CASHING IN ON INEFFICIENCY

Interference by central banks means the currency market is prone to profit-making opportunities

One of the key trends to emerge in recent years has been the growing investor interest in non-traditional asset classes, both as stand-alone investment vehicles but also as value-added components of an asset allocation programme.

This has been driven by several factors, including the bear market in equities with a change in expectations towards more modest stock market returns, together with the dilemma of extracting attractive returns from fixed income in the current low interest rate environment. While the initial focus in the non-traditional arena has centred on hedge funds and real estate, a third specialist asset class – currency management – is increasingly appearing on investors' radar screens.

LIQUIDITY

Despite the significant liquidity generated by a daily turnover of nearly $2000bn (€1600bn), the currency market retains an inherent level of inefficiency. With central banks actively intervening in the markets and using currencies as another policy tool at their disposal, they do not allow currencies to reach a fair market equilibrium, thus making them inefficient and prone to profit opportunities. With the majority of currency market volume provided by participants not seeking to maximise profits, this creates an opportunity for active currency managers to utilise.

What role can currency management play in an overall investment strategy? There are two choices available to investors – currency overlay being the value-added bolt-on to an asset allocation programme, while total return currency portfolios provide a distinct asset class option, which can be packaged as a fund with a specific risk/return target. The benefit of a segregated currency fund is that it has very low correlation with other traditional assets and thus may add diversification to an overall portfolio.

BUILDING BLOCKS

When determining their asset allocation building blocks, investors will typically first review the split between equities, fixed income and cash. For a Europe-based investor weighing up how much to place in assets denominated outside of their investing currency, the impact of forex movements on portfolio returns requires careful consideration. Here, the investor has three options: do-nothing, be passive or be active.

The do-nothing option is the least optimal solution as equity and fixed income assets do not generally move in parallel with currencies (see chart 1), hence the portfolio manager is taking two uncorrelated risks on any deviation from the benchmark.

The passive option is where the portfolio manager seeks to hedge all currency exposure back to benchmark, thus neutralising risk, but also eliminating the possibility of adding any excess alpha.

The third and optimal option is active, which can be a

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useful source of additional returns for the portfolio. In this scenario, a currency overlay programme is used to add alpha through a controlled and managed process that is applied on top of the investor's existing asset allocation.

For example, an allocation strategy that comprises equity, fixed income and hedge fund managers can employ a specialist currency overlay manager to overview the total currency risk present in the programme. By overlaying currency positions across the underlying portfolios, such a process can easily be applied to diverse asset classes, which range from conservative money market accounts to more aggressive equity and total return products (see chart 2). The end result is an optimised asset allocation that benefits from the additional returns generated by the currency overlay.

STRUCTURE

Currency management can also be used to run a total return vehicle with hedge fund type risk/return profiles for different investor appetites. As a rule, investors are well versed in the benefits of diversifying their equity holdings across a number of stocks, in different sectors and preferably countries. However, they are typically less familiar with the benefits of generating attractive returns from a diversified currency portfolio.

In order to maximise returns, an optimal currency portfolio should include a range of currencies so as to benefit from the different covariance and volatilities of the various currency pairs. For example, a euro-based investor seeking to profit from a bearish dollar view could take only a euro/dollar position. However, this approach may represent a generic view on the euro rather than a pure dollar view, and the portfolio is best structured by being long several currencies such as the euro, sterling, Australian dollar, Swiss franc and yen.

TOTAL RETURN

Returns from currencies tend to be uncorrelated with returns from equities or fixed income as the underlying factors which drive these asset classes differ. As a result, a total return currency portfolio can additionally provide diversification benefits to investors, thereby reducing their overall risk.

What makes currencies tick? Whether the investor focus on currencies is via an overlay programme or total return portfolio, recent dramatic changes in forex markets, highlighted by the end of the two-year dollar bear trend and the recent six-month range trading environment with collapsing volatilities, it has underlined the need for specialist currency managers.

The remit of a currency team is therefore multi-faceted.

Top 3 benefits

Key benefits of currency management include:

- **Exposure to a liquid asset class with profit making opportunities that can be utilised by active currency specialists.**
- **The flexibility to create different investment products that can provide attractive positive returns within a controlled risk framework.**
- **Opportunities for portfolio diversification as currencies have a low correlation to traditional asset classes such as equity and fixed income.**

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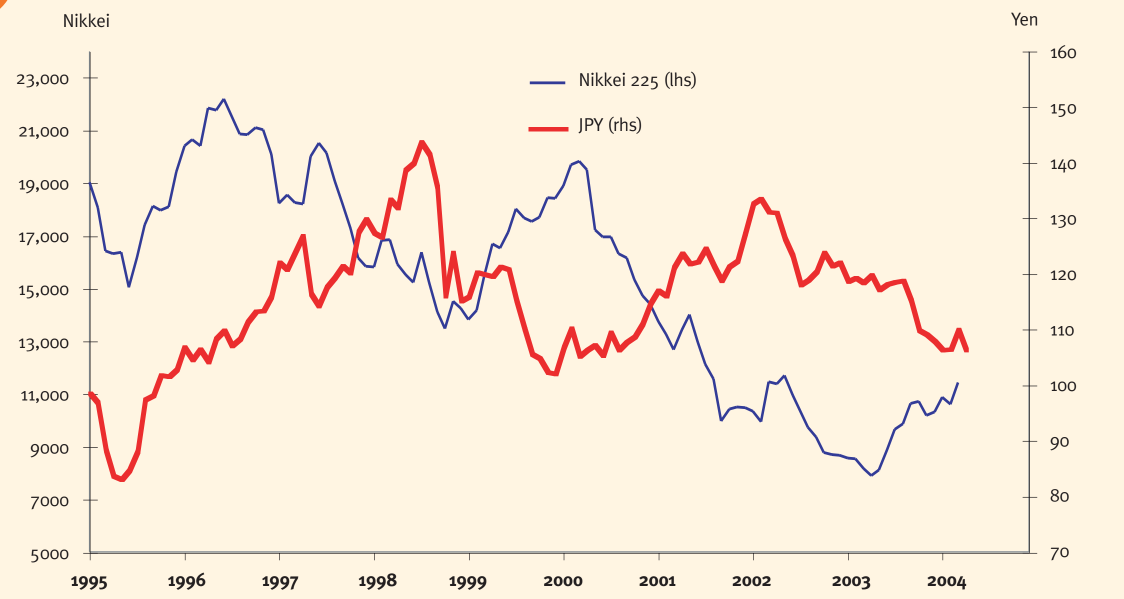
Divergence in performance of the Nikkei 225 and USD/yen exchange rate over significant periods during the past 10 years



