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The Mistakes That Investors Make With Currency Funds

Because predicting the direction of currencies can be challenging, investors should approach these funds with caution, financial experts say

Currency funds aren't for novices. A money changer counts Turkish lira banknotes at a currency exchange office in Istanbul.
PHOTO: MURAD SEZER/REUTERS

By Dan Weil
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Investing in currency mutual or exchange-traded funds may sound tempting. After all, the foreign-exchange market is the biggest financial market in the world, averaging more than $5 trillion in trading volume every day.

But many investment experts urge most individual investors to resist the temptation, saying these funds are usually better suited for those investors with a strong understanding of how

currency markets work.

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Predicting currencies' direction is challenging, experts say, because so many factors can affect foreign-exchange rates. Interest rates and monetary policy top the list, but trade and other elements of economic policy also can play a role, along with financial, political and military developments around the world. There is market sentiment to deal with, too.

"Investing in currency funds requires sophisticated knowledge of financial markets," says Tayfun Icten, a Morningsta r analyst who studies currency funds. "You should be pretty sophisticated to even consider investing in them."

Currency funds come in two varieties: single-currency and multicurrency funds. Many of these funds invest in high-quality money-market instruments denominated in the target currency or currencies. Some funds invest in currency forward contracts and currency swaps, which can make things even more complicated. (Forward contracts offer the ability to buy or sell a currency at a pre-established rate on a pre-established date, while swaps consist of temporary exchanges of currencies between parties.)

The funds don't come cheap and generally have offered paltry returns in recent years, Mr. Icten says. Morningstar tracks 45 open-end currency mutual funds and ETFs with combined assets of $5.9 billion. As of April 30, the funds averaged an annualized return of negative 0.63% for one year, positive 0.22% for three years, negative 0.94% for five years and negative 0.16% for 10 years.

Returns have suffered amid narrow interest-rate differentials and inconsistent performance in emerging markets since the 2008 financial crisis, Mr. Icten says. Narrow rate differentials have kept currencies in tight ranges, limiting investment opportunities, while the volatility in emerging markets has taken away the sustained currency trends that allow investors to flourish.

As for expenses, the average is 1.33% of assets annually for the 11 mutual funds and 0.74% for the 34 ETFs. More often than not, "you're paying fees for an investment that will go nowhere," Mr. Icten says.

Should you try?

So why would even a sophisticated investor have anything to do with currency funds? Mr. Icten and others say academic research suggests there are two types of currency investments that can, at times, be profitable: momentum trades and carry trades.

Momentum trades represent bets that a currency will continue moving in a certain direction. The dollar sustained an upward trend against major currencies from mid-2014 through late 2015, and currency funds that wagered on the move made a lot of money, Mr. Icten says. Since then, however, the dollar has been stuck in a range. “That was the last time funds made decent money following trends,” he says.

Carry trades, meanwhile, involve borrowing a currency from a country with low interest rates, say the yen, and using it to finance the purchase of another currency earning a higher interest rate, say the dollar. The trader invests the dollars in interest-bearing instruments such as bank deposits to earn the higher U.S. rates. The bet is that the dollar will rise against the yen.

“Currency carry is a well-known and long-studied effect,” says Chris Geczy, academic director of the University of Pennsylvania’s Wharton Wealth Management Initiative. “You’re getting paid for the risk of unexpected interest-rate movement.” He counts the carry-trade ETF Invesco DB G-10 Currency Harvest Fund (DBV) as one of his own holdings.

“This, in general, is a way of diversifying long equity and bond risk, while delivering some premium in the long term,” Dr. Geczy says. Others, too, point out that currencies generally are an uncorrelated asset, meaning they don’t trade in sync with stocks and bonds, though in times of stress a country’s stocks, bonds and currency can all tumble at the same time.

Dr. Geczy agrees with the consensus that currency trading isn’t something the average investor should be doing. “When my mother-in-law starts buying currency ETFs, I would get stressed out,” he says.

Rare use: a tuition hedge

What about the idea of using a currency fund as a hedge?

Many experts advise against it if the investor is trying to hedge the currency exposure of a foreign stock or bond fund. It is too difficult to figure out what hedges are needed and in what amounts, they say, especially if the stock or bond fund invests in multiple countries and changes its holdings frequently. And trying to keep up by changing the hedge would add trading costs on top of fees.

“You’d be using capital that can’t be deployed someplace else,” says Ethan Anderson, a financial adviser at Rehmann Financial in Grand Rapids, Mich. “And how do you figure out what the proper portions” of the currency funds are for you? In most cases, investors would be better off simply sticking with foreign stock and bond funds that hedge the currency risk themselves, experts say.

There are, however, some exceptions. Investors who have a large known expenditure or liability in a foreign currency, such as a tuition payment or home purchase, might benefit from using a currency ETF as a hedge, says Karim Ahamed, a financial adviser at Cerity Partners, a wealth-management firm, in Chicago. Unlike a stock or bond fund, a home purchase or tuition payment represents a defined exposure in a single currency, so maintaining the hedge shouldn’t require a lot of trading.

“But those situations are few and far between,” Mr. Ahamed says.

Meanwhile, Mr. Ahamed and others warn against buying inverse currency ETFs and leveraged currency ETFs. Inverse ETFs rise in price when the designated currency falls. Leveraged ETFs are designed to generate a price change equal to multiple of a currency’s move—generally two to four times the move. But the ETFs are generally meant to sustain these relationships in an

exact manner only for a day. These tools are fit for day-trading, which often turns out poorly for individual investors.

“Over time the value of your investment can erode very quickly,” Mr. Ahamed says. “And with leverage, you’re doubling your bet. If your view is wrong due to political events, central bank intervention, etc., then you have two to three times the downside exposure.”

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