Citi Investment Guide

Citi's guide to foreign exchange

Manage and make money with foreign exchange

If you have an investment offshore, travel or send money to relatives abroad you will be accustomed to handling and exchanging currencies.

The price you pay for each transaction will be impacted by movements in the currency you are converting and most importantly, the provider you use to handle the transaction.

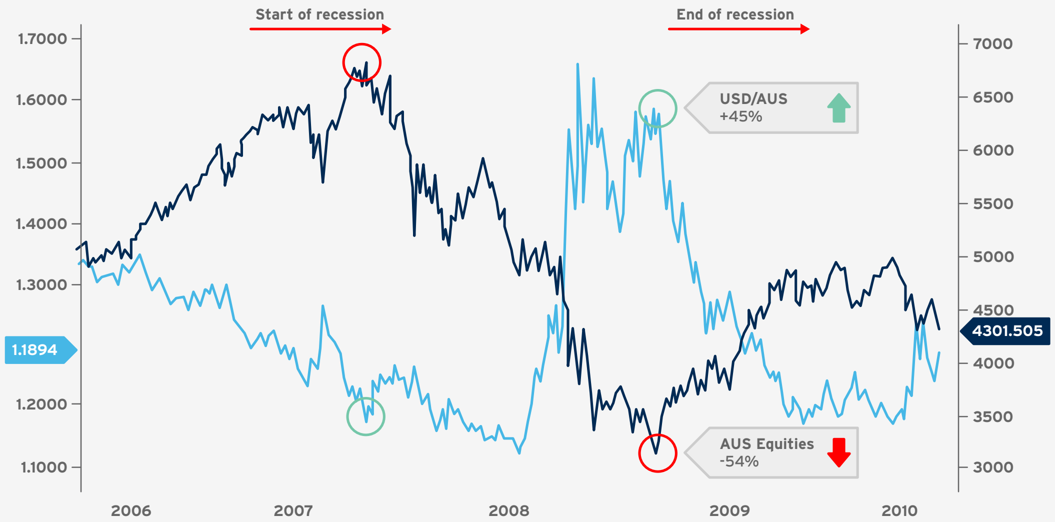
For investors, managing currency exposure within a portfolio is an important part of a wealth management plan. It can both protect and enhance returns while improving risk management.

While the foreign exchange market has its own lexicon of terminology for most people it can be navigated easily and transactions managed with a mobile device. It is the cost of the transaction that requires the most attention.

Whether you use foreign exchange while on holidays or as an investment tool it will help to become familiar with how currencies operate by understanding why currencies move up and down in value and how providers determine the rate to charge for a currency transaction. It's easy to get the basics and this guide will expand on those subjects.

> *"Every day more than $US5 trillion worth of currency is exchanged globally, making foreign exchange, commonly referred to as Forex, the world's largest financial market."*

From the peak to the lowest level during the GFC, the ASX dropped **-54%**. Over the same period USD/AUD was up **+45%**



It's perhaps not surprising as each year well over 1 billion tourists travel across the globe, and companies, their employees and governments all exchange vast sums of currency going about their business.

Yet currency as an investment tool is not on the radar for many people, even though it is a strategic instrument that can significantly enhance the long term performance of a portfolio.

For instance, say you invested $1 million into the Australian stock market in the months prior to the global financial crisis. As you can see in the chart, over the next 12 months the Australian All Ordinaries Index dropped 54 per cent, so if your investment followed that trend your $1 million would have been whittled down to $460,000.

But if you had protected or 'hedged' your investment and put another $1 million into United States dollars, that investment would have increased 45 per cent over the same period, meaning your overall loss would have been pared back to just 9 per cent.

How economic health impacts a currency

Over the same period the US equity market also fell significantly but the US currency is a 'safe haven' currency, ensuring money flows into US dollars in times of uncertainty. It means the US can suffer economically from a global shock but its dollar remains strong.

It does not mean the US dollar is always insulated. If the US economy suffered a shock and global volatility was low, its safe haven status would be of no significance and its dollar would depreciate.

