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Currency risks for the long run?

By Gil Hanoach, February 6, 2006

You may know that diversifying your investments outside the US can significantly reduce your risks, while increasing the potential returns. This is true because the different stock markets don't go up and down at the exact same time, allowing a globally diversified portfolio to have shorter and shallower declines than a portfolio that is concentrated in the US stock market.

Global diversification into thousands of stocks in many countries and continents limits to an acceptable level the various risks, including: country risk, political risk, regulation risk and liquidity risk.

There is one risk that should be addressed separately: currency risk. This article will offer a separate discussion for short-term and long-term currency risks.

What is the short-term currency risk of international investments?

It is the risk of a significant strengthening of the local currency (US Dollar for Americans) compared to other currencies, whether temporary or long-term.

Can this happen?

Currencies tend to be less volatile than stocks, and are not correlated with the price of stocks. As a result, they are not expected to increase the risks of a globally diversified portfolio.

In addition, by holding a portfolio that is denominated in different currencies, short-term fluctuations are diversified. Note that whenever people use more of one currency compared to another one, this currency increases in value while the other declines. By holding a globally diversified portfolio, when some of the currencies you hold go down, others should go up.

All historic measures of returns include the currency impact. Historically, the international diversification of stocks proved to be very valuable, even when considering the currency impact.

What is the long-term currency risk of international investments?

It is the risk of a significant and *irreversible* strengthening of the local currency (US Dollar for Americans) compared to most other currencies.

Can this happen?

Let's try to imagine such a situation. As the dollar strengthens, goods become more expensive in the US relative to other countries. At that point, Americans and others would start buying goods in other countries. The influx of dollars into other countries would make them more widely available, weakening the dollar and breaking the long-term strengthening-streak of the dollar. Academically, this is called "Purchasing Power Parity".

As mentioned in the section about the short-term currency risk, historic evidence shows the contained long-term risk of currencies when combined with stock investments.

To Summarize

All of the risks that are specific to any individual country, including currency risk, are reduced to acceptable levels within the context of a globally diversified portfolio. Diversifying a portfolio globally reduces the risks specific to the home country (e.g. US), without introducing other bigger risks. This is both logical and has withstood the test of time.

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