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Investing in foreign exchange
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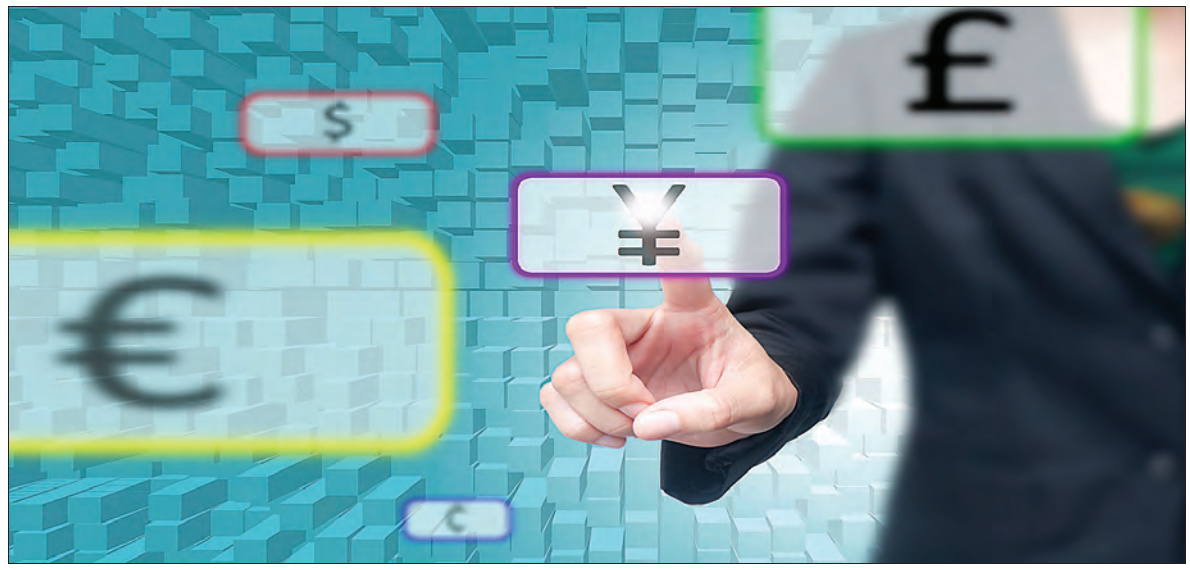
Bruising for investors leaves market becalmed



Land of the rising yen: the Bank of Japan made huge interventions to stem the currency's advance Dreamstime

Overview

It has been a quiet start to the year but longer term interest in currencies as an asset class should revive, writes **Jennifer Hughes**

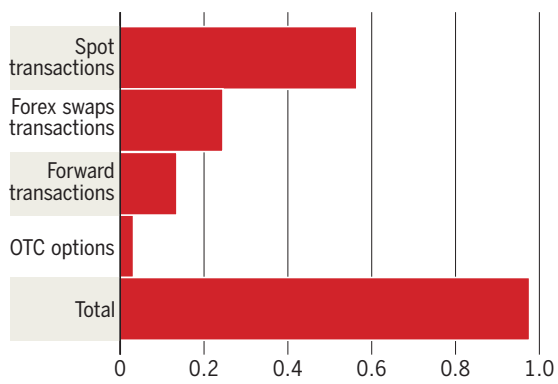
Where is everyone? Like the most popular kid in the class that does not know why he has suddenly been deserted, the foreign exchange market could be forgiven for feeling a little bit bereft right now.

The market, by far the world's biggest by average daily volume, has had an unusually quiet start to the year: while stocks and credit markets around the world have enjoyed a strong rally, prompting speculation that investors the world over are increasingly confident of the prospects for economic recovery, the major currencies have gone nowhere.

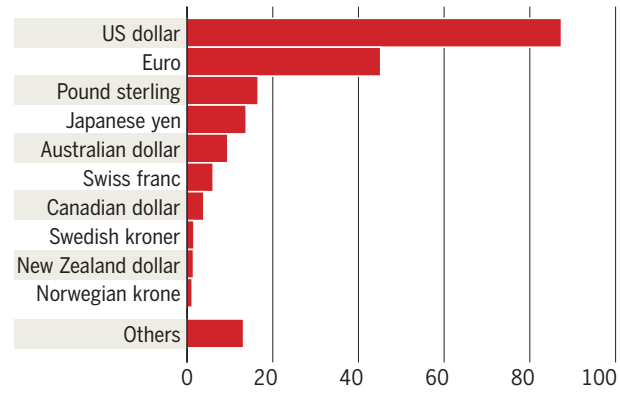
Traders anecdotally report markedly lower volumes. FX was a darling of the pre-crisis boom and indeed most of the last four years. But has FX had its moment in the sun?

Probably not. The argument for treating currencies as a store of value and a distinct asset class, rather than simply a unit of exchange, grew slowly but steadily over the past decade. Strong moves during the beginnings of the credit crunch and the financial crisis only cemented this; investors had to know what was going on with currencies, and be able to use them as a hedging tool at least, or risk seeing gains on their other investments wiped out by the whims of the $4tn a day FX market.

Forex volumes (North America)
Average daily volume by reporting dealers, Oct 2011 ($tn)



UK forex turnover distribution (reported)
Oct 2011



Sources: US Foreign Exchange Committee; Bank of England

As two currencies are involved in each transaction, the sum of the % shares is 200%

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Currency strategists suggest the market's current becalmed state may have a lot to do with the bruising investors took last year.

