DOVE OR IVORY? A CASE STUDY ON CURRENCY IMPACTS

Jeremy Schwartz — Global Chief Investment Officer
03/26/2015

Given the divergence of central bank policies, currencies are among the most important investment topics today. If the U.S. dollar continues to strengthen, it may be a headwind to U.S. multinationals earning revenue abroad, while boosting foreign companies that are earning revenue in the United States. This argues that foreign stocks can be important diversifiers for U.S. companies getting hurt by a rising U.S. dollar. As an example, let's compare the Procter & Gamble Company (P&G)[1] to Unilever PLC (UNA)[2], both multinational companies with well-known household brands. These two companies have very similar business models and often compete with each other, but they are incorporated in different countries, the U.S. and the Netherlands, and hence trade in different currencies, the U.S. dollar and the euro, respectively. • P&G should be negatively impacted by a stronger dollar because foreign sales are converted back into dollars at unfavorable exchange rates. • UNA should benefit from a weaker euro because its foreign sales would be repatriated back into euros.[3] **The most recent warning from P&G about the impact from a stronger dollar is below:** "The October–December 2014 quarter was a challenging one with unprecedented currency devaluations," said A.G. Lafley, P&G's chairman, president and CEO. "Virtually every currency in the world devalued versus the U.S. dollar, with the Russian ruble leading the way." He also said, "The outlook for the year will remain challenging. Foreign exchange will reduce fiscal 2015 sales by 5% and net earnings by 12%, or at least $1.4 billion after tax."[4] **Dove or Ivory?** When you go shopping, are you loyal to brands like Dove (UNA) or Ivory (P&G) soap, or do you just buy the cheapest or whatever is on sale? If you are as price conscious in the *market* as you are at the *market*, then you should consider that as the euro weakens against the dollar, UNA should have a greater price advantage, without having to sacrifice profitability, because of the more favorable exchange rate translation. In this sense, we believe that UNA (along with other foreign multinationals) offers a hedge against P&G (and other U.S. multinationals) and the impacts of a stronger dollar. Even though a stronger U.S. dollar and weaker euro might improve the profits of European companies, the dollar strength can drag down the total returns of U.S. investors who do not hedge their international equity exposure. One common question we hear is this: "Can't I just achieve the same thing by investing in a basket of American Depository Receipts (ADRs), which trade in the United States and thus do not have currency risk?" It is a common misconception that since the ADR is traded in U.S. dollars in the United States, there is no exchange rate risk. We believe it is very important to clarify that ADRs, despite trading in the U.S., do in fact contain the currency risk of the local markets. Here's why. ADRs are created by a global bank that possesses a large number of an international firm's local shares. The bank then sets a particular ADR conversion rate—meaning that an ADR share is worth a certain number of local shares. This conversion rate establishes the linkage between the ADR security and the locally traded security. To preserve this conversion relationship over time, movements in the exchange rate of the home country versus the U.S. dollar must automatically be reflected in the price of the U.S.-traded ADR in U.S. dollars. If this did not occur, it would be impossible to preserve the conversion rate established by the bank. Let's analyze how this relationship worked for UNA over the past year. While UNA's stock price has appreciated 41.0% cumulatively over the past year, the ADR price has appreciated only 9.0%.[5] Why? The euro's exchange rate versus the U.S. dollar depreciated 23.5% over this period; the ADR's appreciation was thus significantly mitigated by the euro's depreciation. It should be clear from this example that UNA's ADRs trading in the United States were still impacted by the euro's exchange rate, despite the ADRs being traded in the United States.

	3/12/2014	3/12/2015	Cumulative Change (3/12/14-3/12/15)
Unilever Local Price (in euros)	€ 27.70	€ 39.07	41.0%
ADR Conversion Rate	1	1	N/A
USD per euro	$1.39	$1.06	-23.5%
Unilever in USD (Local Price x USD per euro)	$38.51	$41.55	7.9%
ADR Price	$38.63	$42.10	9.0%
Procter & Gamble (in dollars)	$79.24	$82.09	3.6%

Sources: WisdomTree, Bloomberg, 3/12/14–3/12/15. The ADR price approximates the ADR conversion rate (1 to 1) times the price of UNA converted into U.S. dollars. You would not expect the ADR conversion relationship to be exact, because the ADRs are traded during U.S. hours, which do not fully overlap the European market hours.
Past performance is not indicative of future results.

Moreover, as the euro declined and the U.S. dollar strengthened, P&G returned only 3.6% over the period—showing how Unilever performed quite well (up 41.0%) and strong in its local currency when compared to P&G. We believe this type of strong relative performance is an example of how European exporters can serve as a good diversifier to U.S. exporter exposure during periods of U.S. dollar strength—assuming the investor is hedging currency exposure. Many assume that because ADRs trade in U.S. dollars in the United States, they eliminate currency risk. Because of the way ADRs are structured, they still contain currency risk, as we illustrated. For those looking to hedge the currency risk within their foreign stocks, ADRs are no substitute for strategies that employ a specific currency-hedging program. [1]Procter & Gamble had a 1.53% weight in the WisdomTree Dividend Index, a 3.11% weight in the WisdomTree Equity Income Index and a 1.84% weight in the WisdomTree LargeCap Dividend Index as of 3/12/15. [2]Unilever NV had a 4.74% weight in the WisdomTree Europe Hedged Equity Index as of 3/12/15. [3]This assumes neither company is undertaking its own currency hedging. [4]Source: The Procter & Gamble Company, Q2 2015 fiscal year earnings press release, 1/27/15. [5]Sources: WisdomTree, Bloomberg, 3/12/14–3/12/15.

Important Risks Related to this Article

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. This information should not be considered a recommendation to buy, sell or hold the individual stocks referenced above.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

Exchange rate : The exchange of one currency for another, or the conversion of one currency into another currency.

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.

ADRs : American Depository Receipts, shares of a firm incorporated outside the U.S. but issued by a global bank and traded in the U.S., denominated in U.S. dollars.