# Spread your bets

**MARK ASHLEY** EXPLAINS WHY CURRENCY FUNDS SHOULD BE PART OF A BALANCED PORTFOLIO.

Historically, some investors may have shied away from investing in foreign exchange as there is no tangible asset – by definition trades are always made on a relative basis. Although investment in currencies is not without risk, there are some key factors that make foreign exchange (FX) a potentially rich source of investment opportunity. As such, if managed optimally as part of a balanced portfolio, currency funds have the potential to deliver attractive returns and a diversified source of alpha. This article explores reasons why investors should look to currency for capital growth, identifying factors which make currency a rich source of investment opportunity.

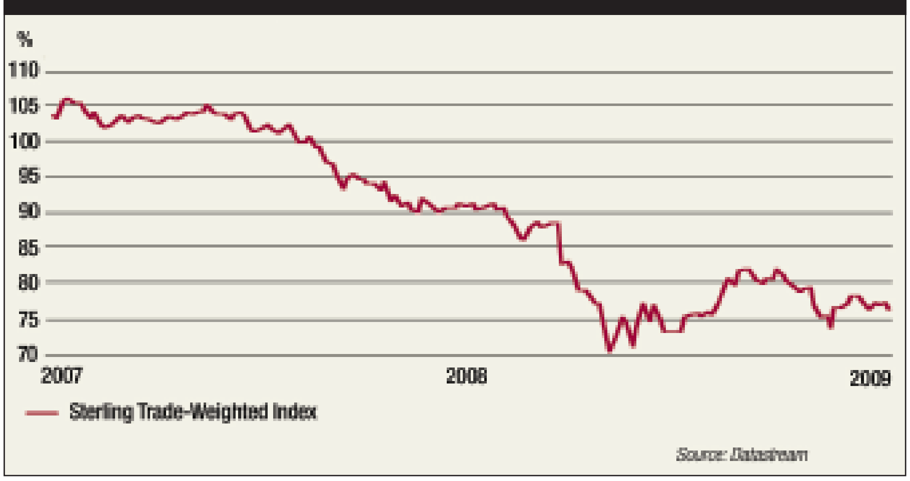
Exchange rates are something to which we can all relate. The dramatic devaluation of the British pound against most currencies in 2008 meant UK earners saw their holiday spending power reduced significantly. Chart 1 shows clearly how, relative to a basket of global currencies, the value of sterling has fallen significantly over the past three years. Exchange rates also change the value of foreign investments and are an important risk to consider when investing abroad.

UK investors in a German bond would have seen the sterling value of their holding go up by over 40% in 2008 from currency moves alone. European investors in gilts, however, would have actually lost money despite a 30% rise in sterling bond values, due to the UK currency's depreciation. The above examples are tangible evidence of how relative currency values can change.

It follows logically that there are substantial opportunities for investors who can identify potential currency moves.

**A LIQUID AND RELATIVELY 'NORMAL' ASSET CLASS** Currency funds continued to function normally during the financial crisis and remained highly liquid throughout, unlike some markets which virtually closed down as investors took fright. In early 2009, for example, equity markets fell sharply for the first two months – far faster than the pace of economic decline and fund manager expectations – leading many equity funds to underperform.

**Figure 1:** Sterling broad index January 2007 to December 2009




Currency funds, in contrast, enjoyed a normal investing environment making consistent alpha generation easier to achieve. In addition, and by definition, currency markets are highly liquid, making trading cheaper and more efficient than many other asset classes. According to the Bank for International Settlements, average daily turnover in global currency markets is just under $4bn – more than double that of global bond markets.

Foreign exchange investing is one of the purest ways to play macroeconomic themes, as currencies tend to move together with changes in economic conditions. This is in contrast to equities, which tend to anticipate changes. Equities are driven not just by macro factors, but are also influenced by earnings and price-to-earnings valuation multiples. Furthermore, there are fewer currency funds than for many other asset classes. While proprietary trading desks exploit short-term market anomalies, currency remains an underused tool for macroeconomic investing, with many currency funds only investing using quantitative models. As such, we believe that currency funds offer an excellent hunting ground for investment opportunities.