"People have had a couple of good months this year in other assets – stocks, credit – and that's been a relief after a pretty torrid time all round last year," says Ray Attrill, North American head of FX strategy for BNP Paribas in New York.

"In 2011 people called the euro lower and lost money on options as they waited and waited for it to happen and in the meantime, they got blown up by unexpected volatility spikes. There's a feeling just now that FX is just far too complicated."

It is easy enough to sympathise with a once-bitten-twice-shy mentality.

The euro's strongest point took it within 10 per cent of its all-time peak against the dollar last May – even as the European Union took negotiations over a second bailout for Greece to the wire through a series of summits and rows that made the actual break-up of the single currency appear all too possible.

Investors also had to cope with the shocks produced by the Bank of Japan's huge interventions to stem the rise of the yen and the Swiss National Bank's even more brutal overnight imposition of a ceiling to stop the franc's record strength extending even further.

"Unless and until we see an interruption of the uptrend in equities and credit markets, FX is likely to remain somewhat unloved," says Mr Attrill, but he holds out hope this can happen, not least because market volatility, as implied by currency

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Eurozone hedging is tough game to play

Risk assessment

Brian Bollen outlines the issues for those who want protection against break-up of the single currency

A break-up of the eurozone might be regarded very much as a tail risk in today's markets, if only thanks to the European Central Bank's brace of three-year longer-term refinancing operations in December and February, but it cannot be completely ruled out.

Tail risk is broadly defined as a remote event that few expect to happen, but which is disproportionately significant if it does happen. A recent example is the 84th-minute goal scored by Kilmarnock Football Club in the Scottish League Cup final that beat Glasgow Celtic in a two-horse race that Celtic were white-hot favourites to win. Celtic fans had a particularly harsh crash course in tail risk that afternoon.

Even those investment managers pushing the official company line that post-LTRO a eurozone break-up is exceedingly unlikely are still having to take the possibility into account.

Simple caution suggests challenges lie ahead, most immediately in the form of French presidential elections. The importance of a smoothly functioning French-German axis must never be overlooked, and there are fears that if challenger François Hollande were to win there could be demands for renegotiation of the latest EU fiscal pact.

Structural issues surrounding attempts in Italy and Spain to bring public finances under control could also present further obstacles to progress.

For those who decide to hedge against break-up, one obvious problem is the clear lack of available alternatives. The US dollar, sterling, yen, Norwegian krone, Swiss franc and gold all have their drawbacks, ranging from quantitative easing to a lack of liquidity and downside risk, observes Alan Higgins, chief investment officer UK at Coutts.

> 'Some things are unhedgeable. This is one of those things. There is no place to hide'

"Our core scenario assumes the eurozone remains intact," he says. "If not, investors will be stretching to find a haven."

A second, perhaps less obvious problem for aspiring hedgers, would be the legal status of euro-related contracts. There are suggestions that investors, corporations and any other organisations with significant cross-border exposure are beginning to think carefully about the impact that fragmentation might have on their eurozone contracts.

For Ugo Lancioni, head of currency management at Neuberger Berman Investment Management, existing contracts could throw up more problems in the event of a break-up, not least because of the asset-liability mismatches that would be created. "And if you have a redenomination event what happens to not just currency contracts but, for instance, Euribor-linked derivatives?" he asks.

If the euro undergoes any form of break-up, the legal profession is likely to be a key beneficiary. A third problem, articulated robustly by Alan Brown, chief investment officer at Schroders, is brutally simple and, in essence, undebatable. "Some things are unhedgeable," he says. "This is one of those things." Alasdair MacDonald, head of investment strategy UK at Towers Watson, broadly shares this view. "There is no place to hide," he says.

The eurozone is by no means out of the woods, despite the ECB's much-discussed recent attempts to restore stability, according to James Wood-Collins, chief executive of Record Currency Management. The ECB's provision of medium-term liquidity merely pushes problems into the future, he says, and he is far from convinced that modern bankers will put the time to good use.

Boot on other foot: defeat by Kilmarnock gave Celtic fans a harsh lesson on tail risk PA

"It would be naïve to assume that there will be an underlying solution in the meantime," he says. "The real reduction in Greece's debt has been minimal, the European taxpayer is still on the hook and competitiveness has not greatly improved. Greece's agreement with creditors will reduce pressure but does not address the eurozone's failures."

Myles Bradshaw, a portfolio manager at Pimco, says the EU needs to use the time to accelerate the political union that is necessary for monetary union to succeed.

Ben Funk, a partner at fund of hedge funds Liongate Capital, describes the ECB's LTRO as a "game changer" for investors' perception of European bank credit risk, with the removal of the threat of imminent default having driven down corporate and sovereign bond yields. "Yields have come in, equity has risen and volatility has dropped like a rock."

Mr Funk cautioned, however, that it is far from clear whether the ECB has saved the day or only delayed the inevitable.

In this atmosphere, investors should stay hedged using cheaper and more asymmetric hedging strategies that have been presented by this lull in concern about a eurozone break-up.

Long-dated volatility in equities remains expensive and the cost of sovereign CDS protection is high, but investors can buy investment grade CDS protection at a low cost as zero interest rate policy has pushed investors to accept more risk in search of yield.

