Title: THE INTERNATIONAL CAPM REDUX

Speaker: ADRIEN VERDELHAN  
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Importance: Why this matters:

When investors invest abroad, but consume at home, domestic and foreign purchasing powers differ. For foreign equities, what matters are the expected returns net of currency risk factors. They include:

- Carry-trade risk that arises from unfavorable convergence or divergence of the interest rate in the investment’s market relative to that of the home country
- Exchange rate volatility unrelated to carry risk.

These factors account for a large share of systematic changes in bilateral exchange rates.

Investigation: "Speaker analyzed XXX data to address the questions yyy, zzz, etc."

The authors suggest that instead of modeling exchange rate risk directly, use currency risk factors to summarize systematic variation. A carry trade risk factor can be estimated by bucketing currencies by their short-term interest rates, and applying a Fama/French type analysis to the high-low carry portfolio. Dollar risk was estimated by exchange rate beta, sensitivity to changes in the dollar versus a basket.

Innovation: Are there new techniques of interest in the data or approach to the problem?

They combined equity risk, proxied by beta, with two FX risk factors. A Fama/French type factor for carry, and dollar risk factor.

Insights: 1-2-3, what are the three most important things the speaker offered?

1. Using three factors (Global Equity, Dollar, and Carry) better describes equity returns. They explain a large share of systematic changes in exchange rates.
2. Currency risk matters for both foreign equity mutual fund and “macro/emerging” hedge funds. They were more important for mutual funds.
3. The authors provide a model of Interaction between currency and equity risk in a simple reduced-form model.

Audience rating: 4.05