

Dove or Ivory? A Case Study on Currency Impacts

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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 Depositary 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. ¹Procter & 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. ²Unilever NV had a 4.74% weight in the WisdomTree Europe Hedged Equity Index as of 3/12/15. ³This assumes neither company is undertaking its own currency hedging. ⁴Source: The Procter & Gamble Company, Q2 2015 fiscal year earnings press release, 1/27/15. ⁵Sources: WisdomTree, Bloomberg, 3/12/14–3/12/15.

Important Risks Related to this Article

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