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International managers' strategies can vary a lot



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The international markets performed very well in 2006, as the Morgan Stanley EAFE (Europe, AustralAsia, Far East) index gained 26.34 percent.

The falling dollar had a big impact on returns for the U.S. investor. The EAFE gained only 16.46 percent in local currency. Therefore, nearly 10 percentage points were attributed to dollar movement.

When a manager buys stocks on a foreign exchange, the transaction is made in that country's currency. The stock price moves in that country's currency but is translated into U.S. dollars for a U.S. investor. As the foreign currency appreciates against the dollar, the U.S. shareholders get a "bonus." However, the reverse is true when a foreign currency falls against the dollar.

There are a variety of approaches that non-U.S. equity managers use to manage foreign stocks. Some managers completely hedge the foreign currency. They're focused on stock selection and want to eliminate the impact that currency has on a portfolio. It's not a big surprise that most of these managers have underperformed the EAFE recently.

The EAFE has been the best-performing broad index in the last four years, returning 24 percent annually, in a generally dollar-weakening environment. There will be times, as the dollar is strengthening, that hedging will add value.

Other managers hedge opportunistically, making active currency decisions to protect equity positions or to bolster returns simply through currency trading.

The most common approach by U.S. managers investing in foreign stocks is to not hedge at all. Most managers believe it's part of the foreign investment experience or that the future of currency movement is difficult to predict.

Further, most managers are sensitive to performing near the unhedged EAFE index, and although hedging can add value, it can subtract as well. Therefore, since the EAFE isn't hedged, most managers won't hedge.

In addition, with the global economy, many companies (stocks) in investment portfolios actively hedge currency, and the approach of a company's hedging may be a factor in determining its attractiveness as an investment.

The emerging markets -- stocks in nondeveloped countries that are outside of the EAFE index (such as China and India) -- also performed very well in 2006.

In dollars, the MSCI Emerging Markets Index was up 32.17 percent. "EAFE" managers -- those who focus only on stocks in developed countries -- have struggled, as opposed to managers that have had some emerging-markets exposure.

"EAFE +" managers, with up to 30 percent in emerging markets or small-cap foreign stocks, have benefited greatly by this exposure as opposed to their more conservative counterparts. It's important to understand a fund or manager's mandates, the reasons for performance and the fit in a specific investment portfolio.

Many economists believe the dollar will continue to fall in 2007, which should be good news for U.S. investors buying foreign stocks. But most economists are more successful in a rearview mirror, and having a diversified portfolio of non-U.S. strategies might be the proper hedge.