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WHY INVEST IN CURRENCIES?

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MERK INVESTMENTS LLC

RESEARCH

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Crash Proof Your Portfolio

The U.S. debt burden and accommodative monetary policy may be exerting downward pressure on the U.S. dollar. The stock market may be in bubble territory. Bond fears abound. Where can one hide: where to invest to both profit and protect?

Investing outside the U.S. dollar may provide attractive opportunities. Alas, while currency markets are the biggest and most liquid markets in the world, the currency asset class is still a big unknown to most individual investors and often considered too risky to meddle with. Yet, the currency asset class may provide valuable profit opportunities and diversification benefits through its unique attributes. One way to un-leash these opportunities is through including an actively managed currency basket in a diversified investment portfolio, just as one might select a diversified basket of stocks for the equity portion of the portfolio.

The Dollar Under Pressure

Unsustainable fiscal debt and deficits along with chronic current account deficits funded by foreign debt may be putting downward pressure on the U.S. dollar. Trying to force a renewed sense of prosperity following the mortgage and financial crisis, the Federal Reserve (Fed) is keeping the economy flooded with cheap money. The Fed may continue to err on the side of too much inflation rather

than face potential deflation following the credit bust. Looking at a 100-year span, as illustrated in Chart 1, the dollar has lost 96% of its purchasing power due to inflation. While the dollar may have appreciated relative to some currencies in the short term, its value has been gradually declining relative to a basket of currencies. Differently said, the dollar has weakened both in absolute terms (purchasing power) as well as in relative terms (foreign exchange rates). *It may be time for U.S. investors to protect their purchasing power by investing part of their assets outside the dollar.* A managed basket of currencies may be a prudent way to do this.

Unique Asset Class

To understand the role currencies can play in a portfolio, it is useful to review how currency markets work and what is unique about currencies as an asset class. In our assessment, currencies are:

- *Well suited for active management*
- *Less volatile*
- *Uncorrelated*

Inefficiency Introduces Opportunity

There are a number of characteristics that make the currency asset class particularly attractive for active management:

- The variety of players and motivation of players in the currency space may provide a greater likelihood of *market inefficiencies* in the currency markets,

compared to equity and bond markets. For example, there are corporate hedgers, governments, central banks, and tourists participating in the currency markets, not explicitly attempting to profit from currency movements. Market inefficiencies may present profit opportunities for investors.

- Currencies offer a *pure play on macro views* and an opportunity to take advantage of the “mania of policy makers,” particularly in today’s era of currency wars.
- The global currency market is the **most liquid in the world** with over \$5 trillion in daily turnover, compared to under \$1 trillion for the US bond market and New York Stock Exchange combined.

Uncorrelated Returns

The currency asset class has historically exhibited very low correlations with many other asset classes. This has held true over both long and short periods of time. Moreover, while many other asset classes have become increasingly correlated, the currency asset class has maintained this unique attribute over recent periods. In addition to having low correlation with other asset classes, currencies also have low correlation with each other; when one currency moves up versus the dollar, another one might move down, or not move at all. This means that combining several currencies in a currency basket can have a significantly improved risk-adjusted return over an investment in any single currency. *Adding an uncorrelated component, like a currency basket, to an investment portfolio may improve the overall portfolio’s risk/return ratio.*

Currencies Less Volatile, More Downside Resilient

Contributing to the somewhat ominous reputation of currency investing is the common misconception that currencies are more volatile than stocks, when in fact *currencies have historically been significantly less volatile than stocks.*

Chart 1: Purchasing power of the US Dollar 1913-2013



Source: Merk Investments, Bureau of Labor Statistics
Calculation based on consumer price index; August 1913 = 100%. Data as of August 2013.

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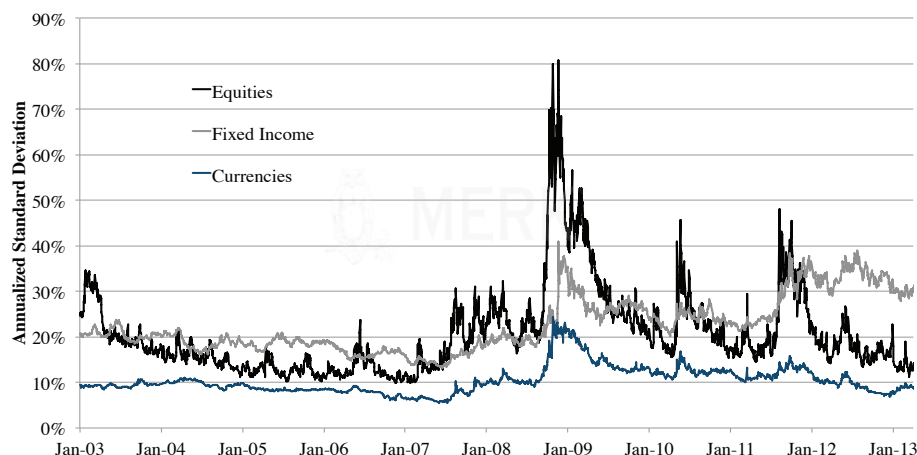
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Chart 2 shows historic volatility, measured by annualized standard deviation, of currencies, equities and fixed income.

