Hedging Currency Risk: 4 Options for the Plummeting Dollar

With the United States Dollar hitting all time lows against the Euro Currency and 3-5 year lows against nearly all of the major foreign currencies, dollar denominated trading system and CTA investors are wondering just what they can do?

The Euro hit an all time high of nearly 1.35 Euros / US $ in the first week of December, and after a brief dollar rally last week, is back to within striking distance of new all time highs. The Euro has gained approximately 8% against the dollar this year after increasing over 21% in 2003. Elsewhere, the Aussie dollar has increased close to 50% over the past two years, and the Sterling, or British Pound, close to 30%. Foreign trading system investors with accounts in US Dollars have seen the value of their Dollars decrease substantially this past year - and its time they took notice.

The bear market for the US Dollar could continue for quite some time given the record levels of debt the United States keeps issuing to finance its ever-widening account deficit. In the simplest terms, the United States government spends much more money than it takes in - by hundreds of billions of dollars - and must borrow money through issuing T-Bills and other government bonds. The more money the US borrows, the amount of money needed to cover those loans increases, and therefore the supply of dollars increases. As in any commodity, the more supply you have, the lower the demand and therefore the lower the price.

Added to this basic economic perspective is the feeling that a weaker US dollar could help erase the deficit that has caused it, putting even more downward pressure on the US Dollar. The logic behind a weak dollar helping reduce the deficit goes something like this: the weaker the dollar, the cheaper US good are, and therefore the more US goods US citizens and the rest of the world buys, and therefore the US has more money than it spends, meaning it doesn't have to borrow as much. The relatively weak stance by the Bush administration regarding the dollar has signaled to many currency traders that a weak dollar is part of the administration's plan to cut the deficit.

Most investors shrug this off as insignificant to their portfolios, but the effect for foreign investors can be severe. To truly grasp what we are talking about here, imagine an investor who opened an account in US Dollars in January of 2003. This investor would have had to convert about 98,000 Euros into $100,000 Dollars. If this investor had exactly $100,000 Dollars left in the account today, and wished to convert her Dollars back into Euros, she would have only about $75,000 Euros left. Without doing a thing, this investor would have lost $23,000 Euros. This loss would be on top of any potential losses or gains a specific alternative investment our fictional investor is weighing - and must be considered as a hurdle rate or break-even point for such an investment.

The crux of the problem is that most investments worth making are in US $. This is especially true in commodity futures, and even more so in trading system and CTA investments, which are invariably run on US $ denominated derivatives. The grand majority of futures markets are traded on US exchanges such as the Chicago Board of Trade and Chicago Mercantile Exchange. So what is an investor to do?

At Attain Capital, where a large portion of our clients are outside of the US, sophisticated investors have been implementing several techniques to guard against further moves in the Euro and other foreign currencies.

Hedging Currency Risk Within your Portfolio. 4 Options:

1. The cash balance of your account can be held in the foreign investor's native currency, converting to dollars when needed to cover closed trades. The cash balance of the account would remain in the designated foreign currency, Euros for example, but if a trade was done in the S&P futures, for instance, resulting in a loss of $2,000 US Dollars, the amount of Euros needed to convert to $2,000 US Dollars at the current exchange rate would be converted. **This method keeps the account in unison with the current exchange rate.**

2. Investors can buy outright futures contracts on their native currency, gaining or losing the appropriate amount of money as the contract moves up or down. After all, this is what futures markets are designed to do. The problem inherent in that is you are locking in the current rate, as the account grows as your dollars become less valuable and shrinks as your dollars become more valuable. Many investors are leery of locking in such high rates. In addition, with no fractional contracts available, the investor must hedge as closely as possible with an appropriate round number of contracts. If having to round down to less than a perfect hedge, this would mean hedging profits less than those needed to offset rate losses, and if having to round up to more than a perfect hedge, this would possible hedging losses not equal to rate gains. **This method attempts to lock in a specific exchange rate.**

3. Investors can sell puts below or at the current market price. You will keep the premium if the foreign currency goes higher, but this premium won't completely offset the loss in value of your dollars. If Euros, for example, head lower, you will be exercised on your option, taking a long position at the strike price. (essentially locking in a lower exchange rate than in option 2) The benefit of this is you lock in a lower rate, and you keep the premium. The risk is that your currency heads higher and you only offset some of the losses. **This method attempts to lock in a lower exchange rate.**

4. You can overweight your native currency in your current trading, going long extra contracts when long term systems such as Dollar Trader or Aberration gives a long signal, and not taking the short contracts, as you are in essence already making money on the short side because of the conversion. **This method attempts to "play" the exchange rate, locking in rates before it moves higher, and putting money back at risk when rates move lower.**

Attain Capital suggests different approaches depending on the situation. For those investors opening new accounts, Option 1 may make the most sense if they believe their native currency will continue to outpace the US Dollar.

For those investors currently holding accounts in US Dollars, Attain Capital recommends a combination of Options 3 & 4. Trading systems are built to capture moves in such commodities, after all, and using a system for this purpose logically fits. Passing on short signals from a trading system in your native currency also makes sense, as holding your account in US Dollars gives you a synthetic short position already. Adding a short position from a system greatly increases the currency risk a US Dollar based investor has already taken on.

The table below shows similar bullish moves in the Euro Currency, Japanese Yen, British Sterling, and Aussie Dollar have occurred over the past year, making this article valuable for anyone outside of the United States. The methods outlined above hold true in the other currencies as well.

Please call Attain Capital at (800) 311-1145 or email currencyhedge@attaincapital.com for a review of your currency exposure risk and what options may be available to you.

- Jeff Malec

Dollar Denominated Investments Losing Value:

	Euro / US$	Yen / US$	Sterling / US$	Aussie $
Jan '03	1.02	85.28	1.53	0.5180
Dec '04	1.34	96.72	1.93	0.7587
	$100,000 US worth			
Jan '03	€ 98,039	JPY 11,726,079	£65,359	AUD 193,050
Dec '04	€ 74,627	JPY 10,339,123	£51,813	AUD 131,804
	-31.37%	-13.41%	-26.14%	-46.47%