Mr Bradshaw prescribes a return to fundamental bottom-up research with an emphasis on the long term and diversification away from traditional sovereign paper. He cautions, though, that this requires a depth of resources that many in the asset management industry do not currently possess.

As is always the case in any debate, some see the situation more clearly than others, and those looking on from the touchline often speak with greater confidence than those scampering around on the playing field.

Among the onlookers is Jerome Booth, head of research at Ashmore Investment Management, brandishing his own form of brutal simplicity. His advice will be of little help to investors with existing eurozone exposure. But it could spare further tears in the future. "The best way to hedge against something is not to invest in it," he concludes.

Bruising for investors leaves market becalmed

Continued from Page 1

options pricing, has slipped back towards historic lows.

This should in theory encourage so-called "carry trades" – where investors aim to profit from borrowing cheaply in a low interest rate currency such as the Japanese yen or, for now, the US dollar, and investing the proceeds in a higher-yielding one.

"The problem for now with this is that the number of opportunities for pure carry-trade activity are limited with rates so low in the US, UK, eurozone, Japan, Switzerland and even Canada, Norway, Sweden and New Zealand. Australia is the only remaining high yielder among the biggest economies," says Mr Attrill.

More generally, volatility has been a big driver of FX trends for a few years.

"If you look at the performance of the Dow Jones Industrial Average and the implied volatility of the dollar, the two are almost a perfect mirror: as stocks rise, dollar volatility is falling and trading interest dropping.

"That's essentially people saying: 'There's nothing going on in FX, let's go elsewhere'," says Simon Derrick, global head of FX strategy at Bank of New York Mellon.

But he sees the reasons for this as a potential danger that could yet blow up on investors.

Low volatility either implies a contented market with no worries, or that something else has lulled the market into producing a false appearance of calm. Given the uncertain macroeconomic picture and the high level of geopolitical tensions, Mr Derrick believes it is the latter, caused by the extra liquidity being injected into the system by central banks.

"When you've seen declines in volatility, it has been the Fed or another central bank introducing additional liquidity. The forces driving it up have been spikes in tensions in the eurozone crisis," he says.

"This is why a lot of investors' favourite strategies – reversion to purchasing power parities, carry trades – just aren't working right now, because it's all about volatility.

"Excluding the yen, the only real trade in the majors is a decline in volatility – and playing that only means you end up building up risk when you shouldn't be doing that."

All things pass, however, and in the longer term, insiders are confident that interest in FX will pick up again at some point.

> 'A lot of investors' favourite strategies ... just aren't working right now'
>
> **Simon Derrick**
> **Bank of New York Mellon**

"If anything, I'd suspect the sovereign crisis alone should increase interest in using FX as an asset class," says John Normand, head of currency strategy at JPMorgan. "If the government is impairing use of other hedging tools like credit default swaps [through regulation and other restrictions] then FX is the last asset class that would be structurally affected if a government does alter other markets."

While governments and central banks have been thorns in the side of investors through their actions to curb currency moves – moves by the SNB and the BoJ for example, or the trading taxes added to some emerging market currencies – most participants are still confident that this is cyclical, not structural. It is hard to imagine that governments behind the most traded currencies – the dollar, euro and yen – would contemplate genuine long-term structural action such as pegging their currency against another.

Many investors might find it hard to imagine betting big once more on FX after the battering they took last year. They may not love the asset class at present, but anyone trading across borders takes on currency risk. That alone makes it very hard to ignore for long.

Funds shine light on custodians' fees

Trading costs

Excessive spreads on FX dealing are being rooted out, says **David Rowley**

How much money can be squeezed out of the costs incurred from currency transactions when investing abroad? A few basis points here and there, but not much.

When overall returns were higher and more consistent this did not get a great deal of attention, but in leaner times there is a trend for independent audits of FX transactions. – not least when one of the main sources of returns on equities has become dividends rather than growth.

When the results of these audits have not been to the liking of investors there have been lawsuits against the custodians who manage these transactions on behalf of clients. The State of California issued a claim of fraud against State Street on behalf of Calpers and Calstrs in October 2009 and numerous US states have brought similar actions against both State Street and BNY Mellon subsequently.

The substance of many claims is that the time of day the transactions took place has been falsified to give the pension fund a lower transaction value than when the trade actually took place.

These are not the only or the first investors who are unhappy with the situation. Audits undertaken by the fund manager Record have found custodians taking big cuts from transactions since 2001, when a client first asked whether their custodian was making excessive profits from the spreads on FX transactions.

James Wood-Collins, chief executive at Record, recalls: "We expected the custodian to be able to provide 'time-stamped' trade deals, which we could then compare with our database of live prices at 15 minute intervals. Instead, however, they were unable (or unwilling) to do so – a theme we've since seen repeated on numerous occasions."

Close to 100 audits for pension funds later and the same story appears.

"Pension funds characteristically pay excessive spreads on FX transactions in the aggregate, and significantly more when execution is left to the custodian rather than subject to the fiduciary duty of the manager of the underlying assets," says Mr Wood-Collins.

There is no shortage of people who will agree with these sentiments. Both Mercer and Russell Investments have responded to the growing call for transparency by setting up special units to monitor or deal in FX on behalf of clients at bargain rates.

Russell has carried out research on 170,000 FX transactions valued at about $83bn and found the average cost was 10.1bp. It has used this figure to highlight the 1bp average for its own specialist trading service.

