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SOLUTIONS FOR EUROPEAN DISTRIBUTORS

CURRENCY HEDGE FUNDS

FRUITFUL SOURCES OF RETURN

Whether because it is a useful investment strategy in its own right or because it is so effective in balancing an equity-dominated portfolio, currency management opens up options for the investor

The broad decline in equity markets during the past few years has led many investors to diversify their portfolios, with some looking at the opportunities available in alternative investments. Although equity market neutral funds have become one of the most popular investor strategies, there is also a wide array of other types of alternative investments to choose from. One such area that certainly deserves consideration is currency management.

'Currency returns tend not to be correlated with the returns of other asset classes such as equities. This means the effect of adding active currency on the total risk of the client's overall strategy will typically be low'
Mark Fitzgerald, Barclays Global Investors

MODULAR METHOD

Historically, the majority of investment managers have typically held currency as part of a global macro portfolio that contains equities and bonds. However, currency works well as a stand-alone investment strategy in a rigorous, risk controlled investment process.

Another key aspect to consider is the fact that allocating a proportion of a portfolio to a currency fund is a good way of gaining additional diversification within an equity-dominated portfolio.

This is a result of the fact that currency returns tend not to be correlated with the returns of other asset classes such as equities. This means the effect of adding active currency on the total risk of the client's overall strategy will typically be low, despite the extra returns the currency strategy is expected to achieve. This allows investment managers to include it as part of their commodity trading agreement exposure.

Adding currency to a portfolio also allows for more bespoke tailoring by using currency hedge funds alongside bonds and equities, instead of having to use a global macro fund. This modular approach to building a portfolio empowers investors who can create their own portfolios using the individual components available.

CONSOLIDATION

The currency hedge fund environment is rapidly becoming more developed and further consolidation should be expected. One reason for this trend is that investors are reducing the number of managers they are investing with, while typically increasing the average allocations per asset manager.

This is partly being driven by the due diligence requirements that investors must fulfil on a regular basis. As investors focus more exclusively on a smaller number of product providers, they are able to apply greater time and resource to each investment decision. This shift plays to the strengths of the major hedge fund managers, who are able to satisfy the increasingly stringent levels of due diligence required by their clients.

The hedge fund industry is also seeing a greater emphasis placed on the institutions, both in terms of investing type and investment manager. Large traditional asset managers have introduced hedge fund activities as an addition to their long-only activities, while pension funds, insurance companies and large wealth managers

are increasing their allocations to hedge funds.

Many of the major participants in the currency market simply do not trade for profit, leaving greater opportunities for those who do seek profits. This might sound strange to those investors who are familiar with the relatively efficient and well-exploited equity markets. However, when we look at the major players in the currency market the picture becomes clearer.

For example, central banks trade currencies to offset exchange rate volatility and to signal their monetary policy intentions. In addition, companies engaged in international trade will often buy and sell currencies as they aim to eliminate the currency risks that their businesses create.

In total, the foreign exchange trade generated by these market participants, among others, makes the positions taken by active currency managers appear tiny.

Currency markets are also highly liquid, cheap to trade and there are no trading taxes. These factors enable currency fund managers to rapidly and cost effectively take positions that reflect their views on the market.

In Table 1, the performance data compiled by Russell/Mellon Analytical Services on 19 active currency managers over the past seven years is shown. The median currency manager has added value over their benchmarks over investment horizons of one to seven years, and the 75th percentile manager has had positive performance in all but one performance period.

TECHNIQUES

Active currency managers use a range of techniques to forecast currency movements and there are some common themes that many managers employ to add value.

Fundamental strategies aim to determine economic fair values for currencies. The fund manager will then buy and sell currencies depending on whether they are seen as undervalued or overvalued. This type of strategy tends to be used over the longer term as the evidence suggests that currencies diverge from fair value for substantial periods of time.

Another option is technical analysis. Fund managers attempt to predict future currency movements by looking for predictable patterns in past movements. This type of analysis is also used in the equity markets and these strategies tend to be used to determine shorter-term decisions and views.

Interest rate strategies are also commonly used with investments being made into currencies offering higher interest rates, or currencies that are predicted to offer a higher interest rate in future. In addition, dynamic hedging strategies are also widely used and they focus on managing the risk of currency loss, while providing some participation in the potential upside gains.

