EMERALD ASSET ADVISORS, LLC

Investment Strategists for Successful Families

August 9, 2012

Thank you for reading Green Thought$. It is our privilege to provide you with our insight on current financial market events and our outlook on topics relevant to you.

Hedging Against (and Profiting From) A Prospective Decline In The U.S. Dollar

Since the end of World War II, the U.S. has been the world's foremost economic superpower and the U.S. dollar has been the world's de facto reserve currency. In fact, it was during the Bretton Woods Conference in New Hampshire in 1944 when central bankers from around the world first agreed to peg their currencies to the U.S. dollar.

At that time, the dollar was backed by the gold standard, which meant that foreign countries could exchange their dollars for actual gold. In 1971, the U.S. abandoned the gold standard and the modern foreign exchange market was born, characterized by floating, rather than fixed, exchange rates.

Under this new floating rate system, currency exchange rates fluctuate according to supply and demand, which reflect a myriad of global variables. With the advent of the floating rate system, volume in the market for foreign currency exchange took off. Today, the currency market is the world's largest and most liquid, with more than $4 trillion in daily volume.

The U.S. dollar has remained the world's reserve currency due to several factors:

- Its large circulation (roughly $1.1 trillion);
- The denomination of many transactions (especially commodities such as oil and other natural resources) being in USD;
- The stability of its political system; and
- The lack of any other viable options.

However, that may not always be the case. Last summer's debt-ceiling drama, the exponential growth of the national debt (currently $15.9 trillion), and the unprecedented debt downgrade by Standard & Poors have caused some investors to question whether at best the USD will structurally decline vs. other currencies, or at worst the U.S. will not honor its future obligations.

If the Fed continues its easy money policies, that could also lead to higher inflation that would devalue the U.S. dollar. Then, just as the Roman and British empires eventually collapsed, U.S. hegemony could gradually dissipate. In fact, that trend may already be well underway as countries such as China, Brazil, South Korea, and others grow their share of global GDP and hold so much of the U.S. government's obligations. These long-term trends compel prudent investors to consider including exposure to foreign currencies in their portfolios.

Hedging Your Currency Bets

Virtually no one can predict accurately what the future holds for the U.S. dollar, nor the timing of those movements. Even Warren Buffett got it wrong for several years in the Berkshire Hathaway portfolio. In fact, despite a weak economy and a burgeoning national debt, the U.S. dollar has strengthened vs. many foreign currencies over the past several months. We attribute this appreciation to a residual flight-to-quality status of the USD as the crisis unfolds in Europe. Over the long term, however, we believe that exposure to foreign currencies can help further diversify investor portfolios and help hedge against a possible decline in the U.S. dollar.

Currencies have also proven to be an excellent source of non-correlated returns, as price fluctuations are driven by different factors than most other asset classes. For example, central banks around the world may intervene in currency markets to prop up or drive down the value of their currency. Similarly, multinational corporations may buy or sell currencies to reduce currency risk. Even tourists can influence currency markets when they decide to visit a certain country and spend money on travel, souvenirs, or other consumer goods. Such non-profit seeking entities generate the majority of total currency turnover and the combined effects of their actions create inefficiencies that can be exploited for profit.

Global macroeconomic trends also play a role in currency markets. For example, due to the ongoing debt crisis in the euro zone, the euro recently fell to a two-year low against the dollar. At the same time, some currencies are gaining strength in the global marketplace, particularly countries with fast growing economies or commodity-rich countries.

A Fundamental Approach to Currency Investing

Investors can gain exposure to foreign currencies by investing in large U.S. multi-national corporations that conduct business in foreign countries using foreign currencies. However, we believe investors should consider ways to gain additional direct exposure to this asset class.

A professionally managed basket of currencies can provide returns with low correlation to equity and fixed income markets, as well as additional diversification benefits. Rather than subjecting investors to high minimums, high fees, lockup periods, and certain strategies common among hedge funds or commodity trading advisors, we believe a professionally managed currency mutual fund can be a better choice for many investors.

In fact, we have had an allocation to a dedicated currency fund within our conservative allocation for some time now. This fund is somewhat unique among currency funds in that its manager applies a long-term, value-oriented approach. Rather than trading currencies rapidly, the manager takes a low turnover, risk sensitive approach based on macroeconomic research. And unlike many currency funds, this particular fund typically buys short-term sovereign debt denominated in currencies from countries that adhere to high standards of fiscal and monetary discipline. To mitigate interest rate risk, the average maturity of the fund's debt holdings has never exceeded 180 days.

A Potential Risk-Mitigation Tool

Contrary to popular perceptions, currencies are not unduly risky or volatile. For example, the US Dollar Index (DXY) has exhibited a fairly low standard deviation over several different time periods (through 6/30/12), as follows:

5YR: 9.55%
10YR: 8.74%
15YR: 8.48%
20YR: 8.44%

Thus, despite all the perceived chaos in the currency markets, this particular vehicle has shown a consistent volatility level of roughly 1/3rd that of the S&P 500 Index.

By using futures contracts, traders can enter into an agreement to sell a currency at a specific price on a specific date. Of course, that doesn't mean such trades are risk-free, but it does mean that the amount of risk is limited to the price paid for the contract. Many other participants access other capital markets – fixed income, ETFs, equities – to create long and short exposures to currencies.

Recent history has shown that, when crises strike, correlations among many world markets - equity, fixed income, and commodities - tend to rise. For example in 2008, the S&P 500 Index fell 37% and the MSCI EAFE Index, a broad measure of developed international stock markets, fell 43%. In that disastrous year, high yield bonds tumbled 26% and commodities indexes fell between 36% - 46% but in contrast, the average decline for the actively managed mutual funds composing Morningstar's Foreign Exchange/Currency category was only 2.96%. Of course, that past performance is no guarantee of future results, but it does provide an indication of this asset classes' potential to minimize the damage during an extremely distressed period.

Using a Currency Strategy in Today's Landscape

We live in an increasingly globalized economy whereby the developed nations of the world are facing slow growth (or recession), aging populations, and growing debt burdens. Meanwhile, emerging markets economies have young, fast-growing populations and higher economic growth. As these nations climb the economic ladder, it's quite possible that the U.S. dollar's dominance of the world economy could decline further. We explored the implications for emerging markets debt in a prior Green Thought$. As a follow-up to that, we believe investing a portion of a diversified portfolio in foreign currencies can provide some protection, along with an opportunity to profit from these demographic, fiscal, and geopolitical evolutions. Given the challenging investment landscape facing investors today, pursuing a strategy such as currencies that can capitalize on these global phenomena has the potential to make a significant difference in client portfolios, both in the short and long-term.

About Emerald

Emerald Asset Advisors, LLC is a Registered Investment Advisor (RIA) founded in 1998. For more information, please visit our website.
Visit our Web site »