INVESTMENT

In the money

After losing popularity following the financial crash a decade ago, currency is undergoing a resurgence with investors considering it as a source of alpha. Lynn Strongin Dodds **reports**

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Ten years ago, investing in currency fell from grace and strategies spent several years in the wilderness until very recently.

Fast forward to today and divergent monetary policies are making it a much more attractive proposition. However, it requires keeping a watchful eye on changing market conditions and taking a more proactive approach in order to generate the best risk-adjusted returns.

There were several headwinds in 2018 and some have blown over into 2019. "Last year we saw a marked divergence between the US and the rest of the world," says Invesco fund manager Stuart Edwards.

"There was the fiscal stimulus introduced late in the cycle by the Trump administration that in effect generated a bit of a sugar rush. However, in the background, there was a slowdown in growth in the eurozone as well as China due to the trade tensions. By the fourth quarter last year the US caught down with the rest of the world and the Federal Reserve responded with a policy pivot and did not raise interest rates."

Mesirow Financial's Currency Management group managing director, Richard Turner, believes that as countries eventually return to a period of normalisation, volatility will return to global markets and to currency markets in particular. "In addition, we are seeing an increased level of geopolitical risk that is translating to increased currency market volatility," he adds. "Investors with exposure to global markets recognise this effect, which is driving demand for products that provide exposure to the currency markets."

His colleague in the same group – managing director Robert Colehan also thinks that "in times of geopolitical tension and slowing growth there is typically less coordination among central banks, which could also create more differentiation between currencies, again providing opportunities. In addition, slowing global growth inevitably leads to lower yield, which will likely lead to higher demand for alternative investment choices such as the FX market".

Currency's appeal

The appeal of currencies is that they can be a valuable source of returns and diversification because they are uncorrelated to the traditional asset classes. As Record Currency Management CEO James Wood-Collins points out, FX has unique characteristics in that it is a highly liquid market that has many non-profit-seeking participants, such as corporates and central banks, as well as the ability to invest on an unfunded basis. This provides opportunities that are not present in other asset classes.

These attributes are and will become more important in a world where current valuations show the traditional asset classes are running out of steam and will not produce the same stellar performance over the next decade as they did in the past 10 years. "The traditional 60/40 equity/bond portfolio is unlikely to generate the returns that pension funds had historically relied on to make their payments," says J.P. Morgan Asset Management currency chief investment officer Roger Hallam. "They now need allocations to alternatives to generate those returns and we see investors reconsidering currency as a source of alpha."

Neuberger Berman head of currency management Ugo Lancioni says: "The advantage of currencies is that they are the perfect portable and liquid source of alpha. If you do it on an unfunded basis, you can open the door to a set of factors that are completely different to the risk

factors within the equities and credit asset classes of your portfolio."

There are of course hurdles. "The foreign exchange markets are very liquid and efficient, making the generation of alpha more challenging," Turner says. "Also, foreign exchange markets, particularly in emerging markets, are prone to large moves, increasing the tail-risk of strategies that systematically trade foreign exchange."

Performance may also be more muted than in the past when double digit returns were commonplace.

"Before the global financial crisis, investors would often be looking for double digit annual returns such as 10-15 per cent on 15-20 per cent volatility targets, but today expectations are more modest," says Millennium Global Investments global head of business development Charles Goodman. "For example, an unfunded and unleveraged strategy generating between 2-4 per cent with 3-5 per cent volatility is attractive in the current market environment, which is marked by compressed volatility and lower expected returns across the board."

FX goes electronic

Investors should also take note of the impact structural shifts within the trading infrastructure are having on market dynamics. For example, electronic trading of FX now accounts for roughly 75 per cent, with strategies increasingly being executed by algos based on pre-defined levels and outcomes. At the same time, banks' ability to make market in currencies have been constrained by more stringent capital regulation such as Basel III as well as MiFID II, which reduces banks' ability to hold on to client trades on their balance sheets for meaningful time periods.

The result is that liquidity is seen as one of the biggest obstacles for 2019, according to the latest poll by J.P. Morgan, which canvassed its largest 200 institutional trader clients. Overall, 40 per cent said the two-way flow of tradeable prices was the number-one daily trading issue, up from 29 per cent in the previous year. Three-quarters of those canvassed said that liquidity had come under extra strain since the introduction of MiFID last January. One of the main worries is that dealers will be unwilling to show consistent and competitive pricing of risk through all market conditions.

"Market makers and traders do not take positions in the same way as they did a few years ago and that can have an impact on liquidity," says Amundi Asset Management head of global FX Andreas Koenig. "In the past, there were counterparties to take the other side of the trade but now it is mainly distributed into the market. It becomes like a hot potato that goes from one person to the next and that can lead to erratic markets."

This has led to so called 'flash crashes', the most recent being at the beginning of the year when the yen appreciated more than 3 per cent against the dollar in just eight minutes. In contrast to previous lurches, the jump was not confined to one currency pair. Instead, the yen registered moves of similar magnitude against the Australian dollar, as well as some emerging market currencies.

Similar spikes were seen in October 2016, months after the Brexit vote, when sterling plunged about 9 per cent against the dollar in a matter of minutes. The New Zealand dollar and the South African rand have also experienced similar episodes in the past two years. Numbers crunched by the UK's Financial Conduct Authority reveal that it was due in part to banks who were typically seen as the backbone of the market, withdrawing.

Against this backdrop, it is unsurprising that there are different variations of products on the market. They range from active multi-currency strategies to hedging tools to passive ETF products. Many market participants, though, believe adopting a more active approach order is more effective to enhance returns, reduce cash flow drawdowns and mitigate the risks. However, close attention should be paid to how well the fund manager navigated the choppy water in the past most notably the financial crisis and the subsequent crises that emanated from the fallout.

While many would put currency in the alternative bucket, there is less agreement over whether it should be defined as an asset class or a strategy. Research from Deutsche Bank suggests that it is an asset class because returns are relatively similar to those in the bond and equities markets. Using the Deutsche Bank Currency Returns Index, it found FX delivered 8 per cent average annualised monthly returns since the 1980s, compared to 7 per cent for bonds and 9 per cent for equities. Medium term, returns are similar. Since 2005, FX has offered an average of 3 per cent returns compared to 3 per cent for both bonds and 7 per cent for equities.

Others, such as Goodman, believe, "currency is not generally categorised as an asset class because it does not have all the characteristics of one, such as a theoretical ex ante expected return. However, FX is a $5 trillion a day market with many non-profit seeking participants, which means it is a suitable source of uncorrelated alpha". ■

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