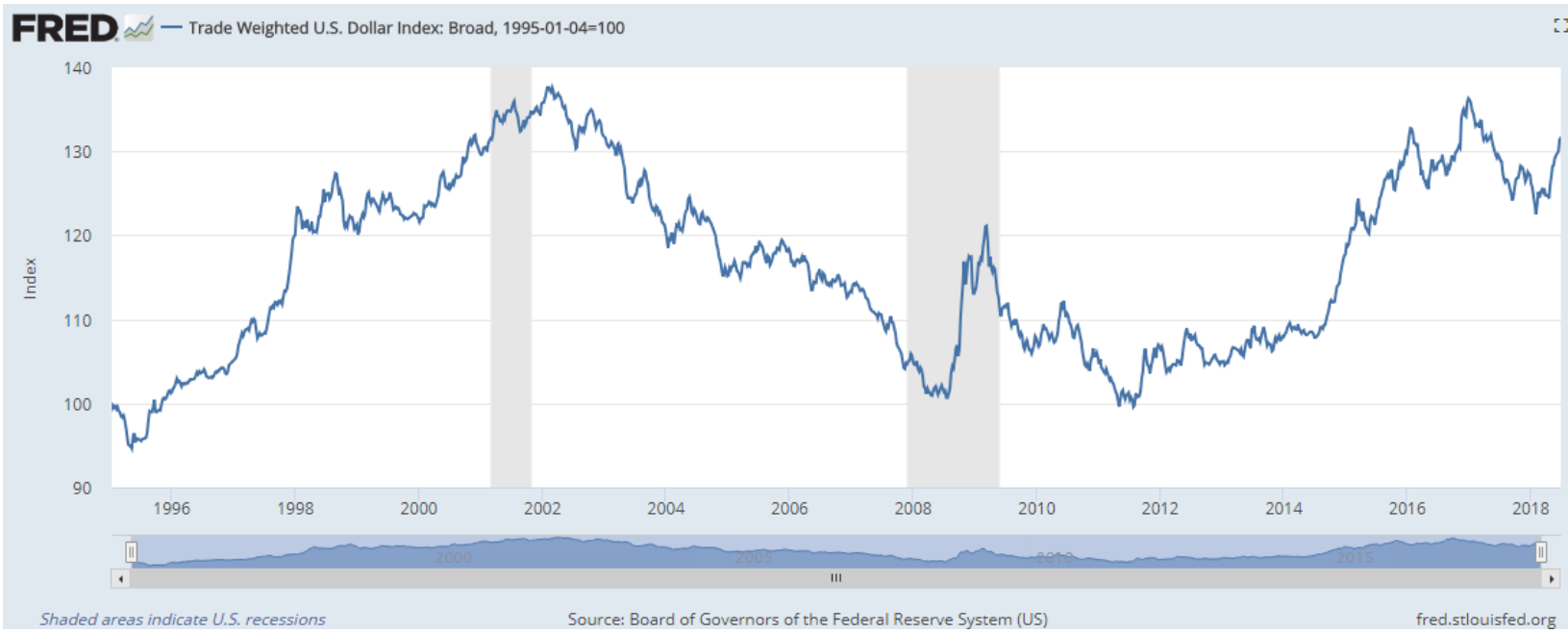
Knowing when the $USD is weak or strong is not always simple either. We have headline indices to use, but like all indices they contain unique biases. For example, the USDX, which has futures traded on the Intercontinental Exchange, is based on the following array:

CURRENCY	WEIGHT
Euro (EUR)	0.576
Japanese Yen (JPY)	0.136
British Pound (GBP)	0.119
Canadian Dollar (CAD)	0.091
Swedish Krona (SEK)	0.042
Swiss Franc (CHF)	0.036



As you can see, it is made up of a limited set of developed "club" currencies that don't really reflect our global trade realities. It is useful, but must be well understood. The index started in 1973 with a value of **100**. The USDX reached a high of **165** in 1985 and a low in 2008 with a value of **71**. It stands at **95** today – so the $USD has lost around 5% versus developed peers over 45 years, within a volatile trading band. Internationally minded investors can profit from these moves by overweighting exposure to the U.S. dollar when it is near its lows and reducing exposure when it is near its highs.

A more contemporary index is the Federal Reserve's *Trade Weighted U.S. Dollar Index - Broad*. It includes more than 20 currencies rebalanced on the basis of actual trading realities:



The *U.S. Dollar Broad* started in 1995 (a period of serious dollar weakness according to the USDX index) and has climbed ~35% since then with peak-to-trough periods of ~8 years. Looking at both indices gives us quantitative confidence that we are late in a cycle of bullish USD trading on the basis of historical mean reversion in a market that has been strongly cyclical for the past 50 years.

More qualitatively, I must also point out that the majority of currencies that have undergone extended weakness (think Latin America) are often preceded by over-borrowing, deficits, and debt monetization. These are all things our leaders in Washington (regardless of party) have kept us perpetually worried about since 2001 when the debt started exploding to the upside.

Initially, the USD declined 30% as the debt leapt up. Then the dollar found a bottom in 2008, and has been strong since despite the debt more than doubling from 10 trillion to nearly 21 trillion in a mere 10 years. It is anyone's guess when the market grows tired of loaning to the Treasury, but when they do we know dollars will be sold in the process.

If the Fed's Broad Dollar were to fall back to 100 over the next 8 years, repeating a standard cycle, a U.S. investor would theoretically see 3.75% per annum of excess currency return if they were invested abroad across the same basket of currencies that compose the index.

With that consideration on the table, we conclude that currency diversity looks smarter than usual. It makes sense to sell appreciated dollars, particularly to buy stocks in other cheaper currencies when we think the other two other components of total return look good as well. That is, when those stocks are showing above average dividend yields and also are priced below average historical valuation levels. With these factors in place we can potentially see positive contribution from all three sources of return simultaneously.

While this all sounds logical and straight-forward, it is far easier in theory than in practice. Common sense and fear still often overpower our analysis. For example, right now, one of the most interesting markets we see in the world is Turkey. Turkish stocks are priced at extremely attractive levels on a full range of value measures (P/E, CAPE, Price/Book, Price/Sales). They are also showing some of the best dividend yields globally. Lastly, the Lira, Turkey's currency, is also in shambles relative to the USD.

Clearly we can't put a significant amount of capital to work in a country with such a limited economic footprint, but it may make sense to have some small exposure there for the truly committed value investor. Fortunately, we also have a range of other international ideas with similar characteristics that can be tailored to each client's tolerance for volatility and political risk.

To alleviate any generalized doubt about the international investment mindset, which is very understandable given the recent 10 or so years of strength in both U.S. stocks and the USD, I'd like to offer a closing data table. As you read it, please keep in mind that it runs from 1975 through last month, so it includes this recent decade that we have acknowledged was a period of underperformance for international markets. If anything the sample time period is biased against international shares. The results speak for themselves:

Long-Term Investment Returns
(Price Change + Dividends + Currency)
January 1975 – May 2018

S&P 500:	8.18%	Source: Robert Shiller, Yale
MSCI Emerging Markets:	9.77%	Source: MSCI Inc. *(Since 2000 only)*
MSCI EAFE Developed Markets:	10.43%	Source: MSCI Inc.
MSCI EAFE Developed Markets Value:	11.67%	Source: MSCI Inc.

We hope you are having a wonderful summer and please don't hesitate to reach out with any questions.

Best,

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