WINTHROP
Capital Management

Foreign Currency Investing

A Penny Sold [Short] is a Penny Earned?

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Investment Rationale

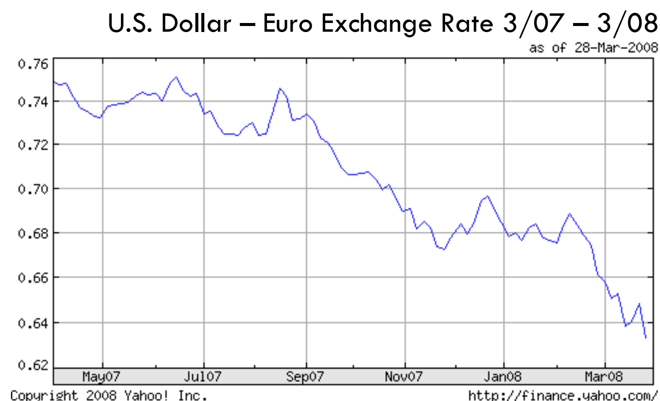
Professional investors are always on the lookout for new ways to either increase a portfolio's returns without adding risk, or to maintain the level of risk while enhancing expected return. As the field of investment management has matured, those alternate goals have become increasingly difficult to accomplish. And in practice financial advisors can make only so many new arrangements using the same vase and flowers, so to speak.

Speculating in foreign currencies is, of course, a very old practice but the existence of a disciplined, risk-controlled foreign currency investment process is really fairly new. Historically accessible to institutional investors and hedge funds, foreign currency investing is now becoming available to individual investors.

Currencies as an Asset Class

In years past, the Dollar was tied to the value of a set weight of gold. Today currencies predominantly no longer trade on the gold or silver standard. For many decades gold has been a very reliable barometer of inflation: if inflation runs high, the value of gold increases, and likewise the value of a Dollar backed by gold. This acted as a natural brake on inflation, but it also limited the Federal Government's ability to manage price stability and economic growth through monetary policy.

Now the value of a currency is largely a function of a country's short-term domestic interest rates. *Interest Rate Parity* (IRP) is a theory which holds that the currency values in country A will rise and fall vis-à-vis country B's currency as short-term interest rates in those countries change. So, if one unit of A's currency buys one unit of B's currency but short-term interest rates in country A are higher than in country B, the value of A's currency should appreciate versus that of B until the difference is erased—until the exchange-rate adjusted interest rates are at parity. If you could exchange 1 US Dollar for 1 Euro and receive a 5% higher yield on your bank savings account, why wouldn't you sell your Dollar, buy a Euro, and put your money in the European bank? As that process repeats itself, currency traders will respond to the supply and demand by lowering the price of a US Dollar and raising the price of a Euro.



Of course there are many factors which cause a country's interest rates to change. But relationships expressed in IRP offer investors an opportunity to earn a return, while investing in a manner which is dissimilar to other asset classes (stocks, bonds, cash, real estate, etc.). This dissimilarity is expressed as an investment having a "low correlation" with other asset classes. This means that if the stock market, for example, declines in value, the value of the foreign currency investment is not also likely to decline—it may even go up. Attractive return potential + a low correlation with other assets in the portfolio = effective diversification.

The Carry Trade

Speculators decide which foreign currency will appreciate or depreciate the most relative to other currencies and make large financial bets accordingly. Some of them are handsomely rewarded. Others lose their shirts.

An alternative to trying to pick the biggest winners and losers is the *carry trade*. In a foreign currency carry trade, investors use the proceeds from selling one currency short (e.g., borrowing Euros from another investor and selling them with the hope that you will be able to buy them back for fewer Dollars when it's time to return them) to purchase another currency. More specifically, an investor would sell short the currency of the country with low domestic interest rates and buy the currency of a country with relatively higher rates. As IRP begins to work, the low-interest rate currency declines in value as the high-interest rate currency appreciates. It is a bit like bankers paying out 3% over night on savings accounts and collecting 7% on long-term loans—they "sell short" the yield on savings accounts to "buy" the yield on long-term loans, thereby collecting the 4% spread.

But as we acknowledged above, there are many factors which cause a country's interest rates to rise or fall. IRP is a principal which usually holds but it does not materialize in every two-currency relationship. One measurement of the general success of the foreign currency carry trade strategy is expressed in an index developed by the German financial institution, Deutsche Bank. The *Deutsche Bank G-10 Currency Index* begins by selecting currencies from among ten of the largest developed countries. The index then measures the effect of selling three of those currencies short (the three with the lowest domestic interest rates) and investing the proceeds in the three currencies with the highest domestic interest rates. The index is reset on a quarterly basis to capture the changes in relative value among the composite currencies.

The Place in Portfolios

The Deutsche Bank G-10 Currency Index can provide insight into returns only through a process known as "back testing", or applying the strategy retroactively to determine what the results would have been. However, a test of the IRP strategy among the G-10 currencies indicated that annual returns over the past decade would have been akin to those of common stocks. More impressive still, the index displayed a very low correlation with cash and stocks. The result is that incorporating the strategy in a portfolio might well have very favorable risk-reduction benefits.

Investors have several means to invest in foreign currencies today, from traditional mutual funds to futures contracts. One which we have made use of is an *Exchange Traded Fund* (ETF) which tracks the Deutsche Bank G-10 Index and trades with the symbol: DBV.

We do not consider currency investing to be a core investment strategy, but rather a satellite investment in a well-constructed portfolio. Thus our allocation will typically be from two to ten per cent of a portfolio. However, we do believe that a satellite allocation to an Interest Rate Parity currency strategy, like the one embodied in DBV, can offer investors attractive returns while serving to lower portfolio volatility.

Gregory J. Hahn, CFA
President & CIO

Stephen P. Carr, CFA
Portfolio Manager

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