> 'I am always wary when investment services providers bristle at questioning on fees and expenses'

The 10.1bp average is a figure which both Mercer and Record think is too high for the institutional world where large sums change hands for proportionately smaller fees.

Mr Wood-Collins says for institutional size trades in major developed market pairs, spreads are more typically 3 to 8bp, so the cost would be 1.5 to 4 bp – the true cost of any transaction is from the mid-market price to the price paid, i.e. half the bid-offer spread.

Michael DuCharme, head of foreign exchange at Russell, argues that this is done well by specialists who by their nature have to compete on price with custodians and fund managers who have built special internal capabilities.

"Trading with the custodian is a very convenient low risk way to trade, the trade-off is it comes at a higher cost."

So what will become of the custodians' FX services, which are most frequently used for regular dividend and coupon conversions, carried out under directed trading arrangements?

Benjamin Gunnee, European director at Mercer, believes they will have to change their model.

"Historically custodians have 'hidden' fees in costs such as FX as they are not closely monitored," he says. "As more transparency is sought on costs it will mean that the custodians' revenue mix will change and they will have to recover their fees from other sources, albeit in a more transparent way."

More pragmatic advice for investors comes from Steve Delo, an independent trustee for many UK pension funds.

He advises: "Pension funds are always exposed to the risk of getting ripped off when any fees or charges can exist which are not explicit, disclosed and fully transparent.

"From my experience, I am always wary when any investment services provider bristles at questioning on fees and expenses. Clear demonstration of the facts and transparency is what is required."

Benjamin Gunnee: custodians will have to change model

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Achieving more together

Double delight: the "carry trade of the moment" is the Japanese yen and Turkish lira – investors will have been paid by the capital appreciation of the lira as well as its yield

Flexibility is key to picking right style

Strategies

Emma Boyde looks at how the four main approaches to investment fared in last year's markets

Increasing numbers of investors find they cannot ignore the potential yields offered by trading in currencies, but many lack the relevant expertise to be effective traders themselves. This means they must make informed choices on both manager and investment strategy.

Those decisions are important for returns, says Momtchil Pojarliev, senior portfolio manager at Hathersage, a specialist currency manager with $550m in assets under management.

Mr Pojarliev, who was previously head of currencies at Hermes, is co-author of an academic paper published in 2010* that examined exactly this topic.

The unfortunate conclusions of the research – that managers tend to stick with one style and that inflexibility does not pay – have stark implications.

Mr Pojarliev and co-author Richard Levich conclude: "We find no evidence to support alpha persistence; a manager's alpha in one year is not significantly related to his alpha in the prior year. On the other hand, there is substantial evidence for style persistence; funds that rely on carry, trend or value trading or with a long/short bias toward currency volatility are likely to maintain that style in the following year."

Of the four main strategies – carry, trend, value and short volatility – carry and trend attract most trade. Carry, the practice of selling a currency with a low interest rate and using the proceeds to buy one with a high interest rate, is the most widely used, Mr Pojarliev explains.

Value, buying undervalued currencies and waiting for them to rise, makes up a smaller portion because its time horizon is often much longer. Short volatility, which relies on selling options to protect against volatility, accounts for only a tiny proportion of purely speculative currency trading, according to Mr Pojarliev.

He says that none of the three dominant strategies would have delivered a positive return for investors last year.

The DB Value Index lost 2 per cent over the year. DB Global Currency Harvest Index, which tracks the performance of a portfolio of carry strategies, lost 0.5 per cent last year. The DB Currency Momentum Index, which tracks trend strategies that buy rising currencies and sell falling ones, performed much worse, losing almost 10 per cent.

"Last year was a bad year for trend followers," Mr Pojarliev says.

But while those indices lost on the year, nimble currency investors made money and are still doing so.

The "carry trade of the moment" is the Japanese yen and Turkish lira, says Chris Towner, director of FX advisory services at HiFX, which advises on about £20bn in currency exposure. At the beginning of this year, there were 40 yen to the Turkish lira, but now there are 46 which means investors will have been paid by the capital appreciation of the lira as well as its yield.

But carry trades can go wrong, he says, and points to sterling/yen starting in 2007 when there were 250 yen to the pound. Sterling halved in 18 months and is still running at about Y130.

Trend also paid timely investors last year, points out Mr Towner. "They say the trend is your friend, and last year the trend was the yen."

> 'Even though the FX market is incredibly liquid, the exits are very small because volumes are so large'

But failing to spot when a trend is about to turn can quickly turn that friend into an enemy. Last year, the friend-turned-enemy trend was euro/dollar.

"Even though the foreign exchange market is incredibly liquid, the exits are very small, because the volumes are so large," says Mr Towner.

James Wood-Collins, chief executive at Record Currency Management, which has $25.4bn in assets under management of which $1.7bn is in return-seeking mandates, thinks investors can apply some rules of thumb. "The key point for investors to recognise is that these strategies can behave differently in different risk environments," he says.

Mr Wood-Collins believes that carry performs well except when risk appetite turns negative, at which point "drawdown events without risk management can be quite painful".

Value, he says, is risk-neutral and momentum, or trend, is inversely correlated to risk, because if you have a sharp reversal in risk appetite, you can follow that trend.

Record offers four main strategies: carry, which it calls forward rate bias, value and momentum, as well as emerging markets, which it prefers to treat as a separate strategy.

