The McGraw-Hill Companies BusinessWeek.com

FIVE FOR THE MONEY November 30, 2006, 12:00AM EST

Ways to Weather a Weaker Dollar

The greenback has plunged recently against the euro and other foreign currencies. Here's how to protect your portfolio

by Marc Hogan

The recent pattern in the currency market can be pretty much summed up this way: Another day, another decline in the U.S. dollar. The New York Board of Trade's dollar index, which tracks the greenback against a basket of major currencies, fell to a 20-month low on Nov. 28 (see BusinessWeek.com, 11/28/06, "Europe May Bear Burden of Dollar's Swoon"). While the buck rebounded in the next trading session, many analysts expect dollar weakness to continue.

The U.S. currency's drop comes amid speculation the Federal Reserve might cut interest rates next year as other central banks are raising them. The European Central Bank is projected to hike rates by a quarter of a percentage point at its Dec. 7 meeting. Bank of Japan policymakers have said rates may need to rise there as well.

Meanwhile, top government officials have rallied to the buck's defense. "A strong dollar is clearly in our nation's interest," Treasury Secretary Henry Paulson said in London this week.

Nevertheless, a weaker dollar isn't necessarily bad news for investors, analysts say, so long as the greenback's slide doesn't become an avalanche. This *Five for the Money* looks at a few asset classes that might be smart choices if the dollar remains woozy and wobbly.

1. U.S. Large-Cap Stocks

On Nov. 27, domestic stocks suffered their steepest losses since July, hampered in part by investor worries about the weakening dollar. Such fears are overdone, however, according to Alec Young, equity market strategist at Standard & Poor's, who says the dollar's skid should give a boost to U.S. corporate earnings. "It's a positive for the market, not a negative, as long as it's orderly," Young says.

For one thing, big U.S. companies do a growing chunk of their business abroad. In 2005, 41% of revenues for the Standard & Poor's 500 index came from overseas, up from 32% in 2000, and the percentage is expected to rise this year. When the dollar is weak, international sales denominated in foreign currency translate into more revenue in dollars. S&P has a strong buy recommendation on package shipper FedEx (FDX), which generated 37% of FedEx Express revenues internationally in its most recent fiscal year.

Beverage giant PepsiCo (PEP) may be another well-positioned U.S. name, with more than a third of its business in exports. "Coke (KO) exports significantly more, but we think Pepsi is a much better buy at today's levels," says Morningstar (MORN) equity analyst Allan Nichols. PepsiCo shares earn Morningstar's highest rating of five stars.

2. Foreign Stocks

U.S. companies doing business overseas aren't the only ones likely to benefit from a weaker dollar. Investors with a reasonable allocation to international stocks should get a boost as well, analysts say. When the greenback goes down, the value of non-U.S. securities goes up in dollar terms.

An international mutual fund can be a good way to tap into overseas stocks. Investors looking for protection against a weaker dollar should make sure to pick a fund that doesn't use a relatively rare strategy called currency hedging. Neil Brown, a certified financial planner at West Columbia (S.C.)-based Burkett Financial Services, says he uses such unhedged funds as Artisan International (ARTIX), Dodge & Cox International (DODFX), and UMB Scout Worldwide (UMBWX).

Exchange-traded funds, or ETFs, might be another savvy, low-cost option for investors seeking broad international exposure. S&P's Young suggests allocating 15% of the equity portion of a portfolio to developed foreign markets, represented by the iShares MSCI EAFE index (EFA) ETF, along with a 15% weighting in iShares MSCI Emerging Markets (EEM) (see BusinessWeek.com, 11/17/06, "World Won't Sniffle If U.S. Sneezes").

Whatever the dollar's direction, some foreign exposure can be a smart addition to an investor's portfolio. By adding foreign bonds funds, "a well-diversified portfolio will not only gain from multiple currencies but add diversification," says Scott Leonard, president of Redondo Beach (Calif.) financial planning firm Leonard Wealth Management.

3. Foreign Bonds

Along with overseas stocks, foreign bonds would also get a boost from a falling greenback, financial planners say. "The most direct beneficiary of the weakening dollar are bonds denominated in foreign currencies, most commonly the euro and the yen," says Louis Kokernak, a certified financial planner with Austin (Tex.)-based Haven Financial.

Kokernak uses institutional shares of Pimco Foreign Bond (Unhedged) (PFUIX), which invests in government-issued overseas bonds. The fund posted a 5.76% return this year through Oct. 31. T. Rowe Price International Bond (RPIBX) also provides foreign currency exposure and has a three-star Morningstar rating.

It's important to keep in mind that not all currencies move in the same way vs. the dollar. Investments pegged to various foreign currencies will probably have varying results. "Each economy can react quite differently to a rise or fall in the greenback," says Anthony Ogorek, operating manager of Williamsville (N.Y.)-based financial planning firm Ogorek Wealth Management. "As investors will certainly discover, nothing is as simple as it appears."

4. Energy

Energy-based commodities, like crude oil, could get their own boost from the dollar's drop, some analysts say. That could be particularly true if the greenback's decline were to accelerate from a gradual dip into a full-fledged panic. "If we had a severe crash, interest rates and inflation would take off," says Jeffrey Bogue, principal at Wells (Me.) financial planning firm Bogue Asset Management. "Commodities would do well with heightened inflation," he says.

As the underlying commodities rise, companies in the energy sector are also poised to gain from the greenback's woes, adds Shigeko Makino, global investment manager at Putnam Investments and manager of the Putnam Global Equity Fund (PEQUX). Specifically, Makino likes Houston-based oil companies Grant Prideco (GRP) and Marathon Oil (MRO).

5. Basic Materials

Metals from copper and zinc to silver and gold might also see their prices rise as the dollar drops, analysts say (see BusinessWeek.com, 11/28/06, "Time to Hop on the Gold Wagon?"). Don Martin, owner and founder of Los Altos (Calif.)-based Mayflower Capital recommends investing in base and precious metals—and the companies that make them—along with foreign securities, oil, and natural gas.

Putnam's Makino favors Canadian mining company Teck Comincko (TCK), which produces copper, nickel, and zinc.

"They're about 8 to 9 times earnings, copper is only marginally off its all-time highs, and the supply-demand situation looks very positive," Makino says.

Whether or not the greenback's decline persists, savvy investors can find plenty of ways to hedge against currency risk. The key is to maintain a globally well-diversified portfolio, experts say. Though the dollar may be falling, the sky is not.

Hogan is a reporter for BusinessWeek.com in New York.