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Cost of diversifying

Investors must heed loonie's value

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If you want a diversified portfolio, you need to go beyond Canada's borders. That's the advice of pretty much every portfolio manager, financial planner and adviser you can find. This is largely based on the notion Canadian stocks account for less than five per cent of the market worldwide.

Moreover, our markets are dominated by banks, energy and mining, so even a diversified Canadian portfolio is heavily concentrated in a relatively small number of sectors.

But going outside Canada poses a risk often unrecognized by the average investor: the value of the Canadian dollar.

Its value relative to currencies in the nations you're deploying capital can affect the returns on investment — positively or negatively.

The challenge is twofold. One, when you're seeking to invest in another market, if the currency there is highly valued relative to the dollar, it can be costly just to gain access to the marketplace. Moreover, if that currency falls, the value of your investment in Canadian dollars also decreases.

You could even see losses on your investment if the investment itself — its share price — increases in value. The reason being is if you were to sell it and convert back to Canadian currency, you'd be getting fewer loonies in return.

Of course, the opposite is true if you buy a foreign asset when the Canadian dollar is high relative to that nation's currency. If the dollar then falls against the foreign currency, the value of your investment in Canadian dollars will increase.

For most investors, when we're talking foreign currency, we really mean the U.S. dollar.

That's where most people seek to diversify beyond Canada.

And right now, the Canadian dollar is low relative to its U.S. counterpart. It could be the case that you invest in U.S. stocks and see the Canadian dollar rise, which would negatively impact the value of your U.S. investments.

So what's a globetrotting investor to do?

Well, plenty of options are available to eliminate the currency risk associated with your foreign investments. But most experts argue hedging — eliminating currency risk — isn't always the right thing to do.

Cory Papineau, a certified financial planner with Assiniboine Credit Union in Winnipeg, says currency is a concern for his clients for a few reasons.

Some are retirees who vacation in the U.S. for extended periods, so a falling loonie can impact their purchasing power south of the border. Others are investing in stocks and bonds in the U.S. In that case, the rising loonie can hurt their U.S. investments.

"For snowbirds, I encourage them to keep short-term needs in U.S. cash," Papineau says. "The funds they need next year should be liquid and easy access."

That means you should look at a U.S.-denominated savings account.

But Papineau also encourages those who know they will be travelling south for a number of years to think longterm. He suggests they purchase U.S.-denominated mutual funds. This is more of a long-term play for money that will be invested for 10 years or more.

Those with a shorter timeline — but more than a couple of years out — should consider currency-hedged U.S. mutual funds.

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"These are the same funds investors are likely already familiar with, but the portfolio manager is using future contracts to set the price of the currency in the future so the fluctuations of currencies have a more minimal impact," he says.

Do-it-yourself investors who want to own U.S. assets and hedge against currency can select currency hedged exchange-traded funds (ETFs), says Scott Clayton, a senior researcher with the TSI Wealth Network (tsinetwork. com), an investment information website for DIYers.

"These ETFs are sold in Canada and hold U.S. stocks — but they are hedged against movements of the U.S. dollar against the Canadian dollar," he says.

"That means that the ETF's Canadian-dollar value rises and falls solely with the movements of the stocks in its portfolio."

For instance, if a stock increases in value by 10 per cent on the U.S. stock exchange, but also increases an additional five per cent for Canadian investors because of a rise in the U.S. dollar, a hedged ETF would eliminate that currency increase, so the investor would only receive the 10 per cent rise in the value of that holding.

"At the same time, the reverse is also true," Clayton says. And that's where hedged ETFs pay off. They protect against the Canadian dollar rising in value against the U.S. dollar. So you'd still get the 10 per cent gain in the aforementioned example, but you wouldn't experience any loss that results from currency.

Yet investors can also hedge with more traditional means using actual futures, says Adam Pukalo, an investment and commodity futures adviser with PI Financial Winnipeg.

Investors can buy currency-future contracts, for example, usually under the guidance of an adviser experienced in futures trading that allows them to purchase Canadian dollars with U.S. dollars at a future date at a set price.

The investor pays a premium for the contract, and if the Canadian dollar doesn't end up increasing, then the contract expires and the investor's loss is the cost paid for the futures contract. But if the Canadian dollar does rise, the investor can then exercise the contract and purchase Canadian dollars at a lower price than the market price. In turn, this can help eliminate losses that could result from a soaring loonie.

"But there are times of the year where it doesn't make sense to protect from the Canadian dollar's rise," Pukalo says.

Now, for example, may not be the best time to hedge because the Canadian dollar faces a lot of headwinds that would likely prevent it from significantly increasing in value against the greenback.

"With everything up in the air with NAFTA and the Bank of Canada holding rates, it may not make sense to protect against the Canadian dollar going higher for a little bit of time."

He adds the "Canadian dollar could be headed toward 70 cents, and that could also be a floor where it could rebound and increase in value."

At that point, hedging may again be warranted.

Yet, for the majority of investors buying U.S. stocks, they are better off not hedging at all, Clayton says.

"If you are wary of the possibility of a U.S. dollar decline, our advice is to reduce your exposure to U.S. stocks and other U.S. dollar assets," he says.

No one — not even experts — can predict currency movements with accuracy. What's more is hedging comes at a cost, in most cases a higher management expense ratio with hedged fund products.

"Over the long term, exchange rates do seem to smooth out, so paying for protection from currency risk in the U.S. and other global markets doesn't hold significant value," Papineau says. "And for younger individuals who have a decade or more for their time horizon, I would suggest the cost of the hedging is likely not worth it."