Safe haven status is reliant on investors' confidence that the nation's treasury will continue to honour government debt. Other safe haven currencies include the Swiss Franc, Euro and Japanese Yen.

Australia, like Canada, is known as a commodity currency due to its dependence on the export of minerals, gas, agriculture and bulk commodities like iron ore, bauxite and coal.

It is why during the Chinese-demand fuelled commodities boom between 2003 and its peak in 2011 the Australian dollar rose strongly against the US dollar, even becoming worth more than the US dollar (known as 'breaking parity') in October 2010 for the first time since the dollar was floated in 1983.

What's a floating dollar?

The currencies of most western countries are 'floated', with the value of the currency set by the market and reflecting the economic and trade position of the country.

However, because the foreign exchange market is so large it means there are a lot of participants, and each will offer a different price to buy or sell a currency. The price differential can vary enormously so it pays to do a bit of homework before choosing an agent to handle your currency exchange.

Some investors also trade in 'currency pairings', which involves playing two currencies against each other and deciding which will depreciate and which will rise in value.

Pairing a currency

In a pairing of the US and Australian dollars an investor may expect the US dollar to strengthen against the Australian dollar, perhaps because commodity prices are falling and the investor expects the trend to continue. If the event plays out as the investor expects they will make money on the pairing.

Currency pairs can involve any currency but typically involve only major currencies and is undertaken more at an institutional level as it takes substantial funds to create meaningful returns.

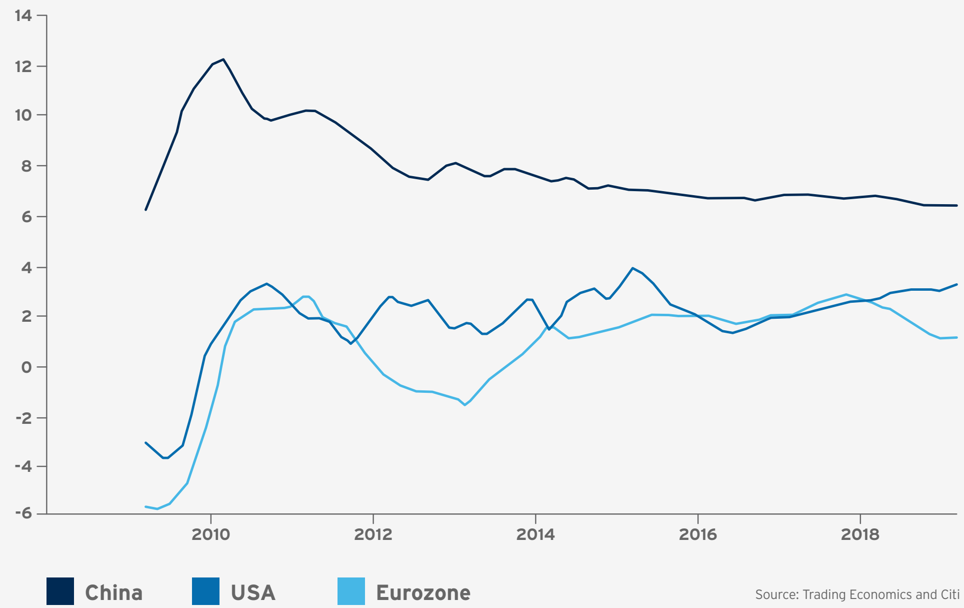
How currency expands your opportunities

Australia offers limited opportunities to the sophisticated investor. Our equity market accounts for just two per cent of the global equities market and offers limited exposure to major global sectors like health, technology and pharmaceutical.

A portfolio only with Australian focused assets is dependent on the outlook for the Australian economy and investment outlook. If the local economy has a downturn a localised portfolio will take a similar or even greater hit.

A portfolio with assets spread across different global regions can smooth out returns over the long term as regions like Asia, the United States and Europe follow different growth paths. Although the global financial crisis in 2008 was an exception, it is highly unusual for all regions to suffer economic declines simultaneously.

