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Understanding the impact of currency on your international investments

The fluctuating Australian dollar (AUD) is a major feature in the daily news that appears regularly. Whether the AUD goes up or down in value, its value is something that impacts most of us. For example, if you shop on-line globally, holiday overseas, or have international investments in your superannuation then you will be impacted by movements in the AUD – technically known as 'currency risk'.

So what is currency risk?

Broadly speaking, 'currency risk' is a financial risk that arises from the fluctuations in the exchange rate of one currency in terms of another. While currency risk generally refers to a price movement resulting in a *negative* impact on a security or portfolio's value, the opposite is also referred to as currency risk.

Investing in international shares allows investors to access many different countries and sectors, improving the overall diversification within a portfolio. However, to gain a more diversified international share exposure and access the potential returns from international markets, investors are exposed to currency risk. Currency risk can broadly be categorised as either 'indirect'[1] or 'direct' foreign currency exposure. This paper focuses on managing direct currency exposures.

Direct currency exposure is the additional risk held in a portfolio as a result of an investment being held in currencies other than the investor's home currency. For an Australian investor this refers to any investments that are denominated in currencies other than the AUD.

A hypothetical example

When an Australian investor invests in international markets, currency fluctuations become an additional driver of returns for the portfolio. To examine this theory lets use a simplistic example (and ignore transaction costs, dividends and tax, etc).

Say for example, your research suggests that Japan Autos (a fictitious automobile manufacturing company) is about to launch an environmentally friendly car which is likely to take the market by storm. Japan Autos is currently trading at 4000 yen a share and the exchange rate is 80 yen per AUD.

To work out how much a share of Japan Autos is in Australian dollars, we simply divide the price in local currency (4000 yen) by the exchange rate (80 yen). Therefore a share in Japan Autos works out at $50 AUD. You place an order for 100 shares (a $5000 investment) in Japan Autos with your broker.

Twelve months down the track you review your holding in Japan Autos and as it turns out your research was accurate and the new car has surpassed the company's expectations with revenues and profits both exceeding their targets. As a result, Japan Auto's share price has appreciated from 4000 yen per share to

[1] Indirect foreign currency exposure typically refers to translation risk, which can be broadly defined as the foreign currency risk associated with companies that have income or assets priced in foreign currencies on their balance sheets. The greater the exposure to foreign currencies, the larger the translation risk.

4600 yen per share; representing a 15% gain (totalling $5750 Australian dollars). You decide to sell your shares and lock in your 15% profit.

However, over the same period, the Japanese Yen has also rallied strongly from 80 yen per AUD to 92 yen per AUD, representing a 15% appreciation. While your shares rallied 600 yen to 4600 yen per share, we now must divide 4600 yen by 92 yen to work out the AUD price for your shares.

In AUD terms your shares are worth $50 and your total holding (which you thought was worth $5750) is still only worth $5000 and your Australian dollar return is zero. Therefore, Japan Autos was a poor investment once adjusted for currency fluctuations. However, for a Japanese investor, a 15% return would probably be considered a very good investment.

However, conversely, let’s assume that your research was incorrect and Japan Auto’s new car was not greeted favourably by the market. On the back of poor sales, profit downgrades and global economic uncertainty, the company’s share price falls 10% from 4000 yen per share to 3600 yen per share.

At the same time, on the back of global economic uncertainty, investors remove risk from their portfolios and reduce their exposure to the AUD. Assume that one AUD is now worth 70 yen (rather than 80 yen). Therefore, rather than dividing 3600 yen by 80 and realising a loss of $5 per share (in AUD terms), we instead divide 3600 yen by 70 and realise a **gain** of $1.43 AUD per share.

It is therefore important that you remember that when investing in a company domiciled overseas, you are effectively:

(1) investing in the performance of the company in which you invest, and

(2) making an investment ‘call’ on currency movements.

Ideally, investors would always invest in a company where the stock price goes up while the home currency depreciates. However, more often than not, it is likely the results will be mixed.

Please contact Susan Baker Financial Planning if you would like to understand further the impact of currency on your investments.

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