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CURRENCY EFFECTS: A DEEPER LOOK

Introduction

In 2006, non-US developed stock and bond markets generated substantially higher returns than US stock and bond markets. Year-to-date, this outperformance has continued. However, all of this outperformance is due to currency movement, and more specifically, the weakness of the US dollar. In this *Monthly*, we look at how currency has affected non-US stock and bond returns. We also address why it is important to separate currency decisions from underlying asset class decisions when managing global portfolios.

Recent Trends

Much attention has been given to recent weakness in the US dollar. Thus far in 2007, the dollar has declined by more than 9% against the euro, 6% versus the British pound and 18% versus the Canadian dollar. If we consider a longer-term perspective and extend the time frame to the beginning of 2000, it might be a surprise to some that most of the dollar's weakness against the euro and pound occurred between 2001 and the end of 2004 (Figure 1). With respect to the Canadian dollar, the bulk of its appreciation relative to the US dollar took place in a less concentrated timeframe: between 2001 and the middle of 2006 (Figure 2). The more recent decline of the US dollar against these major currencies has been a continuation of what occurred in the early part of this decade. It is interesting that the recent pessimistic comments regarding the US dollar are being made after a considerable decline has already occurred.

Effect on Returns

The weakening dollar has clearly helped boost returns earned by US investors from holding non-US assets. Fig-

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CURRENT TOPIC

Currency Effects: A Deeper Look

- *Introduction*
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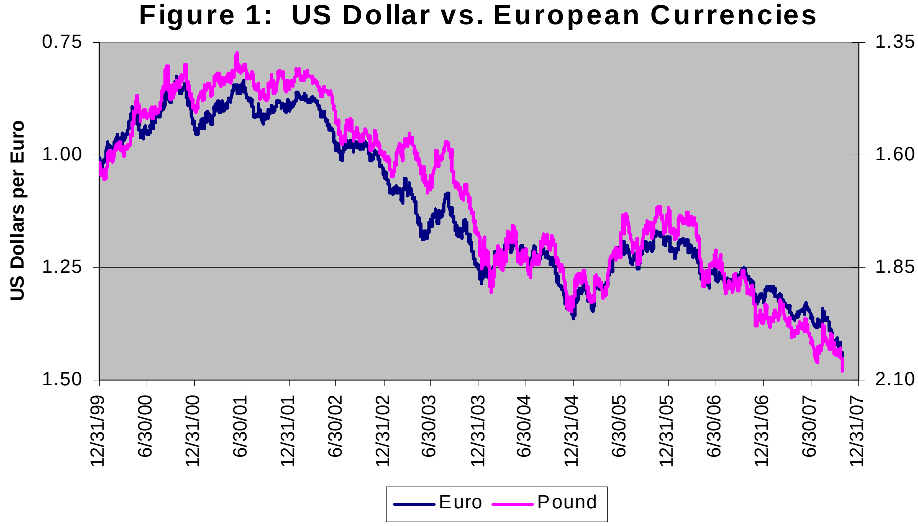
STRATEGY

- *No changes were made to strategy*
- *We remain underweight equities, high yield and emerging debt across portfolios*

Figure 1: US Dollar vs. European Currencies



Source: Bloomberg

"IT MIGHT BE A SURPRISE TO SOME THAT MOST OF THE DOLLAR'S WEAKNESS AGAINST THE EURO AND POUND OCCURRED BETWEEN 2001 AND 2004"

Currency Effects: A Deeper Look - Cont'd

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ure 3 compares the returns of the US and non-US developed stock and bond markets to US investors. In examining market or asset class returns, we use broadly-diversified indexes that provide objective representation for each asset class: the Russell 3000 for US equities, the Morgan Stanley Capital International (MSCI) EAFE index for non-US developed equities, the Lehman Aggregate index for US investment-grade bonds and the Lehman Aggregate ex-US index for investment-grade bonds outside the US.

