FINANCIAL TIMES
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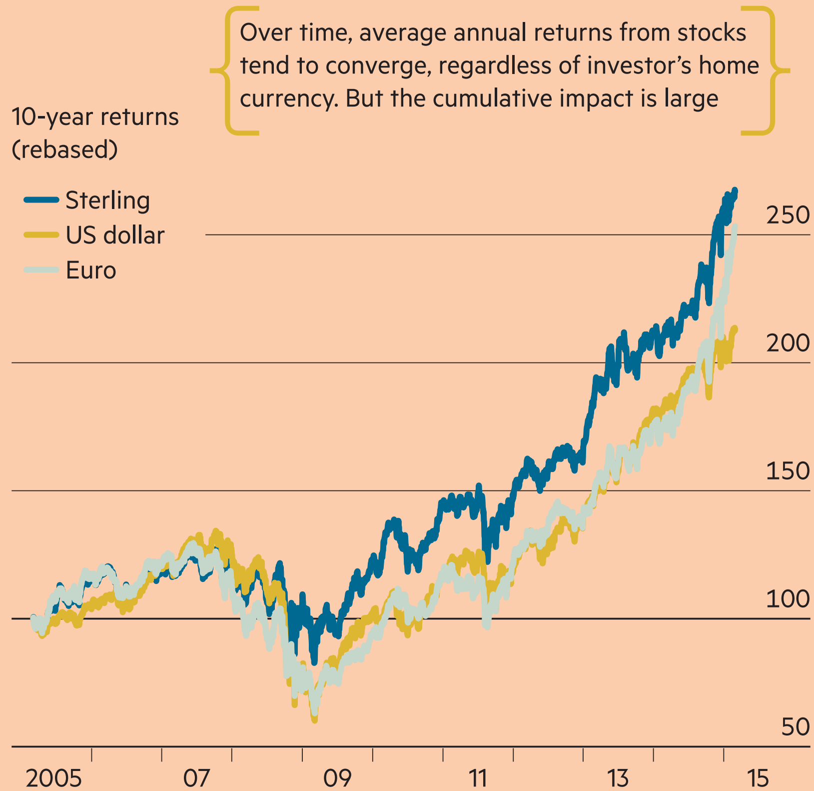
THE LEX COLUMN

Hedge rows

S&P 500 index,
total returns in different currencies

	Annualised return Year-to-date	Annualised return 10-year
Sterling	24% (4% YTD)	10.5%
US dollar	17% (3% YTD)	8.3%
Euro	91% (11% YTD)	9.9%



FT graphic. Sources: Bloomberg, FT research

The dollar is up, the yen and the euro are down and currencies are back on the agenda. Take Procter & Gamble. Last quarter it reported earnings per share down 8 per cent. With stable currencies, earnings would have risen almost as much. P&G, naturally, put the ex-currency number front and centre. This seems fair. But imagine if it did the same with, say, demand: "Without the impact of customers' hating our soap, earnings would have risen nicely."

There is an intuition that — over the long term — currency impacts should be discounted. Why? Well, currencies are out of management control. Revenues and costs can and should be aligned to create natural hedges, but big currency moves still have big impacts, and there is little management can do. Poor products, by contrast, reflect bad strategy. This argument is weak. Companies are valued on cash flows, not management quality (though the two are related) and currencies have a cash impact — by affecting the regional cost and therefore competitiveness of products, and by diminishing the cash flows available for distribution to investors.

Another argument: what is lost to currency in one period is gained back in another because currencies, over time, revert towards purchasing power equilibrium, or just because they bounce around. This won't do, either. Currencies follow long-term trends and are notoriously hard to predict.

Currency effects are cash effects, and they can persist. Investors, as opposed to companies, face another problem — the translation of returns from foreign holdings into their local currency. US holders of European stocks have seen much of this year's high returns eaten up by the strong dollar. Over long holding periods, average annual returns converge, regardless of investors' home currency, but the cumulative currency effect can be huge. Buy hedges? A zero-sum game, with fees taken out by middlemen. A Credit Suisse study has shown that hedging adds nothing to average long-term returns and that diversification takes out much more risk. Never predict currencies; don't buy hedges; expect some pain; diversify; and hold on.