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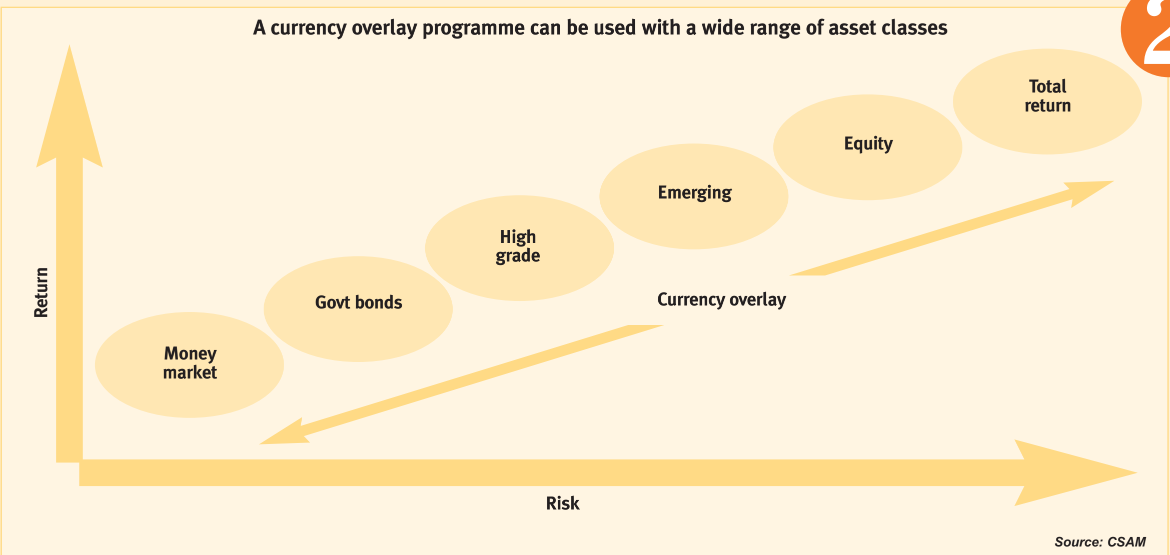


They not only need to analyse the macroeconomic developments of an economy, but also be aware of geopolitical and other risks in a region, understand the policy makers' intentions, as well as understand what other factors affect currencies at that particular point in time. These include bond yields, stock market flows and commodity prices.

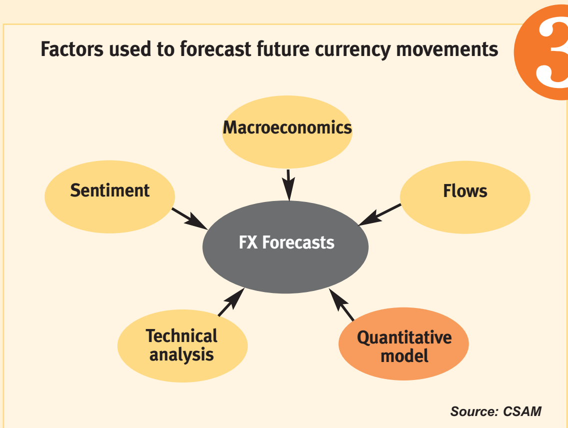
One of the key questions to ask is – over what time frame are we forecasting? The factors that may affect currencies over the next one to two years can be very different to those driving them over the next month or quarter. A three-month horizon is therefore, in our view, the most effective.

While currencies are ultimately driven by macroeconomic developments over the longer term, it is vital to be aware of and react to behavioural factors such as technical analysis and sentiment, which can mis-align them in the short term.

FORECASTS

In providing accurate forecasts for future currency movements, an optimal decision-making process should first blend together these behavioural factors with fundamental factors comprising macroeconomics, flows and a stand-alone quantitative model that is based on macroeconomic variables (see chart 3).

Following an analysis of these different variables, the currency team combines this output with the latest volatility and covariance data to derive three-month



forecasts and formulate a model portfolio. Individual portfolios can then be constructed in line with client risk/ return objectives.

Many investors have historically tended to view currencies as a residual from their overall asset allocation decisions. Just five years ago currencies were of little concern as double-digit equity returns meant that a few basis points made or lost on the currency deviation from benchmark was unlikely to register on investors' radar screens.

But as equity markets have turned, with a future of more modest returns and yield levels currently at near record lows, the search for alpha has spread to areas such as currency management, hedge funds and other total return vehicles. This trend is likely to continue.

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