Mr Wood-Collins says: "If you accept the argument that there are at least four strategies that can earn you robust returns, then a simple approach would be to agree a fixed allocation between them."

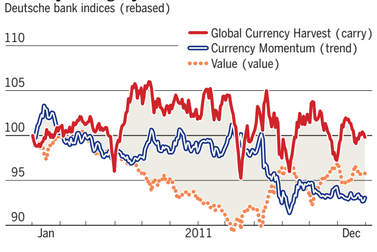
He adds that Record then conducts periodic rebalancing to capture the best returns.

If Mr Pojarliev's findings hold true, the crucial thing should be the ability to change your mind, and quickly.

"Investors should look for flexibility – the ability to rotate into any strategy as the micro market environment dictates," Mr Pojarliev says.

**Trades of the living dead: style differences, style persistence and performance of currency fund managers, Momtchil Pojarliev, Richard Levich. Journal of International Money and Finance (2010)*

Currency trading styles of FX investment funds
Deutsche bank indices (rebased)



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Contributors

Jennifer Hughes
Lex Writer, Asia,

Steve Johnson
Deputy Editor, FTfm

Emma Boyde
FTfm Online Editor

Josh Noble
Asia Emerging Markets Editor

David Rowley
Editor, Pensions Week

Heather Dale
Reporter, Ignites Asia

David Ricketts
Senior Reporter
Ignites Europe

Brian Bollen
FT Contributor

Andrew Baxter
Commissioning Editor

Helen Bennett
Design Editor

Andy Mears
Pictures Editor

For advertising contact **Steven Canfield,** tel +44 (0)20 7873 4802, email steven.canfield@ft.com

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Renminbi pauses for breather as GDP growth slows

China

Heather Dale compares various ways to gain exposure to the currency

China's growth story and the willingness to internationalise the currency has seen strong interest from investors for renminbi exposure to boost returns and portfolio diversification.

Recently a number of market commentators have said the short term outlook for the currency's appreciation looks limited, but asset managers say investors should not be perturbed as the fundamental principles for investing in it remain in place.

The latest Chinese GDP figures from last year, of 8.9 per cent year on year growth, are down a bit from the previous 9.1 per cent but hardly a sign of a "hard landing", says Michael Hasenstab, portfolio manager in the Franklin Templeton fixed income group.

Angus Hui, fund manager, Asian fixed income at Schroder Investment Management, says depreciation is unlikely.

"In our view this undermines efforts to internationalise the currency, and China needs to manage the political expectation from other countries. Overall, the renminbi is a rewarding currency in which to invest given its relatively low volatility."

The renminbi has previously been problematic to access because of strict controls on it but since policy changes by the Chinese government in 2010 the capital markets are opening up

China continues to demonstrate a willingness to take steps toward unrestricting its currency and capital flows, says Mark Hogg, director, FX product development at RBC Dexia Investor Services.

"The renminbi foreign exchange market is thriving," he says.

"Full liberalisation is likely to still be several years away, but we can expect a future where the renminbi is a globally traded reserve currency, commensurate with China's status on the world economic stage."

Currently, investors can gain access through onshore non-deliverable FX forwards, which have the advantage of being very liquid.

Peter Eerdmans, head of the emerging market debt team at Investec Asset Management, says the drawback is that the yield on the non-deliverable FX forwards is typically negative as currency appreciation is priced in.

A slightly higher yielding way to hold the currency is to take advantage of the offshore renminbi (CNH) market.

This is possible via deliverable FX forwards, which Mr Eerdmans says typically have paid slightly higher or less negative yields, "but are less liquid and require a local account to be set up".

Neil Weller, director, fundamental fixed income team at BlackRock, says investors can also open a bank account denominated in renminbi and put money on deposit.

"This has been popular in Hong Kong and has been easy to access," he says. "It is also possible to access from other regions such as London and New York, but deposit rates are quite low at around 1 per cent and it also leaves you with credit exposure to your bank."

For investors that would prefer a higher yield, the offshore bond market – dubbed dim-sum bonds – provides this.

Mr Weller says investors can buy bonds directly or through a pooled vehicle. There have been a number of dim-sum bond funds launched by asset managers in the past year, including one launched by BlackRock.

Mr Weller says these funds have proven reasonably attractive. He says: "We feel funds are one of the better ways to access the market because you get the benefits of high quality credit research and a manager to do that security selection for you."

> 'We can expect a future where the renminbi is a globally traded reserve currency, [in line with] China's status on the world economic stage'

Investors can also now access the onshore bond markets with the introduction of the renminbi qualified foreign institutional investor (RQFII) programme, which launched last September.

Quotas to invest in mostly onshore bonds were awarded to Chinese asset management companies based in Hong Kong and the first pooled funds were approved by Hong Kong's Securities and Futures Commission in January.

The take-up of these funds has been low, however. Mr Weller says this is because they are run by "less well-known names". Investors also prefer the offshore market as they feel more confident with the tax and legal systems in Hong Kong, he adds.

Geoffrey Lunt, director and senior product specialist for fixed income at HSBC Global Asset Management, says that while RQFII has not been widely popular it is just another step in broadening access to the Chinese bond markets.

"I would expect the RQFII scheme to be broadened at some point to allow more investors access to the onshore market," he says.

