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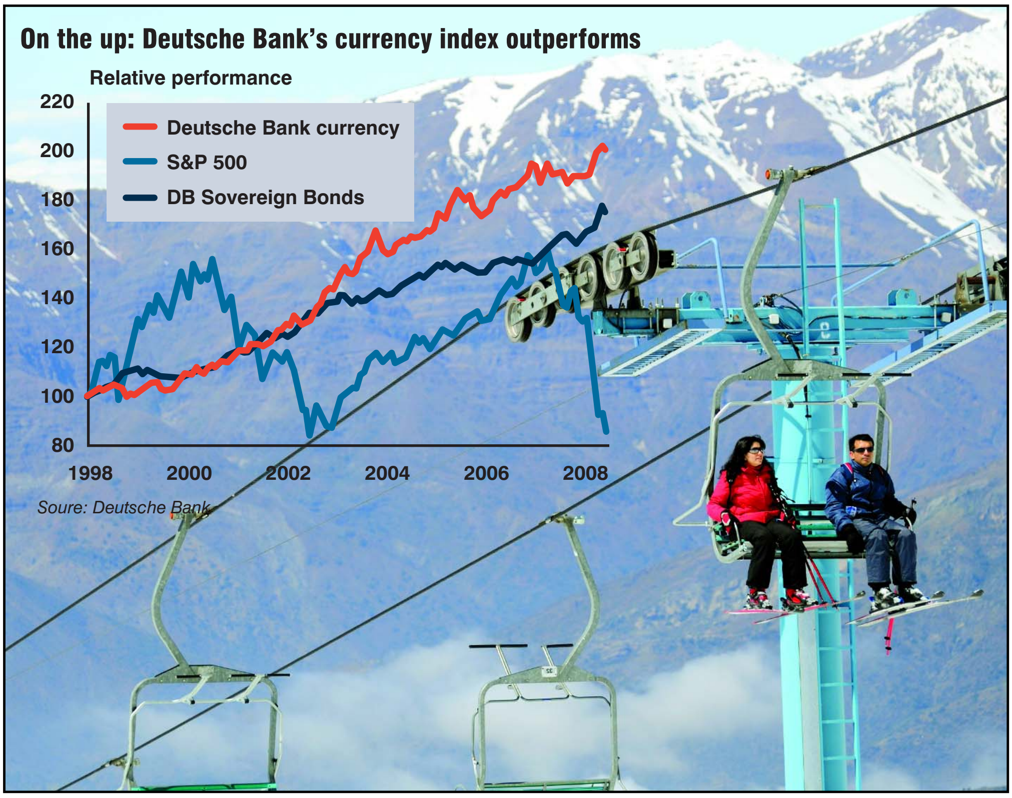
Tradable FX indices offer cheap alternative



The search for uncorrelated returns leads to currency, writes William Essex

At a time when achieving returns of 0% rather than negative numbers is a cause for celebration, the latest performance figures suggest that tradable foreign exchange indices might just have beaten the economic crisis.

The purpose of tradable FX indices is to enable investors to achieve currency exposure without either buying into a currency fund or trading directly in one or more currency pairs. They are intended to reduce volatility of returns as well as delivering absolute returns while maintaining negative correlation with equity and bond markets.

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Since its launch as a tradable benchmark in March 2007, the Deutsche Bank Currency Return index has returned 9.3% compared with the S&P 500's -37.4% and the DB Sovereign Bonds index's 12.7%. On the face of it, sovereign bonds are the winner – but after digging a little deeper and separating out the strategies that make up the DBCR index, a different story emerges. The momentum strategy within the DBCR returned 32.6% over the two-year period while the other two component strategies of the index, valuation and carry, returned 15.6% and -20%. While all three strategies beat equities, carry – where investors borrow low yielding and lend high-yielding currencies – failed to outperform bonds.

Jason Batt, global head of FX indices at Deutsche Bank, said: "The extreme moves we had last October caused tremendous fluctuation in the carry strategy. In that period of high volatility the other strategies behaved exactly as they had historically in cushioning the index and creating a low volatility of overall return, and a small positive return."

As the world moves towards near-zero interest rates, it is hardly a surprise carry strategies have lost their allure. Yet there has been a surge of FX indices launched just before or during the period when the credit crunch became a full-blown crisis.

Barclays Capital launched its Adaptive FX Trend index last September and it had risen 2.5% by mid-February on a euro-denominated total-return basis. Andrew Kaufmann, head of FX structuring at Barclays Capital, said: "Barclays Capital has for some time been building on the concept of foreign exchange as an asset class. This index has low-to-negative correlation with fixed income, equities, commodities and other FX indices."

Deutsche Bank was among the first out of the gate with its DBCR index. Other tradable FX indices include a range from JP Morgan designed "to support specific investor objectives for regional exposure to Asian, Latin American and Emerging Europe currencies", CitiFX, HSBC and Standard & Poor's.

Srikant Dash, head of global research and design at Standard & Poor's, said: "Two years ago, there was a big push for less correlated alpha. The volatility of currency movements had been quite high, and that had heightened awareness of currency products."

Dash said FX indices were a cheaper and more transparent alternative to hedge funds and although it was recognised that currency markets are the most actively traded in the world, most investors had no exposure to those markets.

FX as an asset class has other points in its favour, including size, liquidity and unlike equities or structured debt, there is no value destruction in FX – if the US dollar falls against the Chinese renminbi, for example, the renminbi goes up.

Batt said: "FX is still perceived to be an alternative investment to almost the entire real-money community. Despite it being the most liquid asset class in the world, and despite FX turnover being multiples of even the bond or equity markets, it still isn't attracting the attention it warrants."

Part of the reason for this is that FX is simply viewed as a tool of trade – except within single-currency areas such as the EU, all cross-border economic activity triggers an FX transaction that will in many cases be hedged.

FX markets are thus populated with potential trading counterparties which are not primarily concerned with profit maximisation. A global corporate, for example, will contribute liquidity to the FX markets by trading to support its commercial activity. Crucially, such an entity must trade regardless of whether it expects to gain from the FX transaction itself, which means that the "weight of money" will not all be trading in the same direction. While commercially tradable currencies do not have a built-in floor, there will be liquidity at both ends of a currency pair.

But if the selling point for FX markets is negative correlation to equities, what is the future for FX indices once stock markets recover? Batt's assessment, based on 20 years of the FX forward data on which the DBCR is based, is that "in periods when equities have done well, the index has not done badly, but those have tended to be periods when the index has been in a lull".

FX indices may do well in bad times, but that doesn't mean they do badly in good times. Dash said: "It is important to remember that there's more to currency indices than simply strategies that seek to exploit the carry trade, or momentum, or fundamental valuation. There are exposure plays and hedging plays as well; there is a broad panoply of products."

Dash points to a growth in exchange-traded products, particularly in Europe, and said currency hedging products have the potential to act as a bridge between mainstream asset classes and FX.

Dash said: "Fewer than 5% of institutions actively consider currency hedging indices when they are making asset-class allocations. I would expect that to rise."

Batt is optimistic on FX. He said: "It looks like we are entering a bull market in currency returns." The financial world may be in meltdown, but every cloud has its silver lining.

For further information on Deutsche Bank's products and services please go to www.db.com/fx

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