Growth rates vary by country and region



Source: Trading Economics and Citi

A geographically diversified portfolio may include assets like offshore bonds, equities and property. A selection of assets is also part of the diversification component of a portfolio and these assets are purchased in the currency where the asset is held, creating a need to manage the foreign currency component and perhaps also to add additional layers of risk management.

For instance, you may be considering a property purchase in the UK and consider the UK economy is primed for growth and likely to flow through into strength for the pound. While your property purchase may still be 12 months away a strategic investor may decide the Australian dollar would weaken against the pound and purchase a large amount of pound in advance to fund the property purchase.

Or you may have shares in a US tech giant and receive dividends in US dollars. You may decide to hold and build those US dollars until a time when you consider the exchange rate is favourable to convert back to Australian dollars.

Alternatively you may decide to remain invested in the US but consider there is volatility ahead and want to move down the risk scale to a fixed income investment by switching from shares to bonds. You can find out everything you need to know about bonds in Citi's Guide to Bond Investing.

Sending money offshore

According to the World Bank, Australia is the fourth most expensive country from which to send funds offshore, with a $10,000 transaction costing $770, mainly due to exchange rate mark-ups for foreign-currency transfers.

> *“In 2017 Australians sent $A9.6 billion abroad – gifting intermediaries a mind-boggling $740m in the process.”*

A lot of these charges were either unnecessary or could have been significantly reduced.

For most users, the biggest cost will be built into the exchange rate itself. The foreign exchange providers make their profit through the spreads offered.

These spreads are reflected in the advertised conversion rates, which can vary enormously. In the case of transfers involving large amounts, the advertised rate is almost always negotiable.

Providers make the difference between the buy and sell

Client Transaction	AUD/USD Buying rate 0.72	AUD/USD Selling rate 0.64	Margin
$1,000 AUD	$720 USD	$640 USD	$80 USD
$10,000 AUD	$7,200 USD	$6,400 USD	$800 USD
$100,000 AUD	$72,000 USD	$64,000 USD	$8,000 USD

Don't get caught out by currency

Currency exchange is a multi-billion dollar a year industry in Australia and for too long customers have been treated as a cash cow given the lack of transparency and woefully uncompetitive rates.

Here are five ways travellers and other currency users can avoid the traps:

- Buy overseas currency ahead of the time of need, such as when booking the trip. This will help you avoid the nasty surprise of unfavourable currency movements.
- Avoid the airport forex booths - or those in the back streets of Bali or Phuket. Converting currency at a respected outlet at the destination will often get a better rate while avoiding the swindlers.
- Compare, compare, compare: no advertised conversion rate is ever the same.
- Avoid using cash, which is usually more expensive to convert than an electronic transaction
- Consider a modern flexible product such as a Citi Global Currency Account, which reduces the need to convert funds.

Currency management made simple

Of course there are many reasons you may need to deal with different currencies outside of pure currency plays.

For the geographically diversified investor and global citizen you may own a commercial property in the US and be receiving rent in US dollars, pay for children studying in Europe, send money to relatives abroad every month and spend the winter months travelling.

In the past, such activities would involve significant management time to ensure enough currency was available to cover expenses while managing capital inflows from a tax and exchange rate perspective.

The rise of global currency accounts has mostly displaced all that additional work. You can hold a variety of currencies in segmented holdings within the one account, shift money from one currency to another and manage balances and reporting issues from a mobile device.

By taking the hassle out of managing currency the investor can better focus on how to make the best returns from investing overseas.

The wide world of currency

Currency transactions can take place in any recognised currency. While the US dollar is considered the world's reserve currency the United Nations still recognises 180 global banknotes, ranging from the ubiquitous 'greenback' (the US dollar) to the Uzbekistani som or Venezuelan bolivar. It used to be over 200 but the introduction of the Euro in 1999 replaced 22 currencies.