As mentioned, non-US stock and bond markets have outperformed their US counterparts. But, how much of the return was due to the dollar's slide? We can separate the underlying asset class returns from the currency returns to determine how much of this outperformance was driven by the weakening dollar. In order to see what returns would have been available to US investors excluding movements in currencies, we use *dollar-hedged* returns. The index providers, Lehman and MSCI, provide these hedged returns to show what a US investor would have received, had the non-US assets' currency exposures been hedged back into dollars. Doing so allows us to compare how the assets actually performed independent of changes in foreign currencies. What we observe is that, hedged into the US dollar, non-US developed stock and bond markets have, for the most part, actually underperformed the US stock and bond markets since the beginning of 2006.

Figure 4 presents the corresponding hedged returns for non-US equities and bonds alongside the US and unhedged non-US numbers from Figure 3. Clearly, the dollar's weakness has had a substantial impact on how well non-US assets have performed. In fact, if we compare *hedged* returns of non-US asset classes to US asset classes, it is clear that US markets performed better. For example, since the start of 2006 (last column Figure 4), dollar weakness has added 22 percentage points to non-US equity returns (48.6% - 26.6%).

Currency Movement

In keeping with our firm's investment philosophy, we value currencies, like asset classes, in terms of long-term fundamentals. The starting point for constructing a fair value for a currency starts with the concept of Purchasing Power Parity (PPP). This is the notion that identical goods should be priced the same whatever currency they are denominated in. If PPP holds, there is no "arbitrage" profit to be made – i.e., buying in a cheaper currency, shipping to a more expensive currency location, and reselling for a profit. The fair value level acts as an anchor for assessing the attractiveness of a currency.

But currencies often deviate from long-term fair value. A number of our previous *Monthly* articles have discussed factors that can affect currency movements. Some of these include: interest rate differentials, inflation differentials and differences in economic growth rates.

In addition, there is also a behavioral aspect to currency movements, which is criti-

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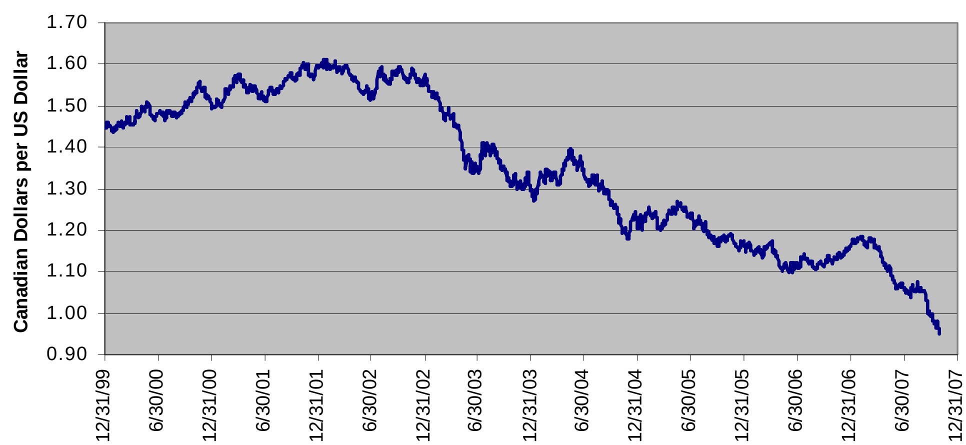
Figure 2: US Dollar vs. Canadian Dollar



Source: Bloomberg

Figure 3: US & Non-US Developed Market Returns

	YTD 10/31/07	2006	12/05 - 10/07
Russell 3000	10.8%	15.7%	28.2%
MSCI EAFE	17.6%	26.3%	48.6%
Lehman Aggregate	4.8%	4.3%	9.3%
Lehman Ex-US Aggregate	9.6%	8.2%	18.6%

Sources: Russell, MSCI, Lehman, Stairway Partners   Note: Returns are not annualized

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

cally important when thinking about currency deviations from fair value. The behavioral story can be best understood using an example. As the dollar weakens against the euro, a US investor sees returns in European stocks and bonds exceeding the returns of US markets (not unlike recent performance given the US dollar decline). The response is typically to allocate more funds to "better performing" European markets and away from US markets. This results in capital flows out of US dollar assets and into euro assets. The effect of these flows is to put additional downward pressure on the already declining US dollar and upward pressure on the euro, thus further increasing returns to euro-denominated assets. It is easy to see how this cycle, and what can be viewed as performance chasing behavior, can drive a currency well beyond its fair value justified by fundamentals.

