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PROFIT & LOSS IN THE CURRENCY & DERIVATIVE MARKETS

As equity markets continue to show few signs of recovery, investors are naturally turning to sectors of opportunity. The currency market has traditionally been a beneficiary in such times – and there are some strong signs that 2009 will be one of these times. Julie Ros looks at the effects that the global financial crisis is having on FX investing and why some think 2009 will be the…

Year of Capitulation

As the global financial crisis continues to squeeze markets around the world, the foreign exchange market has of course taken its lumps. But despite the turmoil plaguing the credit and bond markets, FX has proven itself a truly uncorrelated asset class in its own right – something that a number of industry veterans are now saying will make currencies a key destination for investors in the years to come.

The currency management segment argues that currencies will gain favour as an important way to diversify an investor's portfolio, as the decline of equities leads them to the highly liquid, transparent markets that define foreign exchange.

According to Steve Jury, chief investment officer for the Tradex Currency Fund (TCF) in Greenwich, CT, the decoupling that occurred in 2008 marked a major change from 2007 when stress in the system affected the markets in tandem. "Prior to 2008, the markets had been mired in the carry trade, but in 2008, a lot changed. There was an environment of interest rates near zero and it was not uncommon to see stocks drop 8-9% in a single day. So as equities broke down and other hedge funds suffered as credit tightened, we saw huge moves in FX that were counter-intuitive. Currencies as an asset class were able to break away, and the transparency and liquidity of currencies will remain very attractive going forward," he says.

Tradex Capital Markets operates TCF, a fund of funds, which has $1.3 billion in institutional funds invested in 20 currency-only strategies around the world. TCF, which has a 10-year track record, has never had a losing year, according to Jury. "The amazing thing is, if you placed one dollar with us 10 years ago, it would now equal $103; while in stocks, that $1 would be flat; in commodities it would be $60; in bonds, $80 – so over the last 10 years, currencies have been the best investment out there," he says.

The uncorrelated asset class

Joe Conlan, global head of FX sales at FC Stone, a futures commission merchant (FCM) that operates a managed currency account in New York, points to a number of opportunities for investors in this segment. "As the equity markets have fallen off the deep end, there are some opportunities in FX that investors are beginning to notice. Firstly, FX tends to be an uncorrelated asset class to equities – some FX managers had yields as high as 20% in 2008 – and that will be noticed by the broader population. Those only investing in equity funds simply have to consider adding FX to their portfolios," he says.

Sources cite a number of reasons that managed accounts are of particular interest as an investment vehicle at this time. "Because of the rundown in the price of stocks and the need for diversification across various asset classes, I think we're looking at something that really needs to happen," says Conlan. "As a result, people are looking seriously at FX as an asset class."

Conlan says FC Stone is trying to cultivate five strategies at the moment: A high-frequency, algorithmic strategy; mean reversion; moving average; cash and carry; as well as global macro. "After what we've seen in equities, investors are concerned with capital assurance and capital appreciation. They don't want to see what happened in equities again – and diversification will take us away from that," he adds.

Tradex's fund of funds also relies on the concept that managed currency funds can play an important diversifying role in a portfolio. Jury notes that a key factor when adding alternatives to a portfolio is liquidity, and "the most attractive features of FX are the transparency and liquidity of the investment".

"You really can add value during periods of stress," he adds, "FX is not correlated to pressures in equities over the longer run, so to include currencies as part of a portfolio can actually reduce volatility and add real value in terms of alpha."

"Over the last 10 years, currencies have been the best investment out there"

Steve Jury
Tradex

Pension funds' desire for transparency, liquidity and diversification is leading to much of the growth in the sector. "FX will really start to pop up on the radar as these funds do comprehensive reviews of which asset classes did well in 2008," says Jury. "They are bound to notice that you can make money consistently in currencies and I think we will see more money coming into this space. We had inflows of capital in November, no outflows. Rather than trying to pick the best one or two funds that you can make money with, we say: 'Come to us, we know the space very well and are better placed to manage that money'. FX is a real specialist, niche area so those coming in will need to think very carefully about how to build a portfolio."