The reason why many people have burned their fingers, and then some, in the currency markets is that they have used excessive leverage and made significant bets, often on a single currency, that they cannot afford to lose. The same has happened in the stock market, in the real estate market and in every other asset class. Nobody would advise an investor to bet their life savings on one single stock and lever it to the hilt. Similarly, nobody should invest in any one currency unless they are willing to take the risk to lose the bet. **There are no safe assets left, including the U.S. dollar.** Rather than considering any single currency (like any single stock), **we should consider the investment benefits the currency asset class might provide within the context of our overall portfolio.**

It naturally follows, that currencies' low volatility and low correlation may help buffer the portfolio when other asset classes tumble. We call this the downside resilience of currencies. Hence, diversifying into the

Chart 2: Historic volatility of currencies, equities and fixed income



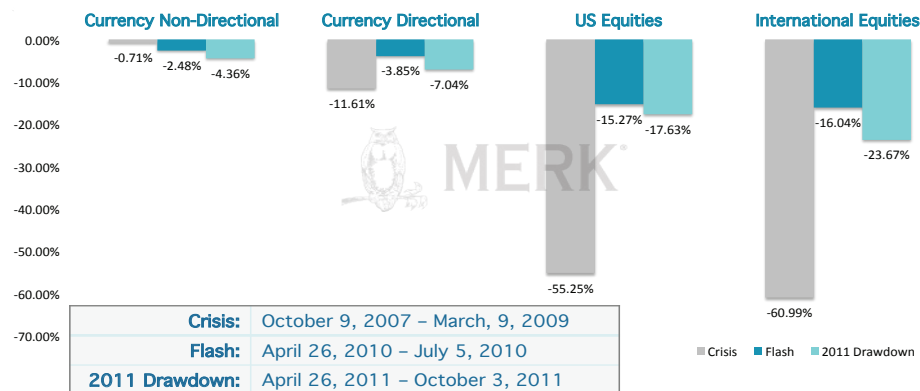
Source: Merk Investments, Bloomberg.

The following are used as proxy for the asset classes: Equities: Chicago Board Options Exchange Market Volatility (VIX) Index measures the market expectations of near-term volatility of S&P 500 index options; Currencies: Deutsche Bank Currency Volatility (CVIX) Index measures the currency volatility; weighted average of the implied volatility across 9 major pairs of currencies; Fixed Income: USD Swaption 5 Year Fixed/Floating Volatility Index (USSV055)

currency asset class may not only improve the risk/return on the upside, but adding an actively managed currency component into a portfolio **may also help protect against downside risks.** To illustrate the point, Chart 3

shows the returns of a currency basket during three recent market downturns, compared to how US and international equities fared during the same time periods.

Chart 3: Performance in market downturns



Source: Bloomberg, Merk Investments.

The following are used as proxy for the asset classes: Currency Non-Directional: DBCRUSI Index; Currency Directional: Inverse of DXY Index; US Equities: S&P 500 Total Return Index; International Equities: MSCI EAFE Index.

Improved Risk/Return Tradeoff

Piecing all of the above characteristics together one can summarize: Due to potential profit opportunities in the currency asset class, its un-correlated nature, and its downside resilience, **adding an actively managed currency component to an investment portfolio may enhance its overall risk/return profile.**

While there are no safe assets, one might be able to improve the risk-adjusted return and downside resilience of any portfolio. Adding a managed currency component might be a prudent way to do this, especially given the policy environment in the U.S. **M**

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ABOUT MERK

Merk Investments, LLC is a leader in the currency asset class and a pioneer in providing uncorrelated returns and portfolio diversification through actively managed currency funds.



AXEL MERK

Axel Merk is the Founder, President and Chief Investment Officer of Merk Investments.

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