A few things to know about the Australian currency

Despite Australia's relatively small economy, the Australian dollar is one of the world's most frequently traded currencies. This reflects Australia's importance as a commodities exporter, which underpins the value of the currency.

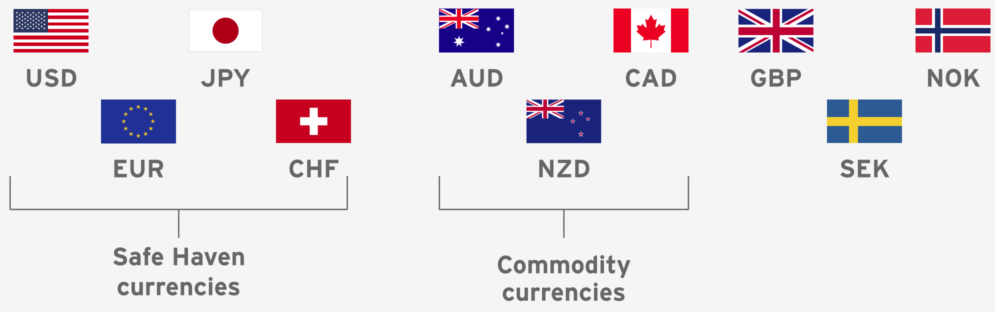
The Australian dollar became tradable after the Hawke/Keating government 'floated' the currency in 1983. This meant the Australian dollar's value became subject to the market's view of what it should be worth, taking into account factors such as the country's terms of trade and inflation and growth outlook.

Currencies are affected by numerous factors, including geopolitical events, trade data and central banks' monetary policy.

Currencies can react to sharp movements in stock, bond or commodity markets. As a resources-linked commodity, the Australian dollar reacts to movements in the price of key export commodities such as iron ore and coal.

Reflecting the volatility factors, the Australian dollar has traded as high as $US1.10 (in 2012) and as low as $US48c (2001).

"G10" is the group of the 10 most traded currencies



Currencies have nicknames

For the purpose of brevity and a bit of levity, traders have ascribed nicknames to the major currencies over the years.

For years the $US has been known as the greenback a reference to the colour of US bank notes.

Self explanatorily, the Australian dollar is known as the Aussie while the NZ dollar is known as the Kiwi.

The Swiss Franc (traded under the code CHF) is known as the Swissy.

The Canadian dollar (CAD) is known as the Loonie, a reference to the country's $1 coin that has a loon (a bird) on one side.

When paired with the $US (USD) the British pound (GBP) is the Cable, a reference to transatlantic telegraph connection built in 1858.

Paired with the Euro, the pound is known as the Chunnel (as in the Channel Tunnel)

The Euro (EUR) is called the Fibre, which is a play on the Cable given Europe has one of the world's most advanced fibre optic networks.

Citi's capabilities

As one of the world's biggest forex traders, Citi offers a robust currency capacity for clients with varying needs.

> “ *Our flagship offering, the Citi Global Currency Account makes the cost of moving currencies cheaper, simpler and more flexible.* ”

The holder can keep balances in up to ten major currencies, without the hassle of holding bank accounts in multiple jurisdictions. There are no minimum account balance and no fees, with highly competitive rates.

Users can also receive money from friends, family or overseas investments (such as rent from a property) in any of the available currencies and hold the funds until they wish to exchange them.

The account allows investors to repatriate the dividends of their overseas portfolios without the cost of a forex transaction.

If clients become more sophisticated with their requirements Citi can provide other services, such as an “order watch” feature, by which clients can set a price level at which to execute a trade at a later date.

Citi is also a leader in income generating assets both domestically and internationally, such as bonds and structured investments utilising both foreign currency and Australian dollars.

Citi can help

Citi's Global Currency Account is a new way to manage multiple currencies – giving you complete control of your money no matter where you are in the world.

Learn how to simplify your global life

Additional resources

www.citibank.com.au/aus/insight/wealth-management/currency-trading-made-easy.htm