Many active managers will combine a number of these

CURRENCY MANAGERS' PERFORMANCE

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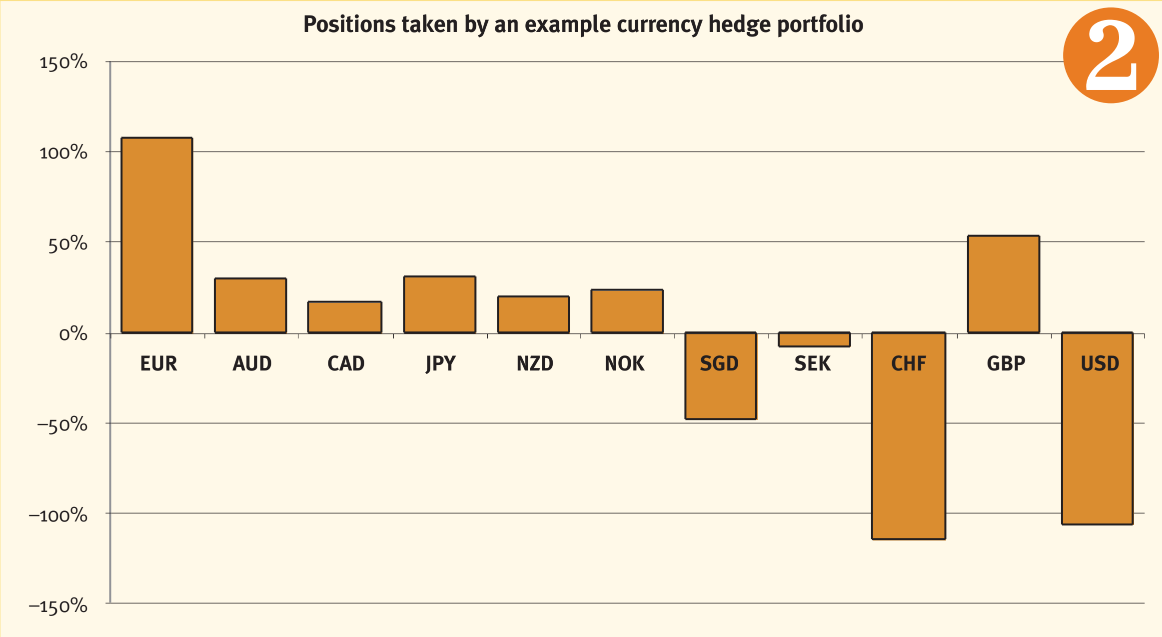
RUSSELL/MELLON SURVEY OF 19 ACTIVE CURRENCY MANAGERS ENDING 31 DECEMBER 2002: ANNUALISED ACTIVE RETURN IN %

Percentile	1 yr	2 yrs	3 yrs	4 yrs	5 yrs	6 yrs	7 yrs
25th	3.01	1.35	1.13	1.22	0.83	1.15	1.32
Median	1.2	0.5	0.74	0.57	0.43	0.71	1.05
75th	0.34	0.04	0.29	0.18	–0.04	0.2	0.79
Mean	0.92	0.41	0.39	0.42	0.29	0.76	1.22

Source: Russell/Mellon



Source: Barclays Global Investors

strategies in order to add value through active management.

Another differentiating factor is whether the manager uses a defined quantitative model. This type of model is based upon gathering and assessing a broad range of real economic and market data, such as gross domestic product data, interest rates and the international flow of funds.

It is also worth noting that a quantitative approach is more commonly used in currencies than in most other asset classes and these models can be used to systematically capture a wide range of forecasting insights. In reality, many currency hedge fund managers combine a quantitative model with some degree of predetermined discretionary override.

RANGE OF TOOLS

Chart 2 illustrates the positions taken by a currency hedge fund, running at 12 per cent risk. The vertical axis shows the relative positions taken by the fund, while the horizontal axis refers to the currencies that these positions are taken in.

In this case, the manager has negative positions in the US dollar (USD), Singapore dollar (SGD), Swedish krona (SEK) and the Swiss franc (CHF). The fund also has positive positions in the euro (EUR), Australian dollar (AUD), Canadian dollar (CAD), Japanese yen (JPY), New Zealand dollar (NZD), Norwegian krone (NOK) and UK pound (GBP).

Different risk and return targets, management techniques and the range of currencies included in a hedge fund's universe result in a wide range of portfolios that are suited to different investors.

The key here is that this broad range of available investment tools should mean that a suitable fund exists to meet most investors' goals, while also complementing the existing portfolio that currently lacks currency exposure.

The evidence suggests that the currency market is an attractive area in which to seek out additional returns through a rigorous investment approach. Moreover, currency hedge funds are a means of gaining additional diversification within a portfolio, allowing investors to adapt the component parts of the portfolio to meet their own specific requirements.

The market is becoming increasingly developed with both large established investment managers and small specialist boutiques offering a wide range of solutions. With this in mind, now might be an opportune time to review what the currency market has to offer your client's portfolio.

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