Currency – an Asset Class

In the world of 'alternative investments', currency portfolios have moved into the limelight by emerging as an asset class that compares favorably against others in terms of a) return, b) risk and c) correlation statistics. They have shed their conventional skin as serving merely as a fund manager's foreign exchange risk hedging device. Currency overlay is no longer the panacea to managing foreign-exchange risk. Creating independent alpha in the new asset class 'currencies' can outweigh beta gained from conventional overlay-currency hedging.

What is an asset class?

The modern hedge fund manager's liberal tongue-in-cheek definition is: "If it moves up and down independently, then it's an asset class." While currencies surely do a lot of moving up and down, they also stand out for other reasons:

- The global foreign-exchange (FX) market can be considered by far the largest marketplace in the world, not only geographically but also with reference to trading volume. The daily turnover is growing constantly and has long ago surpassed the $1 trillion mark: forty times the size of world trade.
- An important difference between currencies and other markets is that currency prices allow us to analyse also their reciprocal values. A falling dollar/yen is synonymous with a rising yen because the dollar can be expressed in yen and, vice versa, the yen in dollars. By comparison, the dollar is never measured in units, as the Dow Jones for example.
- For the same reason the expression 'short sale' – so much maligned in equity trading – does not exist in currency trading because the short sale of a currency is equivalent to a purchase of the other currency.
- For similar reasons, the currency market cannot suffer a 'crash' (such as the stock market crashes of 1929 or 1987) through which the wealth of all market participants dwindles. In the currency market each loss is matched by an equivalent gain of the counter-party.
- Another unique feature of the currency market is that it is active without interruption 'round-the-clock'.

> *"Currencies, as an asset class, demonstrate high liquidity and transparency and low correlations."*

Inefficiencies, e-forex, automation and STP

In one of their annual surveys, Greenwich Associates states that the number of institutions globally trading FX as well as the number of trades done online could easily top 50% in 2004, further proof that currency trading has now become a top contender as a desirable asset class.

Because some of the participants in the currency market are not purely profit-motivated, such as commercial hedgers and central banks with their finger on the intervention trigger, currency portfolios benefit from exploitable inefficiencies available nowhere else. All these advantages are further enhanced by a recent revolution in technology: e-forex, automation and straight-through processing (STP).

- *E-forex*, the term for electronic trading where banks are functioning as electronic market makers, has increased dramatically, and bid-ask spreads have collapsed to meet the demands of the fast growing clientele of corporate and hedge fund e-clients. Many of these now prefer not to use a Request-For-Quote (RFQ) system, where customers have to reveal their intentions in order to get price quotes from the banks, and favour live executable 'click-and-deal' bids and offers on their screens. The advantages are obvious: tighter spreads, faster fills, tighter risks and by consequence the potential to make use of higher leverage.
- *Automation* has recently arrived to supplement the novel click-and-deal mechanisms: using an Applied Programming Interface (API) allows for executions to be done by robots and remain completely anonymous beforehand. It is conceivable that market participants will eventually deal through their robots with each other directly rather than through an intermediating bank: a utopian vision of a self-organised exchange mechanism.
- *Straight-Through Processing* (STP) has now been integrated with most electronic forex trading platforms offered by banks and forex dealers. From trade execution to trade reconciliation, reporting and settlement, e-clients benefit from STP by way of increased convenience, risk reduction and lower costs. STP means saving time and resources by eliminating the need to re-key trades and by automating the data transfer. The whole life cycle of a currency transaction, from initial setup to trade execution to posttrade processes – such as allocation and settlement – can be linked to the e-client's internal system and help to perform risk checking. Trading staff, operations staff and risk managers all recognize the advantages of a faster, more accurate flow of trading. Asset managers in particular, with multiple accounts and complex internal structures, can reap tremendous efficiency gains from STP, which also allows them to automate the sending of trade records from managed client accounts to the administrators and custodians of the investment funds they manage. This reduces costs and risks and saves time. STP maintains a complete audit trail and has become indeed the most important overall mechanical aspect of e-forex.

Portfolio composition

Modern portfolio theory postulates that relative risk can be reduced by diversification into at least six or more components. This is not necessarily true for currency portfolios. Most

> *"In the current context, the potential returns from currency portfolios can be very attractive."*

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successful currency fund managers choose only three or four major currencies in their quest for risk-adjusted profitability. It is easy to see why: within the major currency blocks of Europe, North America and the Pacific Rim, currencies other than the euro, the dollar and the yen are often considered mere satellites that are too correlated to provide suitable diversification. Furthermore, liquidity costs are a chief contributor to currency portfolio returns, but most cross rates do not offer low enough execution costs to qualify for inclusion in frequent turnover trading.

The Parker Global FX Index

The hedge fund industry has barely woken up to 'currency' as a new asset class. Indeed, the term 'currency fund' cannot be found among hedge fund classifications and glossaries. Some not purely systematically driven 'discretionary' currency funds are listed under Macro Funds. Yet it can be shown from analysing the information used in compiling the *Parker Global FX Index* that systematic currency managers outperform discretionary currency managers by a substantial margin.

Performance characteristics of the *Parker Global FX Index* are proof that currencies are indeed a *class asset*. Currency portfolio managers contained in this index have shown that as a whole they can deliver consistent risk-adjusted returns and that it is important to manage risk rather than focusing on delivering percentage returns. The index serves as a proxy for available currency manager portfolio returns in general and has the added benefit of being *uncorrelated* to returns of other asset classes. *Low correlation, liquidity* and *transparency* are good enough reasons for currencies to be considered a prime candidate for inclusion in any investment portfolio.

Impending business from pension funds

For the past several years asset money flows have been moving into the currency sector, yet the conversion process has understandably been slow, particularly with pension funds, which usually take years to adopt a new investment strategy. The potential benefit for currency portfolio managers from the eventual arrival of such pension and endowment fund business could indeed be huge. The advanced financial technology of e-forex undoubtedly plays an important role for this kind of investor.

The above facts and arguments promise a tremendous growth potential for currency portfolios in the hedge fund universe. The necessary ingredients are all there:

- *a suitable benchmark* in form of the Parker Global FX Index (the foremost evaluation service specialising in currencies only),
- enabling the measurement of *excess returns* over an established benchmark such as customary equities and bonds,
- a marketplace that runs *uninterruptedly* and round the clock,
- *liquidity* unmatched by any other asset class,
- *automated* execution and reporting pipelines, which provide
- *efficiency* and *transparency* for auditors.

Final note

One noteworthy comment about the increasing acceptability of foreign exchange as an investment product was made last year by Paul Fisher, Bank of England's foreign exchange division head: "In the context of relatively stable exchange rates and low volatility in the G3 currencies we have, perhaps surprisingly, seen a growth of interest in foreign exchange as an asset class […] and in the context of lower returns available in other financial markets, the potential returns from currency portfolios can be very appealing."

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