

MYTH: THE EURO AND YEN MAKE GOOD DIVERSIFIERS FOR U.S. PURCHASING POWER

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When investors allocate to foreign stocks, they implicitly assume a secondary currency exposure on top of their local equity market returns. In discussing [currency-hedged](#) strategies with clients over the last few years, I've heard a few common explanations as to why investors like making this secondary "currency bet" on top of the global equity diversification they are obtaining. **Myth: Adding euro and yen exposure on top of local equity market returns is a good hedge against the purchasing power of your U.S. dollar.** A common argument for why people take on currency [risk](#) is that they want diversification from a declining U.S. dollar that could ultimately help maintain purchasing power within their portfolios for future consumption. I believe this is a misguided reason to take a secondary currency bet when buying foreign equities to diversify equity allocations. The [Consumer Price Index \(CPI\)](#) is one metric for analyzing how far the purchasing power of a dollar goes and is a general measure of [inflation](#) in the United States. We start this analysis by asking this: If you live and invest in the United States, do you have a house in Europe where it is beneficial to [hedge](#) future consumption in euros? Or do you vacation in Japan where you need to hedge future yen-denominated expenses? If not, I believe the concept that the euro and yen make a good hedge for the purchasing power of your U.S. dollar is a myth, because their values do not make good hedges for U.S. inflation rates. What makes a potentially better hedge against inflation and the purchasing power of the U.S. dollar, in my view, is stocks, which represent claims on [real assets](#) and which historically have seen their dividends grow with inflation over time. In the United States, inflation since 1970¹ has averaged just over 4% per year². During this period, dividend growth on the [S&P 500](#) averaged 5.76% per year, approximately 1.5% per year above inflation³. This means that dividends not only provided an inflation hedge, going up with inflation, but they provided real growth on top of inflation. Over long periods, I believe U.S. stocks are fairly good diversifiers for inflation generally. **What About Foreign Currencies?** The currencies represented in the [MSCI EAFE Index](#) returned 1.6% per year, with sweeping trends within that longer period back to December 30, 1970, where foreign currencies moved up and down versus the U.S. dollar. This means the dollar depreciated by about 1.6% per year versus the EAFE currencies over this period of approximately 43 years. The bottom line: This depreciation of the dollar (synonymous with appreciation of these foreign currencies against the U.S. dollar) failed to keep pace with inflation of more than 4% per year. One period to focus on was one of the highest inflation periods in the U.S., from October 31, 1978, to February 28, 1985. Inflation in the U.S. was 7.5% per year, yet the **U.S. dollar increased** significantly and the EAFE currencies declined approximately 8% per year. The fact that the U.S. dollar saw a large increase in its value against foreign currencies during one of highest inflation periods in the U.S. brings into serious question why foreign currencies should be a hedge against the declining purchasing power of the U.S. dollar. Stocks, by contrast, are a better long-term hedge because dividend growth has the potential to keep up with inflation over time. The dividend growth of the MSCI EAFE Index measured in local currency outpaced U.S. inflation during this period, meaning that stocks by themselves without the currency exposure—specifically their dividend growth—actually represented a better inflation

h e d g e . Inflation vs. Currency vs. Dividend Growth

Period	CPI Inflation	S&P 500- Dividends	MSCI EAFE- Dividends	MSCI EAFE- Currency
High Inflation ²	6.3%	6.8%	5.9%	2.3%
Full Period ¹	4.2%	5.8%	5.4%	1.6%
Strong Dollar & High Inflation ³	7.5%	6.7%	8.1%	-8.1%

Past performance is not indicative of future results

¹Full Period: 12/31/1970 to 3/31/2014.

²High inflation period: 12/31/70 to 12/31/89.

³High inflation/dollar strength period: 10/31/78 to 2/28/85.

Sources: WisdomTree, Professor Robert Shiller and MSCI, with data from 12/31/1970 to 3/31/2014.

What About Future Trends of the U.S.

Dollar? Putting the historical picture aside, will foreign currencies continue appreciating against the U.S. dollar? It is hard for anyone to really know where currencies are going. In many ways, evaluating the relative attractiveness of stocks, which produce a set of cash flows (earnings and dividends), can make for easier comparison of [relative valuation](#) than trying to do the same with currencies. This is why I advocate strongly for blending currency-hedged strategies with non-hedged strategies in a strategic mix to minimize the possibility of being on the wrong side of the currency equation. If investors have no expectations for foreign currencies to continue to appreciate against the dollar on a sustained long-run basis, given the minimal cost to hedge the developed world currencies that we discussed [here](#), they should diversify their approach to developed international allocations by adding in some currency-hedged allocations. We believe that investors must really examine why they are taking on the euro and yen risk in their portfolios. If it is for diversification against purchasing power of the U.S. dollar, the historical evidence presented in this blog post suggests that these investors need to go back to the drawing board to find better inflation hedges. ¹This period was chosen to coincide with the launch of the MSCI EAFE Index, which has a history starting in 1970. ²Source: Professor Robert Shiller, for period 12/31/69 to 3/31/14. ³Source: Professor Robert Shiller.

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DEFINITIONS

Currency hedging : Strategies designed to mitigate the impact of currency performance on investment returns.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Inflation : Characterized by rising price levels.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Real assets : Assets that have their own value independent of their price, typically used to mitigate the potential impact of inflation lessening the purchasing power of an investor's home currency.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

MSCI EAFE Index : is a market cap-weighted index composed of companies representative of the developed market structure of developed countries in Europe, Australasia and Japan.

Relative value : The relationship between a particular attribute, e.g., a dividend, and the firm's share price compared to that of another firm.