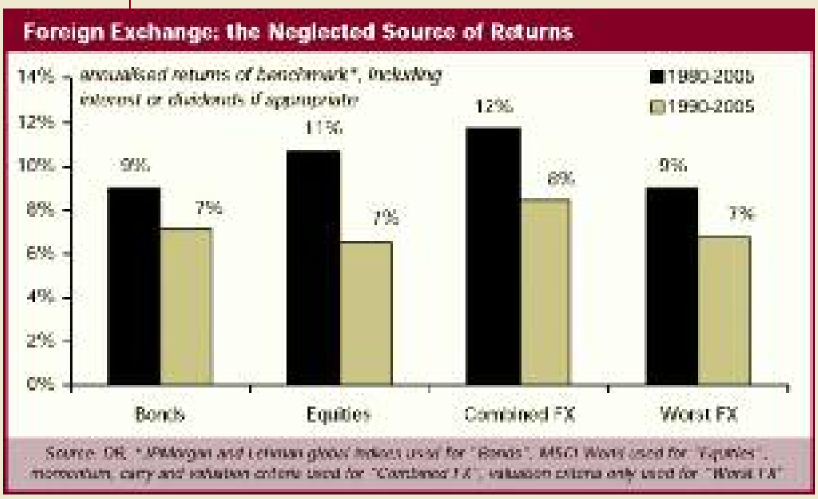
All of those interviewed for this article advocate investing with more than one manager or style in order to achieve diversification within FX, thus the multi-manager model

Currencies: Pensions' Saviour?

Research from Deutsche Bank first published in August 2006 for the pension sector but still being cited by the bank today, upholds that FX returns have a very low correlation with bond and equity markets. The bank's research shows that between 1980 and 2006, FX had a 5% correlation with equities and a -21% correlation with bonds. Equities and bonds, meanwhile, had a 26% correlation rate over this period.

"Foreign exchange has often been viewed as an alternative asset class, rather than as a comparable asset class to bonds and equities, due in part to the absence of a widely followed benchmark and ignorance of the return characteristics of FX," says the research, authored by Bilal Hafeez, managing director, global head of FX strategy at Deutsche. "We feel that foreign exchange should be viewed as an asset class similar to bonds and equities. It has exhibited long-term systematic returns or 'beta' which are comparable, if not better, than both bonds and equities since 1980. It also has greater liquidity than both."

The research goes on to suggest that for global portfolios to benefit the most from FX, allocations to FX should be in the order of 20-30%.



"Madoff is the perfect example of why a managed solution is superior to an alternative investment with a hedge fund. Too many people need to be involved in managed funds for fraud to occur – it's totally transparent."

Joe Conlan
FC Stone

offers investors diversification within a single market, although they all note that FX must be part of a larger, diversified portfolio as well.

"I don't think anybody new to this market should pick one manager in FX," says Conlan. "That's why I like the managed funds solution, because investors can buy a portfolio of management styles."

According to Jon Stein, managing director at Parker Global Strategies (PGS) in Chicago, PGS looks at five style drivers: trend (momentum), value (measured by underlying economic factors), carry, volatility capture (options), and high frequency trading. PGS operates a currency fund and currency overlay fund (comprised of a series of managed accounts), both of which turned in positive performances at year-end, says Stein. PGS has $170 million under management between the two funds.

PGS also produces a benchmark index, which can be found within the money management section of each issue of *Profit & Loss*. The Parker FX Index was at +4.38% for the year up to November 2008, with the Parker Systematic Index up 3.57% and the Parker Discretionary Index up 5.53% for the same period. Stein says that PGS is now developing indices based on the five style drivers, and possibly other styles, mentioned above.

Stein believes a facet worth noting is that certain investors in currency funds can take advantage of appealing funding aspects as well. "The way that you can invest in the FX markets is going to be very attractive for certain sectors. Investors such as pension funds or family offices with strong credit can limit their counterparty risk with partial funding in a counterparty that they trust. Most large investors, for example, can access currencies exposure with as little as 10% deposited as margin, which can be deposited as T-bills or in overnight funds of the counterparty," he explains. "Institutional investors can invest purely on a credit line. This translates into important overlay possibilities. We can overlay FX to other portfolios with a low correlation to currency returns like equities. Alternatively, for funded investments, the investor can allocate the rest of the investment not required as margin to T-bills and other low-risk investments."

