What is Foreign Exchange Risk?

Worksheet

Foreign exchange risk is the danger that currency exchange rates will change unfavorably, lowering your returns when converting foreign currency to your home currency. It affects all international investments.

Questions

1. Foreign exchange risk definition?
A) Currency exchange rate movements
B) Stock price volatility
C) Inflation rate changes
D) Interest rate risk

2. Example of FX risk harming an investor?
A) Currency weakens on conversion
B) Stock price rises
C) Interest rates drop
D) Central bank raises rates

3. Can currency strength benefit international investors?
A) Yes, if home currency weakens
B) Yes, always
C) No, never
D) Only for emerging markets

4. Hedging strategy to reduce FX risk?
A) Buy put options
B) Use forward contracts
C) Diversify across currencies
D) All of the above

5. US investor buys €10,000 of German bonds at €1 = 1.10. Six months later EUR drops to €1 =0.95. What is the FX loss?

6. Japanese investor buys 100,000 US stock at ¥100/1. Dollar weakens to ¥80/$1. Yen loss on conversion?

7. Australian investor buys Indian Rupee bonds yielding 7% annual return. INR depreciates 8% in one year. Net return?

8. Define: What is foreign exchange risk?

9. Define: When does FX risk occur?

10. Define: Can FX risk benefit you?

Answer Key

1. A) Currency exchange rate movements — FX risk is purely from currency movements when converting.

2. A) Currency weakens on conversion — Weaker currency reduces the home currency value of foreign assets.

3. A) Yes, if home currency weakens — If your home currency weakens vs foreign currency, your investments gain in home currency terms.

4. D) All of the above — All three reduce FX risk: options lock in floors, forwards lock in rates, diversification spreads it.

5. Initial investment = €10,000 × 1.10 = 11,000 Current value = €10,000 × 0.95 =9,500 FX loss = 11,000 −9,500 = $1,500 (even if bonds gained interest)

6. Initial: 100,000 = ¥10,000,000 Later:100,000 = ¥8,000,000 Loss = ¥2,000,000 even if stock gained value

7. Bond return = +7% Currency depreciation = −8% Net return = +7% − 8% = −1% loss

8. Risk that currency rate movements reduce international investment returns.

9. When converting foreign currency back to your home currency.

10. Yes, if your home currency weakens, foreign investments gain value.