Currency Management

Many investors misconstrue the performance of their non-US assets as coming from the assets themselves rather than from the currency. Or, they don't make a clear distinction between the return that is due to currency and the return due to the underlying non-US stocks and bonds. In managing globally diversified portfolios that naturally have currency exposures outside of the US, we separate the currency analysis and decisions from the asset classes. Should a currency move away from its long-term fundamentals, it can be much more efficient to manage the exposure directly rather than trying to adjust it through the equity or bond markets.

It is easier to think about this concept by referring again to Figure 4. We saw that the MSCI EAFE index outperformed the US equity market by 20.4 percentage points (48.6% - 28.2%) since the start of 2006. But, at the beginning of 2006, if you had wanted to hold foreign currencies because you correctly anticipated the dollar decline, it would have been more advantageous to hold US equity assets and hedge the dollars into foreign currencies. This would have led to a superior return – over 50% – because of the combination of the 22% currency return (the currency effect or difference between the hedged and unhedged EAFE indices) and the US equity return of 28.2%. Non-US equities underperformed the combination of a US equity position plus foreign currency exposure. The same is true in bonds.

Given the volatility and persistent trends in currencies, our approach is to leave currency exposures "alone" until an exchange rate moves far from its fundamental value.

Conclusion

It is important to keep the currency and asset class decisions separate in formulating strategy. Additionally, investing in non-US *asset* classes to obtain *currency* exposure can lead to suboptimal results.

It appears to us that many investors are buying non-US assets and chasing performance. The dollar has already fallen a long way from its peak of six years ago against the European currencies and the Canadian dollar. The outperformance of non-US developed stock and bond markets in the last couple of years is entirely attributable to US dollar weakness.

Figure 4: US & Non-US Developed Market Returns

	YTD 10/31/07	2006	12/05 - 10/07
Russell 3000	10.8%	15.7%	28.2%
MSCI EAFE	17.6%	26.3%	48.6%
MSCI EAFE *(USD Hedged)*	8.7%	16.5%	26.6%
Lehman Agg	4.8%	4.3%	9.3%
Lehman Ex-US Agg	9.6%	8.2%	18.6%
Lehman Ex-US Agg *(USD Hedged)*	3.4%	3.2%	6.7%

Sources: Russell, MSCI, Lehman, Stairway Partners

Note: Returns are not annualized

"If we compare *hedged* returns of non-US asset classes to US asset classes, it is clear that US markets have largely outperformed"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			under	
US	2.6%	8.2%	small under	Exposure slightly below normal
Non-US Developed			small under	Moderately unattractive relative to risk
Eurozone	1.2%	7.7%		
Japan	-6.6%	4.6%		
UK	5.3%	9.0%		
Emerging	-10.7%	11.4%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Sector has become more expensive, particularly at longest maturities
2-Year	3.9%	4.3%		
5-Year	3.8%	4.5%		
10-Year	3.6%	4.9%		
30-Year	3.1%	5.1%		
US Municipal Bonds			neutral	Yields at most maturities fairly priced
2-Year	3.4%	3.3%		
5-Year	3.6%	3.5%		
10-Year	4.0%	3.8%		
30-Year	6.4%	4.2%		
US High Yield	5.9%	6.6%	under	Despite widening, spreads over US Treasuries remain tight
Non-US Government Bonds			under	Yields in some markets too low, especially at longer maturities
Euro 10-Year	3.5%	4.6%		
Japan 10-Year	0.4%	2.0%		
UK 10-Year	4.2%	5.2%		
Emerging Markets Debt	2.8%	6.9%	under	Spreads over US Treasuries remain too tight
Cash	4.5%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-7.4%	-6.2%	-3.9%	Euro is somewhat expensive
Japanese yen	4.8%	-1.8%	5.1%	Yen is slightly attractive
UK pound	-7.7%	-2.4%	-3.5%	Pound is somewhat expensive

Notes: **As of: 10/31/2007**

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.
The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).
The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.
Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.