Still flying high? Expectations for further appreciation of the renminbi have waned Getty

Bulls still have strong case – but it is no one-way bet

Emerging Asia

Josh Noble on the ups – and a few downs – across the continent

Whether it is via equities or fixed income, emerging market investment is often summed up as a punt on undervalued currencies.

The logic is straightforward enough – emerging Asian economies look stronger than their G10 counterparts, with lower debt burdens, faster growth, and healthier demographics. Apart from India, few suffer from the kind of fiscal deficits that are hampering the west, while foreign direct investment into the region remains strong.

The credit profiles of many Asian governments are also improving. Indonesia is now rated as investment grade by two major rating agencies, while South Korean government debt is seen as one of the safest investments in the world, despite not yet being rated triple A.

Meanwhile, the growing economic clout of some Asian countries will mean their currencies are used more widely, and increasingly held in reserve by central banks worldwide.

All this should prove bullish for emerging Asia.

Since the fall of Lehman Brothers, those who have followed this logic have indeed been rewarded. Of the major emerging Asian currencies, only two – the Indian rupee and the South Korean won – have lost value against the US dollar since September 2008. Many have risen strongly, such as the Thai baht and the Malaysian ringgit, both up more than 12 per cent, while the Chinese renminbi is up 8 per cent over the same period.

Over the long term many analysts expect this trend to continue, especially as more investors choose to increase their weighting of emerging markets in their portfolios.

However, more recent movements have highlighted the perils of viewing Asian FX as a one-way bet.

Through 2011, India – one of the fastest growing emerging markets – flirted with a full blown currency crisis as foreign capital fled the country following damaging corruption scandals and amid runaway inflation. Between August 1 and the end of the year, the rupee fell more than 20 per cent against the US dollar. The stock market followed suit, creating a worsening cycle of capital flight.

India's experience last year was a "clear reminder of the volatility of investing in emerging markets", says Charlie Lay, strategist at Commerzbank in Singapore.

In 2012, focus has shifted to the renminbi – long touted as a safe investment guaranteed to see steady, if not spectacular, gains.

But the Chinese currency has lost value in the past month against the US dollar. Expectations for further appreciation have "died down significantly" in recent months, says Mitul Kotecha of Credit Agricole in Hong Kong. "The message is clear: it is not a one-way bet," he says. Recent comments from Chinese policymakers suggest that appreciation is at least on hold, if not largely over.

The stuttering rise of the renminbi, and the rapid fall of the rupee both serve as warnings to those banking on Asia currency strength. Over the past month, not a single emerging Asian currency has been in positive territory, as the US dollar has bounced back.

Some also attribute the limp performance to concerns about growth prospects in China. In March, the Chinese central government lowered the country's official growth target for 2012 to 7.5 per cent, the first time the target rate has dropped below 8 per cent since 2004.

Many Asian countries have benefited from China's boom by selling commodities, such as coal, rubber, and palm oil, to their neighbour, or by providing parts to its export industries. A slowdown in Chinese growth would therefore be likely to lead to slower growth across the region.

A drop in Chinese growth is "likely to hurt commodity currencies and Asian currencies generally", says Paul McNamara, an investment director at GAM in London. "With US growth looking rosier, we're concerned that a strong dollar will make it difficult to achieve great returns from emerging market FX."

With growth expectations trimmed, interest rates across the region have also been coming down. Indonesia, South Korea and Thailand have all cut rates recently, while India's central bank is expected to cut as soon as April.

Should growth continue to slow globally, some export economies could act to weaken their currencies in order to stay competitive – a return to the so-called "currency wars".

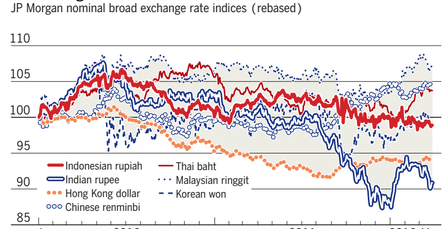
However, for those more positive on the global economy, the region still offers value, says Mr Kotecha, who believes Asian currencies are ultimately a function of investor risk.

"If risk appetite normalises, that should allow high-beta currencies to strengthen," he says.

Mr Lay expects Asian FX to be range bound in the coming months, barring a clear improvement in developed economies.

Trade-weighted currencies

JP Morgan nominal broad exchange rate indices (rebased)



Source: Thomson Reuters Datastream

The long and short of a hedging dilemma

Managing risk

Despite the dangers, it is sometimes better to stay unhedged, writes **Steve Johnson**

The S&P 500 has delivered a total return of 50.5 per cent in the past 10 years, but not everyone has enjoyed the party. A Swiss investor who eschewed the comfort blanket of currency hedging would actually have lost 17.7 per cent by investing in the flagship US equity index over this period, thanks to the Swissie's 45.3 appreciation against the greenback.

The solution seems clear – investors need to hedge the currency exposure of their foreign equity and bond portfolios or run the risk of allowing exchange rate volatility to wreck their carefully thought out plans. But life may not be that simple, for all investors at least.

Recent analysis by Elroy Dimson, Paul Marsh and Mike Staunton, a trio of academics at the London Business School, based on analysis of a mountain of data dating back to 1900, casts new light on the "hedge or not to hedge" dilemma.

