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Should a Shrinking Dollar Worry You?

By JASON ZWEIG



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The dollar is falling. Is the sky falling, too?

As of this week, a dollar would buy only 0.68 euro, down from 0.80 in March and a peak of 1.21 in 2000. The greenback slid against other major currencies as well.



Heath Hinegardner

That may be a problem for investors. If most of your assets are in dollars but much of the goods and services you consume are priced in other currencies -- say you like imported cars or regularly vacation abroad -- your future spending needs have just gotten harder to fund.

Fortunately, it's not that hard to protect against further erosion in the dollar. And not all investors need to take action. Hedging would be vital, quips Campbell Harvey, an

economist at Duke University who edits the Journal of Finance, "if your mortgage is denominated in euros." But if you make your money in the U.S. and spend it in the U.S., a falling dollar isn't the end of the world. Thus, the slide in the greenback need not prompt every investor into urgent action, but it is an ideal pretext for asking whether you are globally diversified.

Three cures are most commonly prescribed for investors worried about a weakening dollar: foreign currency, gold or a diversified basket of commodities.

Trading foreign currencies like Australian or Canadian dollars, both tied closely to commodity prices, sounds appealing. But foreign-exchange trading usually relies on high margin, or leverage, which is risky, and gains are taxed at hefty rates. So an individual investor has to be really right to rationalize doing it, says Mark Kritzman, who helps oversee more than \$25 billion at Windham Capital Management in Cambridge, Mass.

As for gold and other commodities, they have provided an average return of around 20% in the four quarters following the worst drops in the value of the dollar, according to Michele Gambera, chief economist at Ibbotson Associates.

Surprisingly, these glittering returns look tarnished next to those of stocks and foreign bonds. On average, based on more than 20 years of returns, Mr. Gambera found that in the four quarters following the steepest declines in the dollar, U.S. stocks go up 25%, various baskets of international bonds gain between 21% and 28%, and non-U.S. stocks go up more than 56%.

So, with many commodities near record highs, there may be no need to join the stampede into gold or most other hard assets.

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About Jason Zweig

Jason Zweig writes The Intelligent Investor every Saturday for The Wall Street Journal. He is the author of Your Money and Your Brain, on the neuroscience of investing, and the editor of the revised edition of Benjamin Graham's The Intelligent Investor, the classic text that Warren Buffett has described as "by far the best book about investing ever written." Before joining the Journal, Jason was a senior writer for Money magazine and a guest columnist for Time magazine and CNN.com, and he also spent a year studying Middle Eastern history and culture at the Hebrew University in Jerusalem.

If the dollar keeps dropping, stocks and bonds priced in euros, yen, rubles or shekels will tend to become more valuable; anything denominated in foreign currency will then buy more dollars. That's why, for U.S.-based investors, international stocks and bonds tend to outperform commodities when the buck falls. Global diversification thus provides an automatic buffer against a dollar drop, unless the fund managers have hedged the holdings back into U.S. currency.

By the same token, big American companies that earn much of their revenues outside the U.S. may do better as the dollar drops; kronor and rupees will then convert into a greater number of greenbacks, putting more profit in U.S. shareholders' pockets.

But raising your overseas holdings can make sense even if the dollar stops falling. U.S. stocks represent less than half of the total value of equities world-wide, and yet American investors keep more than 70% of their stockholdings here at home. Although roughly two-thirds of the world's debt is outside the U.S., American investors have less than 4% of their fixed-income portfolios in foreign bonds.

For many years, I've kept half of my stockholdings outside the U.S. The more convinced you are that the dollar will fall, the more you should hold in international stocks, ideally through a low-cost index fund that doesn't hedge currencies. Even if your view on the dollar turns out to be wrong, you will end up with a better diversified portfolio.

I don't have any foreign bond funds myself; I was turned off long ago by their risk and illiquidity. But choices are better today. If you are especially worried about Uncle Sam, consider T. Rowe Price International Bond or, if you can avoid the sales charge by going through a discount broker, the Class D shares of Pimco Foreign Bond (Unhedged). SPDR Barclays Capital International Treasury Bond, an exchange-traded fund, is another good choice, but only if you can find a discount broker that won't charge commissions to reinvest your interest income.

Over the course of time, currency fluctuations tend to wash out. And even a long-term decline in the dollar might not be disastrous; since 1950, South Africa has had one of the world's weakest currencies, but one of the best-performing stock markets. The dollar is falling, but the sky isn't.

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