Help Wanted: Currency Managers

Can the…gulp…retail sector offer a second life after spot trading?

So you've just lost your job trading spot FX at *ABC* Bank. You got a decent severance, have some friends that might invest, clearly, you are considering setting up a hedge fund. But that comes at a cost – $10,000-$15,000 in the US just for the legal work, not to mention compliance and AML (anti-money laundering), due diligence for each new client, and don't forget, back office processing.

While most bank traders may still feel that "retail" is a dirty word when it comes to FX, some in the sector argue that retail has come a long way since its introduction more than a decade ago. Now, some in the space are saying that retail platforms offering managed accounts could well provide fledgling managers with "the perfect way to get your feet wet", according to Betsy Waters, global director for Deutsche Bank's retail platform dbFX.

For those looking to have a go at managing funds without the initial, sizeable capital outlay, Waters suggests the first step is to begin trading on a retail platform, get used to it, hopefully make some money, then consider managing other people's money. An account can be opened with a retail platform such as dbFX for $5000 (or less depending on the platform), although managers may ask their investors to put in $20,000-$30,000 minimum. Once a track record is established over the course of a year or two, that is typically when to consider taking the leap to become a proper hedge fund. "The key is that you can begin this with minimal investment," Waters says.

"There is huge benefit to managers to start in this way – it's very much an incubator level," she explains. "dbFX does the due diligence, AML and compliance on you and your client. You don't need a back office; dbFX does that and all of your client's due diligence. The only thing your client has to do is open the account with dbFX and sign a limited power of attorney, giving you authorisation to trade the account – and that quickly, you're managing money."

Unlike hedge funds, the issue of credit is addressed because the investor opens an account with the larger financial institution, in this case Deutsche Bank, as opposed to writing a cheque to a fund manager. "With a managed account the investor has full visibility and control of their

"Many people are questioning whether trend programs can continue to deliver the high returns of '08, and some people are even suggesting that carry may come back with a vengeance."

Jon Stein
Parker Global Strategies

Credit

Few people have anything good to say about alleged fraudster Bernard Madoff, but Conlan calls the "Madoff Effect" a positive for the managed funds sector in particular because, from a credit standpoint, the investor opens an account directly with a bank or larger financial institution; investors are not handing money over to a fund manager.

"Madoff is the perfect example of why a managed solution is superior to an alternative investment with a hedge fund," Conlan says. "Too many people need to be involved in managed funds for fraud to occur – it's totally transparent."

Conlan points out three of the most attractive features of managed accounts: "Firstly, you get capital assurance. You are putting your money into a larger financial institution – you're not giving it to a fund manager wondering whether you are going to see it again.

"Secondly, transparency," he continues. "Sometimes people that invest in alternative investments don't really know what their investment advisor is trading. With the FCMs, we produce a daily statement, so they get to see daily what the position is; what their P&L is; what the risk is. Thirdly, leverage. Typically, when you give your money over to a hedge fund, they determine the leverage. With managed funds, you have some level of control over what kind of leverage you're providing to the manager. Finally, and this is the best thing about managed funds, liquidity. If you decide you want liquidity today, basically you're a phone call away from us closing out the positions and providing liquidity to the account."

Focussing on the credit aspect, Scott Brusso, director for FX products at the CME Group in Chicago, points out that the exchange's central counterparty model offers the ultimate safety net.

"You can duplicate what you are doing in the cash market using futures with the added benefit of the CME as the counterparty to all trades," says Brusso. "There is also the extra advantage of the central marketplace, which means

funds at all times and funds are held at Deutsche Bank," she notes.

Additionally, because Deutsche Bank is Mifid regulated, it has a fiduciary responsibility to the end investor. "Investors pay the manager for their professional services; the bank facilitates the collection of these fees for the managers. Since Deutsche Bank is actually taking the client fees payable to the manager out of the investor account and putting it into the manager's account, we want to ensure that everyone is being treated fairly and everyone is doing well. It's part of our regulatory responsibility; whereas with a hedge fund, the end investor isn't our client, here all the parties on our platform are our clients so we have to ensure that everyone is treated fairly."

