(Don't) forget the price tag

With the dollar rallying once again, investors ignore foreign currency movements at their peril...

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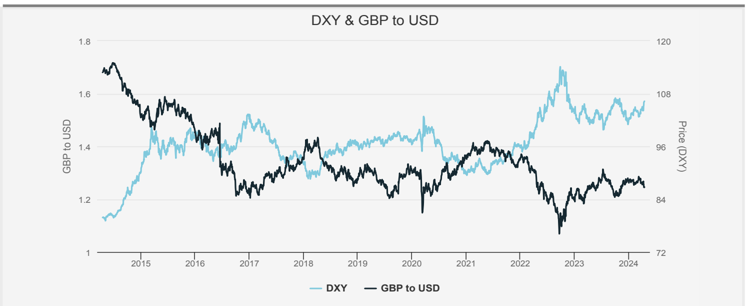
It may be the Year of the Dragon but, for investors, it still feels like the (decidedly less-exotic) Year of the Economist as interest and inflation rates continue to cast a long shadow on equity markets. Countless hours have been dedicated to scrutinising the minutiae of MPC meetings, parsing the words of Fed chair Jerome Powell and coining dubious catchphrases such as "Goldilocks" (for the uninitiated, an economy that's not too hot and not too cold...).

As the saying goes, all things (good or bad) come in threes and exchange rates complete the trifecta of economic issues facing investors. Last week saw the US dollar stage its best weekly performance since 2022 as a higher-than-expected US inflation rate sent shockwaves through equity markets. The euro and pound paid the price, falling to sixth-month lows against the dollar as markets repriced the fading likelihood of near-term rate cuts in the US and rising geopolitical tension.

Equity markets have a certain penchant for catchy monikers and foreign currency is no exception, with the "Dixie" (DXY) measuring the value of the US dollar relative to a basket of six currencies, including the pound, euro and Japanese yen. As the chart below shows, the Dixie has continued to rise over the last decade, with sterling amongst the casualties. The halcyon days of 1.7 dollars to the pound have faded to a very distant memory (and I'll keep schtum about the 2 dollar-plus rate on my first trip to the US).

Fig.1: The US Dollar Goes From Strength To Strength



Source: Bloomberg (as at 16/04/2024)

We may readily lament the effects of a weak pound on our annual escapes to sunnier climes but are we equally cognisant of the impact on our investment portfolios? Despite currency risk being as significant as the myriad of other risks investors aim to mitigate, arguably not. With this in mind, how can UK investors factor a strong dollar into their portfolio allocation?

Given that the appetite for US equities shows little sign of abating, the impact of a weak pound on the sterling value of dollar-denominated investments seems a logical place to start. At the risk of stating the obvious, a strong dollar is bad news for buyers of US equities (which cost more in pounds), but better news for investors with existing US holdings (whose sterling value rises if the pound weakens).

Currency fluctuations can also have a surprisingly large impact on portfolio performance. The weakening of the pound against the dollar shielded UK investors from the worst of the fall in US stock markets in 2022, with the S&P 500 delivering a negative total return of 19% in US dollars but only 9% in pounds sterling. However, this worked in the opposite direction in 2023, when a small bounce in the pound reduced the S&P 500 return from 26% to 17%, illustrating the merit of considering currency risk in portfolio allocation.

Increasing allocations to UK equities is a Route One approach to reducing direct currency exposure and, putting exchange rates aside, UK equity valuations continue to look attractive relative to long-term averages and their US peers. UK small-caps have borne the brunt of negative investor sentiment in recent years but, as my colleague **noted**, they have historically performed particularly strongly after a period of negative returns. The majority of investment trusts are also currently trading on a discount to net asset value, which could provide an added kicker to returns if the discount narrows.

Small-cap specialist **Rockwood Strategic (RKW)** is the top-performing investment trust across the AIC UK All Companies and UK Smaller Companies sectors with a five-year NAV total return of 79% (as at 16/04/2024). Manager Richard Staveley typically targets the less-researched end of the small-cap spectrum to exploit pricing inefficiencies.

The double whammy of a weak pound and subdued valuations has also increased the appeal of UK companies to overseas acquirers. Bargain hunters from across the Atlantic have prompted a sharp rise in the number of M&A transactions over the last 5 years, and given that private equity firms are currently sitting on an estimated $4 trillion of dry powder, this looks set to continue.

Rockwood holds a concentrated portfolio of around 20 companies, meaning that takeover premia can be a substantial tailwind for returns. Richard believes that 80% of the trust's holdings will ultimately be acquired by a trade or financial buyer, with recent takeovers for Smoove, OnTheMarket and The City Pub Group.

Alternatively, income-seeking investors might look to the FTSE 100 to capitalise on the weak pound, with the index generating more than 80% of its revenue from outside the UK. The strong dollar has not only benefited UK large-caps with significant US revenues but also energy and mining companies (as most commodities are priced in dollars). As a result, the strengthening of the dollar added £4 billion to dividend payments by UK companies in 2022, according to Link Group.

Schoder Income Growth (SCF) takes a differentiated approach to the UK equity income sector, blending high-yielding large-caps with lower-yielding, smaller companies offering higher growth potential. SCF's portfolio includes FTSE 100 stalwarts with significant US revenues (such as Shell, AstraZeneca and GSK), as well as growthier companies (including food manufacturer Cranswick and retailer Pets At Home).

This dual approach has paid off, with SCF having achieved a NAV total return of 22% over the last 5 years (as at 16/04/2024) and currently offers a dividend yield of 5.2%. SCF has also qualified as an AIC 'dividend hero' with a 28-year record of consecutive dividend increases, which is an impressive achievement given the challenges of the global financial crisis and pandemic.

The million-dollar question is whether the dollar will continue its upward march, although predicting currency movements can be a challenge for even the most-seasoned economists. Or, as Professor John Galbraith put it (rather less politely): "The function of economic forecasting is to make astrology look respectable." Crystal ball gazing aside, investors might want to remember that 'forewarned is forearmed' when it comes to factoring currency movements into portfolio allocations.

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