THE RISE IN THE CANADIAN DOLLAR

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Canadian Dollar Strengthens

In the past several months, the Canadian dollar (“C$”) has risen significantly vis-à-vis its US counterpart (“US$”). In December of last year, one C$ purchased about 0.62 US$; today one C$ purchases about 0.73 US$. This represents a gain of over 17%.

Effect on Economy: Mixed

A stronger C$ can have both positive and negative effects on the economy.

- Plus - In the near term, the prices of goods purchased in US$ are cheaper in Canada: we can buy more imports.
- Minus - Our exports become more expensive to US buyers, which raises the possibility of an economic slowdown in Canada.
- Plus - In the longer term, a stronger C$ would force our exporters to become more efficient in order to compete. Until the past decade, both Germany and Japan were able to enjoy high levels of prosperity through exports *despite* strong currencies; one of the reasons had to do with high levels of production efficiency.

Effect on Investments: Mixed

The effect of currency fluctuations on investment portfolios can be an important part of overall return. This applies most particularly to foreign investments. The general rule is that a rising C$ decreases the value of foreign investments; conversely, a falling C$ makes foreign investments more valuable in C$ terms. In the past 25-odd years, the general decline of the C$ contributed to the usually-higher returns of foreign investments.

Example: US Equity Fund

So far in 2002, the US market as represented by the S&P 500 Index has risen from roughly 880 to 934, a gain of just over 6%. However, from a Canadian investor’s point of view, the return has been negative, because the C$’s rise made the value of US investments less expensive (much like our imports). Here’s how it works:

- Jan 1, 2003: investor places 1 C$ into a US Equity Fund. The fund manager converts the 1 C$ into 0.62 US$, and then buys a unit of the S&P 500 at 880. [The S&P 500 is being used as a proxy for the US Equity Fund. In reality, a US Equity Fund’s composition would differ from the index.]

- May 22, 2003: investor sells the US Equity Fund. The S&P has risen from 880 to 934 (+6%). Therefore, the 0.62 US$ is now worth nearly 0.66 US$. At this point, the fund company converts the 0.66 US$ back into C$ at the current exchange rate of 1 C$ = 0.73 US$. It took 0.62 US$ to buy 1 C$ on January 1; now it takes 0.73

US$. In other words, it takes more US$ to buy C$. The US Equity Fund rose to 0.66 US$, but this isn't enough to buy a single C$ today. In effect, once the conversion back to C$ takes place, the investor is stuck with 0.90 C$.

Keep in mind that true long-term investors are unlikely to face such a large impact from currency fluctuations, because over time the growth in assets should normally exceed currency swings. The example highlights one peril of overly-active trading.

Other Currencies

In general, many currencies have been rising compared to the US$. As a result, Canadian investments in, for example, European equities, have been impacted to a much smaller degree than investments in the US. Returns year-to-date from Europe are mostly attributable to the equities themselves, and not the currency.

Going Forward

Going forward, the C$ will either: continue to rise, start to fall, or trade within a range around current levels. There are innumerable economists, many with PhDs, who can make convincing arguments for any of these cases. Just over a year ago a prominent economist was calling for a 60-cent C$. Although his prediction almost came true, the current high level of the C$ certainly came as a surprise to many. In other words, predicting the future is dicey, and possibly not the best use of our mental resources. Better be it for us to diversify our investment portfolios to take into account both the benefits and risks of owning foreign securities.

The Tradeoff

Canada does not have a large number of world-class companies, and as a result, buying foreign funds generally increases our opportunity for long-term growth. Conversely, as we've seen so far in 2003, this opportunity can be wasted if currency movement goes the wrong way.

There are two ways to mitigate this risk:

- One is to have a sufficiently long time horizon to withstand currency fluctuations; over time, short-term fluctuations are normally less important than the successes of individual companies.
- Second, some foreign mutual funds have a policy of hedging currencies, which effectively neutralizes the fluctuations (for a cost).

Clients and Advisors

Clients who need to redeem investments in the near term should determine with their advisor whether or not the potential benefits of foreign diversification outweigh the risk of adverse currency fluctuations.