Thoughts that count

Do Big Mac's taste 22% better in Canada?

In 1998, IBM unveiled *Blue Pacific,* the world's fastest computer. This computer could perform 3.9 trillion calculations per second; 15,000 times faster than the average desktop computer. It would take a person using a handheld calculator 63,000 years to perform as many calculations as this computer could execute in a single second. In the 1990's IBM dominated the technology industry and became one of the largest and most successful employers in the world.

IBM's stock was valued at $52 at the beginning of 1998. Ten years later it had increased to $84, a respectable 6% annual return. Its stock handily outperformed the overall US market over that decade by more than 5% per year. Shareholders of IBM would have been quite pleased with their investment. That is, *American* shareholders would have been pleased. Canadian shareholders would have been far less enthusiastic.

In 1998, the Canadian dollar traded at 67 cents relative to $1 US. That means, one share of IBM stock priced at $52 US, would have cost $78 Canadian. Ten years later, the Canadian dollar had risen to 99 cents relative to $1 US. Therefore, one share of IBM stock trading at $84 US would have been worth $85 Canadian. So if a Canadian had bought shares of IBM in 1998 and sold them ten years later, the effect of currency eliminated almost all of their return. Canadians did not experience an annual 6% return; instead they received less than 1%.

This example might lead one to believe they should keep all of their investments inside Canada. Perhaps back in 1998 investors should have simply invested in the Canadian version of IBM. Unfortunately, that option did not exist then, nor does it now. Relative to the rest of the world, Canada offers a limited opportunity set for investment. Our entire market represents less than 4% of the worlds publicly traded companies, about the same size as France. The US represents more than 50% of the world's opportunities and Europe and Asia combined make up 40%. Canada has 3,600 publicly listed companies in which to invest; the rest of the world offers 106,000. Look around at where you are sitting right now, likely very little of what you see was invented, designed, manufactured or distributed by a Canadian company.

If the Canadian market was sufficiently diversified, perhaps our relative size could be ignored. Unfortunately, that is not the case; our market is overly concentrated. A closer look at the makeup of our capital markets shows just how under-diversified Canada really is. In Canada, the 20 largest publicly traded companies account for a whopping 52% of the total Canadian market. Those same companies represent about 2% of the global market. Quality companies certainly exist in Canada, but the quantity is low compared to the rest of the world.

So what is an investor to do if they would like to capitalize on opportunities outside of Canada but are concerned about the effect of currency exchange rates? There are two ways to approach this question. First, if an investor believes the Canadian dollar is going to decline against a foreign currency, the investor needs to do nothing. While a rising Canadian dollar subtracts from IBM's return, a falling Canadian dollar adds to it. Six months ago the Canadian dollar was valued at 90 cents US. By the end of April it had dropped to 83 cents US, thus an investment in IBM was boosted 7% just from currency exposure. Portfolio's at Stewart Financial have a significant weighting in foreign investments and have benefited from this fall in the Loonie.

What if an investor believes the Canadian dollar is going to rise in value like it did in the 1990's, how do you protect your foreign holdings? This can be accomplished through something called a *currency hedge*. A currency hedge is a financial instrument which eliminates the effect of currency fluctuations. In essence, with the use of a currency hedge, the actual return of IBM stock would have been the same for both American and Canadian investors.

Here's a simplified example of how a currency hedge works; Canadian investor, Stephen, wants to buy shares of Apple (a US stock) and American investor, Barack, wants to buy shares of Loblaws (a Canadian stock). Because both of them are investing outside their home countries, they are concerned about how their respective currencies will affect their return. To solve their dilemma, Stephen and Barack decide to make a contract between them that in one year's time they will exchange currencies at a rate of $0.80 Canadian for $1 US, which is the same as today's exchange rate. One year later the exchange rate has moved; the Canadian dollar has depreciated 10% so that $0.72 equals $1 US. Now Stephen owes Barack 8 cents. However, when Stephen sells his Apple shares he is doing so in the appreciated US currency. After he sells his stock he will convert the proceeds back into Canadian dollars and regain his lost 8 cents. The loss on the contract with Barack is offset by the gain on the currency appreciation embedded in the Apple stock. Stephen has hedged his exposure to the US dollar.

With the Canadian dollar dropping relatively quickly over the past few months, our portfolios have added some currency hedging strategies to help protect our foreign investments. It is important to note that the primary goal of the hedging in our portfolios is to mitigate risk, not simply to boost returns. The hedges are there to protect our investments in case the Canadian dollar increases unexpectedly. Currency markets are notoriously difficult to predict over the short term and so the role of hedging is to dampen the volatility of exchange rate fluctuations. We are not making large bets on currency moves.

Academic research suggests a total portfolio should have between 25% and 75% of its foreign currency exposure hedged. For a Canadian, that means 25% of the foreign exposure is hedged when the Canadian dollar looks overvalued (when there is a probable chance of the Loonie falling), and 75% when it looks inexpensive (when there is a greater risk the dollar will rise). By keeping the foreign holdings at least partially hedged at all times we lower the risk in the total portfolio. It is not possible to pick the exact top or bottom of exchange rates which is why utilizing a range is a good idea.

So how does one know whether the Canadian dollar is overvalued or inexpensive? There are many variables which influence exchange rates in the short term (inflation, unemployment and interest rates to name a few), but over the longer term currencies tend to move toward something called *purchasing-power parity*. This theory proposes that a bundle of goods should cost the same in Canada and the US once you take the exchange rate into account.

Let's say the average price of a Big Mac in America is $4.50 and in Canada it is $5.50. Purchasing-power parity would therefore say the Canadian dollar is overvalued by 22% ($5.50/$4.50). The difference in prices of Big Mac's is due to differences in input costs from a wide range of sectors of the local economy, such as commodities (beef, lettuce, bread, cheese), labour, advertising, transportation and real estate costs. Over time the parity in these prices between countries should be unsustainable; the US is much larger and has more resources than Canada and therefore should be able to make a less expensive Big Mac. At these prices Canadians would choose to buy the cheaper American hamburgers. They would buy US dollars in order to import their Big Mac's from the US. This puts upward pressure on the US dollar and simultaneously downward pressure on the Loonie (as people sell their Canadian dollars to get their burger buying US dollars). Purchasing-power parity currently suggests the long term Canadian-US exchange rate should be 80 cents.

Global opportunities continue to outnumber those available inside Canada. The drop in the Loonie has benefited our client's portfolios over the last year and we have begun to utilize hedging tools to protect those gains. We will keep an eye on developments that affect future exchange rates, and make changes as opportunities present themselves.

Your *making summer vacation plans in Canada so I don't have to buy US dollars* investment advisor,

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