



# How high can the dollar go?

✓ **Gary Klopfenstein, senior overlay strategist, explores how high the dollar may go against sterling and how quickly this rise will occur**

Investment professionals and casual observers have frequently asked this question over the past few weeks. Earlier in 2014, when the pound was trading above \$1.70, this question was not top of mind for most people, but as 2015 begins, the question seems a very valid and

appropriate one for both investors and more casual observers of global markets.

It is clear as to why this question is now so relevant. As recently as July 2014, the pound was at its highest level since just before the global financial crisis of 2008 and appeared to be on track for continued strength. Sure, some dark clouds were on the horizon back then, but this had been the case for quite some time, and the UK appeared to be somewhat insulated from the problems in Europe. How quickly things change. Fast forward to today. The US economy seems to be ahead of the curve as lower energy prices create a tailwind for growth, the European Central Bank is fighting deflation with American-style quantitative easing while the US Federal Reserve is withdrawing theirs and providing guidance on raising interest rates. So, how high might the dollar go against sterling? Is \$1.40 in the cards? Maybe the better question is, how soon will it get there?

But before we all jump on the dollar bandwagon, one small observation. Over the last 30 years in the investment management arena – and in the specialist currency management world in particular – we have learned that currency markets are devilishly hard to predict and that even the best minds in economics are wrong as often as they are right. Sorry, that's two small observations. In the summer of 2014 very few experts predicted the now-obvious currency market

movements. We have found this repeating pattern to be true for as long as people have been managing investments and risk. Everything is obvious in retrospect.

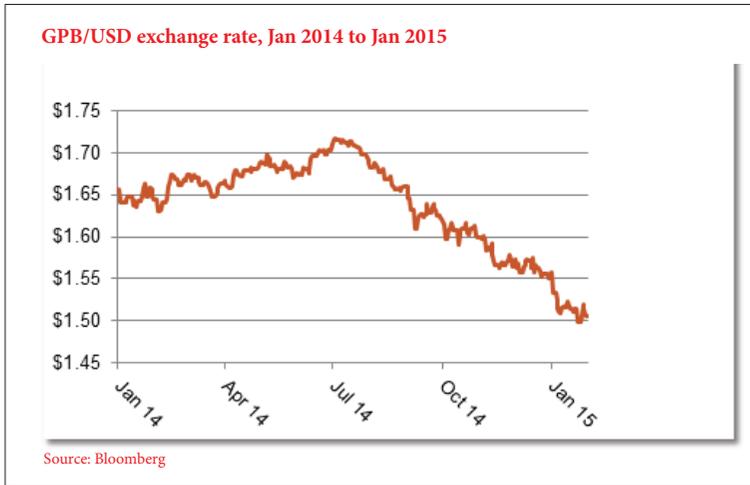
When trying to answer questions like this investors are often asking the wrong question. That seems to be the case now. The question investors and stewards of capital should be asking is not how far up will the dollar go, but is there a way to participate in that strength should it occur, but still be able to protect portfolio values if the dollar confounds us 'experts,' and does not go up this year.

Before we answer that, let's outline why this whole discussion actually matters for investors. Currency risk is embedded in any cross-border investment. For example, equity returns from markets outside of the UK are

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made up of two distinct components; the return from the underlying equity, which is measured in its home currency, and the return from the currency exchange rate which impacts the investment value when converted back to pounds. Most global equity investors don't invest in order to capture the

currency component, but they get it as a by-product of their global investments. Currency is the tail, not the dog. Historically, many UK institutions have taken the stance of hedging a portion of their non-UK equity investments on a passive basis, primarily because the pound has generally been strong and it has been profitable to hedge



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their dollar investments. Looking forward, that approach may not be the best choice as a currency hedge may prove to be very costly in times of a rising US dollar.

Reducing or eliminating currency risk is pretty straightforward and can be done simply and cheaply with forward contracts. However, there is no free lunch. If you have a hedge in place and the currencies embedded in your portfolio fall in value you will be delighted.

Conversely, if they go up, your hedge will lose money. While the downside currency risk would have been eliminated, the upside potential and diversification benefits of currency would have also been eliminated. Another way to hedge away currency risk, although

one that is a bit more complex, is buying insurance in the form of options. The result is protection against downside movements in currency, while still allowing the positive returns due to currency appreciation to pass through. While this may be a reasonable approach, it is often inefficient and expensive. So let's restate the question. Is there a way to protect a portfolio from depreciation of currencies while at the same time benefitting if they rise in value, and do so in an efficient and cost effective manner?

In short, the answer is yes. The process is called active currency management and the goal is to increase currency hedges during periods when the currency is depreciating and decrease or eliminate the hedges when the

currency is appreciating. The result of a successful active currency program would be to offset a portion of negative performance due to currency, allow part of any positive performance related to currency to pass through to the portfolio during times of strength while reducing losses on related hedges, reduce overall volatility and participate in the occasional diversifying effect of currency. The focus is squarely on managing the currency risk in the portfolio – not predicting future currency values – and controlling for both currency depreciation and hedge losses.

At this point, most people are either thinking that this is the best idea ever, or are wondering about many of the perceptions they have previously carried about currency management; hedging currencies reduces portfolio diversification, hedging currencies creates benchmark risk, currencies are a zero sum game, currencies are confusing, or nobody can make money in currencies. We'll take a shot at demystifying these perceptions in a later paper, but for now, we would like to leave you with the following thought:

Will the recent strength in the US dollar continue through 2015? Maybe... but maybe not. In either case, if you are an international investor concerned about the potential negative impacts of currency on your portfolio, you may just be asking the wrong question.



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