The long-term trend in the sterling/US dollar exchange rate, known as cable by aficionados of all things FX, is typical of their findings. Between 1900 and 2011 the pound slid from $5 to $1.55, an annualised rate of depreciation of 1.01 per cent and a meaningful headwind for people in the US investing in the UK.

Yet the analysis found consumer prices rose 0.96 percentage points a year more in the UK than in the US, meaning virtually all the currency movement was due to relative inflation. "The purchasing power of the pound is almost the same as it was 100 years ago," says Prof Marsh.

This pattern – of exchange rate movements being driven almost entirely by relative inflation differentials – held across the 19 countries analysed, produces "compelling evidence that, over the long haul, currencies reflect relative inflation rates".

The upshot is that this long-term tendency for currencies to converge towards purchasing power parity means hedging involves taking a short position in foreign interest rates and a long position in an investor's domestic interest rate. While this helps hedge short-term currency risk, it introduces a new form of risk and a source of volatility, namely a bet on real interest rates at home versus those abroad, the trio argued.

"Hedging thus exposes investors to rapid, unexpected inflation in their home country," the academics wrote in the Credit Suisse Global Investment Returns Yearbook 2012.

While hedging is still shown to reduce risk for short and medium-term investors, over periods of eight years or more the picture is far more mixed, the analysis shows.

"Typically, the benefit falls the longer the horizon and rapidly turn negative. Rather than lowering risk, hedging by longer term investors raises risk," the authors conclude. "Even over relatively brief multi-year horizons hedging on average leads to an increase in the volatility of real returns and is on average counterproductive."

Prof Marsh adds: "By leaving [portfolios] unhedged you can effectively hedge against unexpected inflation in your own country. Therefore, for those with a long-term horizon, you should probably not hedge."

The LBS team goes further still, arguing that the currency exposure of foreign equities is a "valuable benefit", particularly as they also find that currency risk has a slightly negative correlation with asset returns, thereby providing a small hedge of its own.

To some extent this analysis runs counter to the consensus in the investment community, where the norm is to hedge foreign bond holdings, if not equities.

"It is different for equities and bonds," says Marino Valensise, chief investment officer of Baring Asset Management. "For a fixed income portfolio the currency effect can dwarf the fixed income exposure. On the equity side typically we do nothing. In the long run the currency return on a global equity portfolio will be a small part."

Hélie d'Hautefort, chief executive and chief investment officer of Overlay Asset Management, which provides hedging programmes as well as "absolute return" currency investment, echoes this point.

> Hedging involves taking a short position in foreign interest rates and a long position in an investor's domestic interest rate

Overlay calculates that the volatility of an unhedged bond portfolio is typically 3-5 per cent a year, with three-quarters of this emanating from currency exposure rather than movements in underlying bond prices. For a global equity portfolio, annual volatility may be 10-12 per cent, it says, with currency exposure accounting for perhaps a quarter per cent of that.

"The percentage of the volatility of a global portfolio that derives from the currency element is much higher in a bond portfolio, just because the volatility of bond portfolios is much lower," says Mr d'Hautefort.

"You are taking an additional risk if you have a certain percentage of your portfolio which is unhedged. It is an unwanted risk. How can you justify bearing a risk that is not rewarded?

"Over the long term, five to 10 years, the expected return [from] foreign currency may be zero, but its contribution to total portfolio volatility can be significant, resulting in lower portfolio information ratios and Sharpe ratios," he adds.

However Joblu Miah, portfolio manager and head of research at Xenfin Capital, a hedge fund manager specialising in FX, is more supportive of the LBS argument.

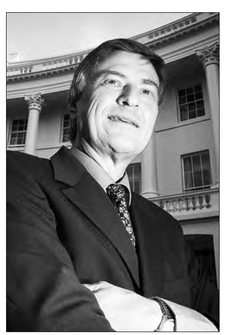
For short-term investors, Mr Miah believes hedging the FX risk allows movements in the underlying asset class to be captured without being "overwhelmed" by potentially large currency swings emanating from "noise".

In contrast, he argues "an investor with a long-term horizon could benefit from having an unhedged exposure", particularly when the cost of implementing the hedge and ongoing costs related to currency moves are factored in.

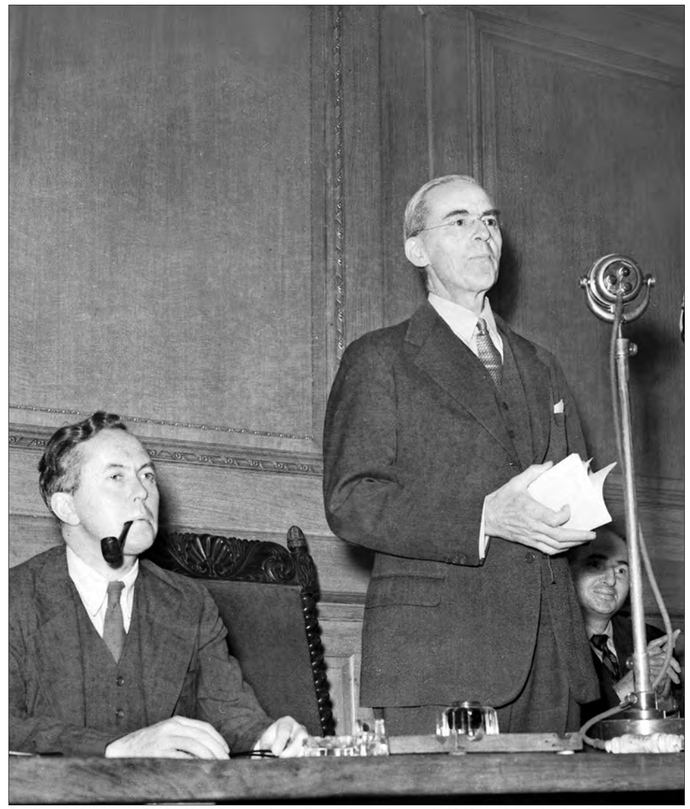
Some investors may also welcome the FX exposure if they believe a currency they are exposed to is likely to appreciate over time, Mr Miah says, a view that is currently guiding much investment in emerging markets.

