

DEALING WITH A DECLINING DOLLAR

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Recently, the decline in the value of the dollar against other major currencies has been one of the most controversial economic topics in the press. The effect of currency changes is greatly misunderstood. Today we want to provide a primer on currency rate changes and how they affect a well-diversified investment portfolio. In this commentary, our goal is to explain some of the basic math involved and touch on the typical hysteria you may read about in the media. The bottom line is that currency fluctuations are virtually irrelevant to a long-term investor with a well-diversified portfolio but can be devastating to a speculator.

An individual American company is affected to the extent they have business relationships overseas. Import and export companies are greatly affected by changes while the impact on other types of companies is only tangential. We strongly advocate broad portfolio diversification to minimize company specific risks of all types. In fact, it



is the health of our economy as a whole, not just currency change swings, that is most likely to affect your U. S. investments. We remind you, however, that predicting how the markets will react to the perceived health of the economy is notoriously difficult.



When we invest overseas, the effect of currency rate changes can be significant. Here is an extreme example. Let's say that we buy shares of ABC company for 100 yen per share when the dollar is worth 100 yen. We convert our dollar into 100 yen and buy a share. Later, the price of ABC stock is still 100 yen on the Tokyo exchange but the dollar has declined in value to 50 yen. If we sell the stock for 100 yen and convert to dollars, we get back \$2. The stock price was unchanged, yet we made money.

This dynamic illustrates how the press has been hyping the dollar's decline on a regular basis while our clients have been making significant returns with the overseas portion of their portfolios. While we know that investing overseas is scary to some, we believe a large part of this fear is media driven. Between war, terrorism, protests, disease, poverty, natural disasters and other events reported to us, the rest of the world can look like a frightening place. It is ironic that while so many foreign issues have increased our anxiety, our wealth has actually increased thanks in part to the very holdings we feared.

We would be remiss if we didn't mention that the counterpart to the tailwind a declining dollar provides our foreign holdings is the headwind a rising dollar would represent. Make no bones about it. At some point the dollar will rise. The press will likely say this will be bad for America. Yes, that is right. The very press that has been saying a falling dollar is bad will say a rising dollar is bad, too. For an example of how this might look, you need only tune in to the European financial media.

The other side of a falling dollar is a rise in another currency. Saying the dollar has fallen against the Euro means the Euro has risen against the dollar. The European press has been crying for months about how the stronger Euro is making European products and services more expensive to Americans and hurting their prospects for economic growth. When the dollar rises, it is a good bet the media here will be saying similar things, such as our products are too expensive in the world marketplace, that we are losing our competitiveness, and that people will be losing jobs. (Germany's unemployment rate is now around 10%.)

For all of us, the long-term is great safety net. Over the long-term, there is zero expected return from speculating on currency rate changes. The long-term diversified investor has the advantage of having something in the portfolio benefiting from changes in the currency rates, regardless of short-term swings. The true investor has the advantage of not needing to make predictions about short-term market behavior to be successful. It may be hard during a time of media hype to maintain perspective and act like a long-term investor, but doing so is a great deal less stressful and more profitable than acting like a speculator any day.