



# Soros on the cheap

## Building a better currency model

**B**ETTING on currencies may have helped George Soros get rich, but for most people it is a mug's game. Forecasters often get the direction of foreign-exchange movements wrong, never mind their magnitude. But there is evidence that investing in currencies can add value to a portfolio, even though it may seem to be a zero-sum game (because as one currency rises, another must fall).

The chance of earning an extra return arises thanks to the presence in the market of what economists might call "non-profit-maximising" participants—in other words, people with motives other than the best currency rate. Tourists are an obvious example: they tend to buy and sell during (or just before) their holidays and have to take exchange rates as they find them. Portfolio investors usually buy foreign assets because they like an individual security, not on the basis of expected currency movements.

Central banks are probably the classic case. They intervene in the foreign-exchange markets to serve political or economic objectives. If those objectives are unsustainable, as were Britain's efforts to stay in the European exchange-rate mechanism (ERM) in 1992, then the central banks are sitting ducks. Currency specialists say the existence of this "dumb money" makes it possible for others to earn excess returns.

Furthermore, these returns do not appear to be correlated with the other main asset classes of shares and bonds. A currency fund can thus be a useful source of diversification for the average investor's portfolio, improving the trade-off between risk and reward. But that still leaves investors with the problem

of knowing which way currencies are going to move. They can rely on the services of a fund manager, but the fees might outweigh the extra returns.

One answer is to find a model that exploits the recurring anomalies to be found in currency markets. The costs should be low and the approach should avoid the fallible judgments that human managers are prone to make. Both Deutsche Bank and Merrill Lynch have recently launched such products.

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Two factors seem ripe for exploitation. The first is the notorious "carry trade", in which investors sell or borrow low-yielding currencies and buy high-yielders. In theory, this should not work, because high interest rates on a currency should compensate investors for the risk of depreciation. In practice, however, owning high-yield currencies has been a profitable medium-term strategy.

The second factor is momentum. Currencies seem to fall in and out of favour: the yen is as out of fashion now as it was popular in the 1990s. As a result, once a currency has begun to rise, it may keep going for some time. Investors can jump on the bandwagon.

Both Deutsche and Merrill include carry and momentum in their models. Deutsche says that, since 1980, a carry

strategy has earned an average annual excess return of 4.9%, whereas momentum has earned 3% (based on buying the top three currencies from the G10 leading industrial countries and selling the bottom three). However, each strategy has had its bad moments. Both suffered horribly in the early 1990s, when the ERM broke down.

Adding a third factor may help. Deutsche Bank uses valuation, based on purchasing-power parity theory, which suggests that, over time, exchange rates should adjust in line with tradable-goods inflation in the respective countries. Although this appears to clash with the carry trade (high-inflation countries should have high interest rates), it both delivers a positive annual excess return and adds stability to the model.

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The problem with all such exercises is that producing great returns by analysing past data is much easier than repeating the trick with real money. Nevertheless, such models will at least compete with specialist currency funds. Indeed, Merrill's, called the FX clone, specifically weights its portfolios on the basis of currency managers' bets. And because central banks and tourists will always be around and currency markets are very liquid, this may be one area where additional capital will not automatically drive down returns. ■

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