Nevertheless the LBS team accepts it may be prudent for those who are concerned about short-term volatility to hedge their exposures. This may include investors who are predominantly concerned with nominal, rather than real (ie inflation-adjusted) returns, such as insurance companies with monetary liabilities, non-indexed pension providers and those investing to generate a fixed nominal sum at a future date.

And Mr d'Hautefort believes it does not make sense for some investors to hedge, such as those insensitive to short and medium-term volatility and those for whom implementing a currency hedge may be prohibitively expensive, a common problem for those whose domestic interest rates are relatively low, such as the Japanese.



Paul Marsh: stirring the debate



Sterling performance: Sir Stafford Cripps, chancellor of the exchequer in 1949, explains the devaluation of the pound to newsmen as Harold Wilson, president of the Board of Trade and later prime minister, looks on Getty

Passive approach begins to gain currency

ETFs

David Ricketts says interest is growing as active manager fees come under continuing scrutiny

The use of exchange-traded funds (ETFs) has grown significantly as investors continue to seek cheaper ways of gaining exposure to certain asset classes over more expensive actively managed strategies.

While ETFs have proved popular vehicles to gain passive exposure to equities, bonds and commodities, currency is something of a late comer to the party and it is only recently that exchange traded products (ETPs) offering exposure to the asset class have started to gain ground.

Hardly surprising, given that currency has only recently started to gain recognition as an area where pension funds and private investors can make returns.

"Currency is a maturing asset class, and was not seen as a return-seeking asset class much before 2004-2005," says James Wood-Collins, chief executive of Record Currency Management.

"Pension funds were looking for new, uncorrelated return sources after the tech bubble burst. There were a number of beneficiaries of that trend, and return-seeking currency managers were one of those."

For institutional investors, says Mr Wood-Collins, there are two ways currency can be relevant: one is around risk management and the other is making money out of currency.

While active managers gained handsomely from a new appetite for currency, passive approaches, such as currency ETFs, have also benefited as investors continue to scrutinise manager fees. "Pension funds are very aware of costs and the fact that currency returns have declined in recent years whereas fees have not," says Malcolm Leigh, a principal at Mercer.

"The concept [of currency ETFs] is still relatively new, but to the extent that they provide access to drivers of currency returns more cheaply than from active currency managers, we should see interest grow."

Manooj Mistry, head of db X-trackers in the UK, argues that "currency beta" can act as a good diversifier for investors, despite the somewhat limited collection of ETFs offering exposure to the asset class.

"ETFs designed to deliver systematic currency beta are niche products, but it does generate interest, partly because investing in currency as an asset class offers the potential for decorrelation with equity and bond markets," says Mr Mistry.

However, according to figures from US-based Strategic Insight, currency ETFs have been out of favour most recently, with those products sold in Europe experiencing net outflows of $142m over a 12-month period to the end of February.

'Currency was not seen as a return-seeking asset class much before 2004-2005'

Assets in currency ETFs stood at $214m at the end of February across 37 ETFs, according to the Strategic Insight statistics, and were split across two main providers: db x-trackers and ETF Securities.

The picture in the US is slightly healthier, where currency ETFs are more prevalent and where six firms currently offer currency ETPs.

According to Strategic Insight, there were 43 currency ETFs in the US managing $6.8bn at the end of February, and for the 12 months to the end of February they saw net inflows of $250m.

Loren Fox, senior research analyst at Strategic Insight, says the positive flows over the 12 months for US currency ETFs have been due to net inflows into one ETF in particular betting long on the US dollar, and net inflows into another betting short on the euro.

But appetite for currency ETFs could start to wane before it has had any real chance to develop, at least in the US.

"I think the calming of the euro crisis and the rise of the S&P 500 in recent months has reduced the appeal of currency strategies in the US," says Mr Fox.

"As for Europe, currency is a very small category, so net outflows from two currency strategy ETFs run by db X-trackers meant net outflows for the group."

Nicholas Brooks, head of research at ETF Securities, says that, as with all new ETFs, time is needed before they can truly gain momentum.

"Exchange-traded currencies (ETCs) are special in that they give access to a new asset class for many investors in an ETF format," says Mr Brooks.

"Education was necessary in the beginning. It is similar to when we launched the first [exchange-traded commodities] a few years ago. There was a lot of education needed then too."

Mr Brooks adds that while ETCs have not seen particularly strong uptake among retail investors, interest among institutional clients remains buoyant.

"What we have heard from institutional investors is that some will not have a mandate to use derivatives, so ETCs are a convenient vehicle," says Mr Brooks.

Manooj Mistry: potential for decorrelation with equities

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