

THE FLUCTUATING DOLLAR

The dollar has always fluctuated and will continue to do so as investors try to gauge the course of the global economy. These moves are largely unpredictable and shouldn't create concern about investing internationally. As with any other market, we believe the best way to prepare is through diversification.

Dollar Fundamentals

The value of the dollar is quoted in reference to another currency, or a basket of other currencies with each currency weighted by the amount of trade done with the U.S. For example, the U.S. dollar basket of currencies is weighted using the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc. The U.S. dollar has been the world's "reserve currency" for the better half of the past century. However, many investors are fearful the dollar will lose this title.

While a movement away from the U.S. dollar as the reserve currency would ultimately lower demand and cause the dollar to decline, this process would likely take years, and maybe even decades, to occur. At present, we think this risk is relatively small given the lack of alternatives.

Changes in the dollar's value can have a major impact on the performance of international investments. When the dollar is weak relative to other currencies, U.S. investors typically experience higher returns from their international investments. But when the dollar is strong, the reverse is true. In the short term, currency movements are impossible to predict. However, over the long run, some analysts try to use fundamentals, such as budget deficits and changes in trade deficits, to forecast the general direction of the dollar. This can be problematic as well.

For example, the United States' budget deficit and weak economy have been cited as reasons why the dollar may weaken over the long term; however, other developed countries have similar problems. Remember, the dollar trades relative to other currencies. In addition, other fundamentals, such as changes in inflation and short- and long-term interest rates compared with those of other countries, need to be considered when forecasting changes in the dollar.

If You Can't Predict, Prepare

Because of this complexity and the enormous difficulties in forecasting so many variables, we believe it's nearly impossible to forecast long-term trends in a particular currency. Instead, investors should consider diversifying their U.S. investments by also owning international investments. When the dollar is weak, international investments should benefit, and vice versa.

There are several moving parts in global economics that may either enhance or offset the effects of a move in the dollar. As an example, another currency may strengthen in relation to the dollar because of growth in a foreign country's economy rather than weakness in the U.S. economy. In other words, the stock market can perform favorably whether the dollar is strong or weak. As illustrated below, there are advantages and disadvantages to the dollar's fluctuations.

A Strengthening Dollar

Advantages

- U.S. consumers see lower prices on imported foreign products and services (including international travel), which may help keep inflation low.
- U.S. investors can purchase foreign stocks and bonds at "lower" prices.

Disadvantages

- Foreign consumers see higher prices on exported U.S. products and services (including travel to the U.S.), which would tend to make it harder for U.S. firms to compete in foreign markets.
- U.S. firms must compete domestically with lower-priced foreign imports.
- Foreign investors find it less attractive to invest new capital in U.S. stocks and bonds.

A Weakening Dollar

Advantages

- Foreign consumers see lower prices on exported U.S. products and services (including travel to the U.S.), which would tend to make it easier for U.S. firms to compete in foreign markets.
- U.S. firms have less competitive pressure domestically to keep prices low, which may help a company's profit margins.
- Foreign investors find it more attractive to invest new capital in U.S. stocks and bonds.

Disadvantages

- U.S. consumers see higher prices on imported foreign products and services (including international travel), which may accelerate inflation.
- It is less attractive for U.S. firms to expand into foreign markets.
- Foreign investors may sell U.S. assets because of losses associated with an investment.

Currency's Effect on Performance

For the five years that ended Dec. 31, 2007, the weakening dollar had a major, positive impact on the performance of international investments.

The Impact of Currency Fluctuation: Annualized Total Returns (2003–2007)

	Return to Local Investors	Currency Impact	Return to U.S. Investors
United States	12.8%	0.0%	12.8%
Pacific Region	14.0%	5.2%	19.2%
Japan	12.4%	1.3%	13.7%
European Region	13.2%	6.4%	19.6%
United Kingdom	10.2%	4.8%	15.0%
International Composite	13.4%	8.4%	21.8%

Source: Ibbotson, Bloomberg. Representation is as follows: United States – S&P 500; Pacific region – MSCI Pacific Index; Japan – MSCI Japan Index; European region – MSCI Europe Index; United Kingdom – MSCI United Kingdom Index; International Composite – MSCI EAFE (Europe, Australasia and the Far East) Index. An index is unmanaged and cannot be invested in directly. Past performance does not guarantee future results. All data includes reinvested dividends and does not account for taxes or transaction costs.

But a strengthening dollar can have the opposite effect. The following table shows the effect of currency fluctuations on international investments in 2008. The strengthening dollar against many currencies negatively impacted international performance. However, some regions (such as the Pacific region and Japan) had declining currencies compared to the U.S. dollar. U.S. investors benefited in these markets as their investments transferred into higher U.S. dollars.

The Impact of Currency Fluctuation: Total Returns (2008)

	Return to Local Investors	Currency Impact	Return to U.S. Investors
United States	-37.0%	0.0%	-37.0%
Pacific Region	-42.2%	6.1%	-36.1%
Japan	-42.5%	13.4%	-29.1%
European Region	-38.5%	-7.6%	-46.1%
United Kingdom	-28.5%	-19.9%	-48.4%
International Composite	-39.9%	-3.1%	-43.0%

Source: Ibbotson, Bloomberg. Representation is as follows: United States – S&P 500; Pacific region – MSCI Pacific Index; Japan – MSCI Japan Index; European region – MSCI Europe Index; United Kingdom – MSCI United Kingdom Index; International Composite – MSCI EAFE (Europe, Australasia and the Far East) Index. An index is unmanaged and cannot be invested in directly. Past performance does not guarantee future results. All data includes reinvested dividends and does not account for taxes or transaction costs.

U.S. companies that export to or operate in foreign countries (commonly referred to as multinational companies) may also have currency exposure risk. A declining dollar can help U.S.-based companies as the U.S. dollars transfer into higher sales outside U.S. borders. However, an increase in the dollar can hurt multinational companies.

Portfolio Considerations

Edward Jones doesn't recommend making portfolio adjustments simply due to concerns about short-term U.S. dollar fluctuations. Quality and diversification remain the emphasis in our long-term investment philosophy. Investments that might benefit from a weakening dollar include U.S.-based multinational companies, international stocks and bonds, and potentially some commodities. When making portfolio strategy recommendations, the Edward Jones Investment Policy Committee (IPC) and our Research department take macroeconomic factors (such as U.S. dollar trends) into account. At this time, we recommend you consider placing up to 20% of your equity portfolio in international investments.

Whether you're concerned about a falling or rising dollar, these movements are largely unpredictable, and international investments can be an important source of diversification within your portfolio. So even if you're concerned about changes in the dollar, we believe the benefits of a globally diversified portfolio outweigh concerns over currency movement.

Diversification does not guarantee a profit or protect against loss. Special risks are inherent to international investing, including currency fluctuations and foreign, political and economic events.