**A WIDE SPECTRUM OF OPPORTUNITIES**

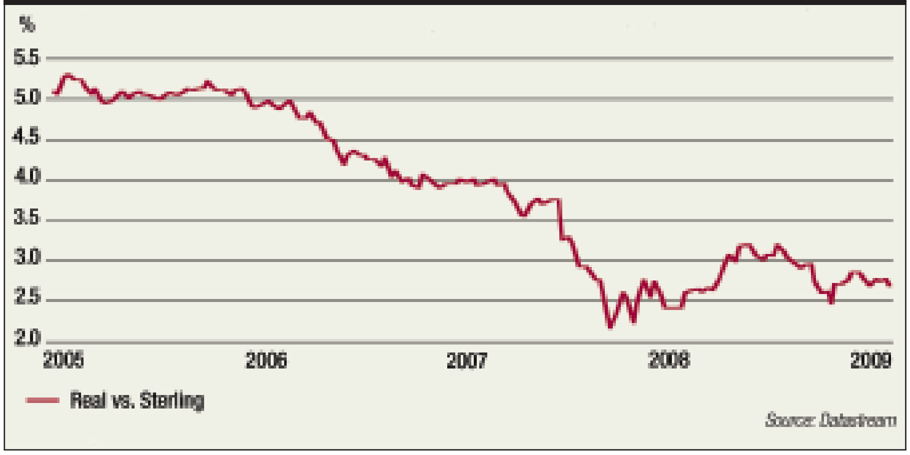
While the US dollar, sterling, euro and yen are most used in a global financial context, the foreign exchange market has a spectrum of over 150 currencies. The rise of emerging markets has opened doors to a whole new investment frontier. Currencies such as the Korean won, Brazilian real and Polish zloty are now widely traded.

Western currencies look set to play an increasingly small role in the future, with many saying the Chinese renminbi will become the global currency benchmark in the next 20 years. While monetary unions such as the euro clearly reduce the number of currencies available, this is more than offset by improving liquidity in emerging currencies.

**DIVERSIFICATION AND VOLATILITY** The low correlation between currency funds and other asset classes means they can provide important diversification benefits as part of a balanced portfolio. The volatility inherent in currency further differentiates it from other asset classes, reducing correlations and improving diversification. One of the reasons behind this volatility is the fact that central bank policies are a significant driver of foreign exchange trends. The presence of non-profit maximising investors – those trading currencies for commercial, rather than speculative reasons – creates volatility around these trends. In addition to improving diversification, this volatility can actually be used to an investor's advantage, as it provides opportunities for tactical investing. Skilled portfolio managers can profit from price fluctuations as well generating returns from underlying trends. A lack of correlation with other foreign exchange funds, especially those reliant on carry trades, is also a key consideration in the management of our fund.

A significant advantage of currency investment is that it doesn't contain the in-built bias of other asset classes. Even a well-known equity index can have high exposure towards sectors, companies or even other countries, which may not be representative of the underlying economy. The Brazilian Stock Market, for example, has a very high weighting in the mining sector and almost a third of the FTSE 100 Index, for example, is made up of just four companies – HSBC, BP, Shell and Vodafone. Those investing in the UK stock market may also not be aware that over 30% of revenue from its component companies comes from the Far East. An investment in the FTSE, therefore, is not a pure play on the UK economy.

**Figure 2:** Brazilian real relative to sterling from January 2005 to December 2009




**ABILITY TO PROFIT FROM ECONOMIC CHANGE** The past five years have borne witness to a wealth of profitable currency trading opportunities. One such example has been the emergence of Brazil as one of the world's leading economies and the impact that this has had on the value of the real. The country's economy has grown significantly faster than the UK's over the same period and this has been reflected in the relative value of the countries' currencies, with the real appreciating significantly on a relative basis to sterling. A currency fund selling British pounds to buy reals at the start of 2005 would have seen annualised returns of over 12% from the trade.

Currency funds particularly lend themselves to absolute return products, as they look to alpha to provide returns rather than underlying market direction. In seeking to maximise return while managing risk, a discretionary decision making process – rather than a wholly quantitative approach – and access to a diverse range of currencies via forward contracts, futures and options is critical, as are robust risk controls such as stop-loss policies.

Currency markets represent a strong environment for generating alpha and there are fund solutions that now allow this asset class to be incorporated as a core component in a balanced investment strategy.

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