Furthermore, Waters says dbFX aims to ensure that the structure of the manager's charges match the trading style. "For example, if a manager is a day trader and he's doing a high volume of trades, then he shouldn't be charging a commission per trade, just a performance fee. If the manager wants to charge commission and he's doing a few trades per day, then charging a commission makes sense. We want to make sure the end investor is as profitable as the manager, and we monitor this very carefully," says Waters.

The difficult part for the new manager, however, is finding those investors. Deutsche provides no cap intro and there are strict regulations governing the marketing of funds. Setting up tables at retail trade shows and word of mouth seem to be the primary way these parties connect. And for the investor, Googling managed forex accounts will bring up a host of such offerings.

"There is huge benefit to managers to start in this way – it's very much an incubator level"
Betsy Waters, dbFX

Deutsche is not alone in offering managed currency accounts over its platform. CitiFX Pro is among the retail bank offerings, while larger FCMs such as FC Stone, Rosenthal Collins and MF Global are well-known in the field, and there are a number of retail platforms also in the managed account space.

So for the career bank trader looking to start a hedge fund, perhaps the unlikely thought of starting out on a retail platform could ultimately get you there, for a fraction of the start-up cost.

"We are calling 2009 the Year of the Capitulation and so expect to see significant investments in FX this year – in both beta and alpha products in the currency markets."

Torquil Wheatley
Deutsche Bank

prices don't get fragmented by credit constraints: all participants are taken on best price."

Furthermore, he points out, firms that trade on the exchange are regulated, and are required to have segregated client accounts.

In terms of interest in FX, Brusso says the CME is seeing a migration towards FX from multi-asset class trading firms, but also notes a degree of interest from those in the over-the-counter market looking to futures for the credit efficiencies, transparency and liquidity available.

Liquidity

Managed accounts are particularly attractive because there are no lock-ups, but even at the fund of funds level, liquidity is readily available. "Investors can get their money back at the end of the week or month, no problem," says Jury. "FX is a very liquid market – so the combination of controlled volatility, liquidity and transparency make FX a very compelling alternative."

Torquil Wheatley, head of currency solutions for pension funds and insurers at Deutsche Bank in London, works with the bank's FXSelect fund of funds platform. With over 70 managers on the platform, 55 of which are invested, FXSelect has trebled the amount of money invested via the platform during 2008 from $1 billion at the beginning of the year to just under $3 billion by year-end, with much of that growth coming from the pension fund sector.

"The low volatility carry trade was the only thing to do in 2007, but you can never rely on a single strategy. Trend followers did extremely well in 2008, and will probably do so again in 2009 given the heightened volatility. The general feeling is that the currency markets are back in play," notes Wheatley.

"Demand today is for transparency and liquidity. FXSelect [has] daily liquidity, total transparency and the ability to see, on an aggregate level, everything that is happening," he adds.

"2008 was a very different year," he continues. "In many ways, it was a much more normal year. In 2007, the market was stymied by the carry trade, but it was very helpful in terms of separating the adults from the children in terms of seeing who had good risk management in place.

"We are calling 2009 the Year of the Capitulation [selling a security for a loss in order to move the proceeds into another investment] and so expect to see significant investments in FX this year – in both beta and alpha products in the currency markets," Wheatley adds.

Jury agrees. "The market's return to market making means increased opportunities in 2009," he says. "A lot of the players that caused the low volatility period – hedge funds and algo traders – that were unable to cope with the volatility got out. So the return to market making means more volatility and therefore, opportunities."

"Generally speaking, FX managers performed well as a whole in 2008 because markets were volatile with strong direction followed by wide range bound prices, which was probably one of the better years for currency market opportunities in several years," adds PGS's Stein. "Trend and certain types of value did well, but carry was obviously hit hard, as was volatility capture (although it had been doing well earlier in the year, many FX options programs broke down late in the year). Overall, 2008 was a great year for currency managers and currency strategies."

"We will likely see style rotation in 2009. Many people are questioning whether trend programs can continue to deliver the high returns of 2008, and some people are even suggesting that carry may come back with a vengeance. In 2009, we are already seeing some volatility capture strategies back in play. Value is the most wide-open of the strategies – managers get in early and often have to take a few hits holding onto those longer term positions, but I'm sure we'll see successes here too," Stein concludes. ■

"The central marketplace…means prices don't get fragmented by credit constraints: all participants are taken on best price."

Scott Brusso
CME