

# Country Funds, Exchange Traded Funds and Exchange Rate Risk

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This paper studies and compares the potential effect of changes in currency values between the US dollar, and other countries' currencies, or exchange rate risk, on country funds and single country exchange-traded funds. A country fund is a mutual fund that invests in a country. It holds portfolio of securities issued by companies located in a given country. A country exchange-traded fund (ETF) offers U.S investors an exposure to a basket of foreign stocks, representative of that country's economy, without actually buying foreign stocks. Both country funds and exchange traded funds are popular in the investment world with growing awareness of the diversification benefits that investing in foreign markets gives to investors. ETFs gained popularity since their inception in 1996 because of low transaction costs, tax efficiency and equity-like features.

The empirical analysis is based on an augmented Capital Asset Pricing Model which incorporates the market rate of return and an additional effect caused by currency risk. The sample consists of 33 funds investing in countries in Europe, Asia-Pacific, North America and South America for the period between 2001 and 2008. The results support the hypothesis that country ETFs, more diversified than country funds, are less affected by the exchange rate volatility. The findings point to the need for country fund investors to look for currency hedging to protect against exchange rate risk.