Currency Risk

Canadians love to cross-border shop. The selection is broader, the prices are better and there are plenty of opportunities to hunt for bargains. But as Canadian shoppers know all too well, the bargains are generally better when the Canadian dollar strengthens against the U.S. dollar than when it weakens.

It's much the same when it comes to investing. With Canadian stocks comprising only around 3% of the world's total market – and heavily skewed in oil companies, miners and banks – there is broader selection outside our borders and plenty of potential bargains for the discerning shopper. But whether the prices you pay will be less or more than in Canada depends on the level of the Canadian dollar.

Just as a US$40 pair of jeans cost the Canadian cross-border shopper C$65 in 2002 when the Canadian dollar was at 62 cents to the U.S. greenback, and only C$38 in 2011 when the Canadian dollar rose to $1.05 against the U.S. currency, so too do the prices of company shares or corporate bonds fluctuate for the Canadian investor venturing into foreign markets.

In investing, there can be a substantial impact. Any change in the value of the Canadian dollar against the currency of the foreign investment you purchased can erode or wipe out any gains, and even turn a profit into a loss–or vice-versa.

This phenomenon is known as currency risk and is an additional consideration for Canadian investors seeking diversification and new sources of return outside our borders.

It's important to be aware of this risk as currencies can be quite volatile over the short term. Even the Canadian dollar has had some significant moves in short periods. In the first six months of 2003, for example, it gained more than 15% against the U.S. dollar. In the last six months of 2015 it lost 9.7%, and in the first three months of 2016 it gained 6.4% – to about 75 cents per U.S. dollar.[1]

[1]Source: Thomson Reuters.

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How can Canadian investors help protect themselves from currency risk?

Purchase a currency-hedged fund

A currency-hedged fund helps reduce or eliminate the fund's exposure to the movement of foreign currencies from the foreign securities it holds. This gives the investor a return on those securities similar to the return they would have on their local market. In other words, hedging attempts to minimize exposure to the underlying currencies.

When a fund is currency-hedged, the fund manager uses futures contracts on the foreign currency (or currencies) in which the securities are denominated, essentially locking in the current exchange rate. For example: If you purchase a fund that invests in U.S. securities and is hedged to the US$ when the current exchange rate is 80 cents to the U.S. dollar you will lock in that exchange rate for the remainder of the time you own the fund. This can have multiple advantages if you need access the US$ funds on an ongoing basis.

Diversify your portfolio through a multi-asset approach

Some currencies tend to fluctuate significantly while others are relatively more stable. Following a multi-asset approach by combining a selection of global bonds, global equities and alternative assets to achieve multi-layered diversification may potentially smooth out the differing impacts of currency movements.

Think long term

A long-held tenet of international investing is that there is purchasing power parity (PPP) between two currencies which determines the level one has against the other, and that they will revert to that level over time. Take the Canadian and U.S. dollars, for example. For most of the 1990s, the Canadian dollar weakened against the U.S. dollar. For most of the previous decade, it strengthened against the U.S. dollar. In early 2016 the exchange rate was essentially similar to what it was in mid-2004 and before that, in mid-1993.

In theory this means long-term investors may not need to be as concerned about currency movements as those who tend to actively trade their portfolios. But even over the long term, currency movements can add volatility to a portfolio's returns. And it is nearly impossible to predict when a currency might change in value. So even those investors with a longer time horizon should be mindful of currency risk in their portfolios.

For more information on how Russell Investments can help you pursue your investment goals, please ask your advisor or contact us at 1-888-509-1792 or visit us at russellinvestments.com/ca

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