FOREIGN EXCHANGE

FX SERIES WITH HATHERSAGE CAPITAL – I

Foreign exchange (FX) absolute return is one of the purest forms of uncorrelated alpha and, unlike many alpha sources, requires little or no funding. Elaborate.

Currency is the only asset not valued in currency, but by another currency. If one currency goes up, another currency goes down, pure relative value. It takes two currencies to value one, meaning the asset is not one currency, but a currency pair.

Currency markets -spot and forward- the largest most liquid markets in the world, are based completely on credit. It does not take cash to trade FX if an entity is creditworthy. There is no cost for going long or short, no charge for borrowing a currency, no fee for lending and no central market or record of trade volume or price.

Funding requirements should not be confused with trading leverage. Trading leverage, controlled by managers, increases return and risk, a well understood concept. As an example, USD100 mn invested in an un-leveraged investment, with a 5% return will earn 5% or USD5 mn. USD100 mn invested in an actively managed currency account, funded with 10% or USD10 mn, with 5% return results in USD5 mn or a 50% cash-on-cash return. A currency trader, like any trader, can use leverage, something transparent in a managed account structure, but this is very different from efficient funding.

"Currency is the source of diversification" …

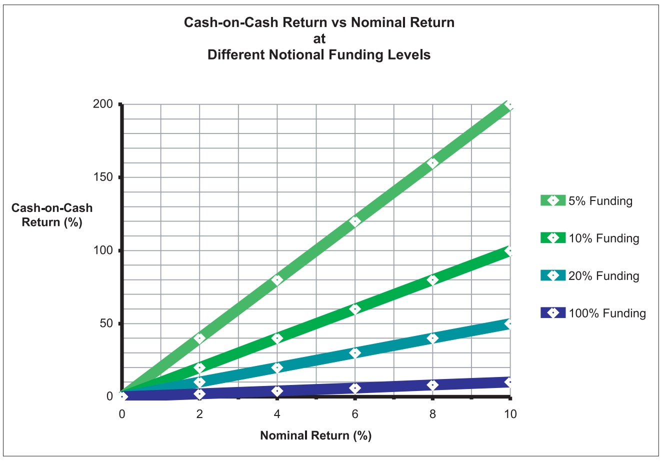
International diversification introduces the currency asset, the base currency and international currency, into portfolios. Many investors have learned about the diversification aspect of currency the hard way, as relative currency movements have produced unanticipated, uncompensated and unwanted volatility. In fact, international equity, fixed income and real estate markets are highly correlated without currency exposures.

What affects currency markets?

Economic, political and psychological factors affecting values of currency pairs are very different from factors affecting other asset markets. Supply is controlled by central banks, many use markets only for exchange values. Most currencies have only freely floated since the 1970's and many are still controlled by central banks.

Due to the unique nature of currency and FX markets, there is no expected return, no beta, to holding any currency pair. Skills required to understand and trade FX profitably are very different from the skills required to passively hedge currency exposure or actively manage equities and other assets.

FX trading strategies such as carry, trend and value can be modelled and have been turned into indices, even referred to as exotic betas, but no one trading style has consistently been successful in currency markets. Simple indices, which may work for short periods of time or in back testing, do not represent skill, alpha.



Source: Hathersage Capital

Separate Risk from Return

Currency risk is much better understood than currency return, although they are two sides of the same coin. FX exposure is easy to decompose and is an important risk to understand and measure. Currency management, predominately risk reduction, grew from the desire to mitigate volatility from FX moves in international portfolios. Traditional "overlay," the passive management of neutralising currency exposures through hedging or offsetting positions, is well understood, mechanical as opposed to skill based and today outsourced for only a few basis points, much cheaper than only a few years ago.

Naturally just as FX can bring unwanted volatility and losses, it can also bring profits, but the point is it can be identified, measured, neutralised and managed. Hedging 100% of currency exposure completely eliminates FX volatility and decreases portfolio risk exposure.

Risk, like cash, is a scarce resource and through portable alpha strategies is most efficiently and effectively allocated. An international portfolio's total risk budget is substantially increased by eliminating all FX risk or hedging 100% of exposure. Leaving currency exposure un-hedged or partially hedged (a more expensive proposition which is by nature constrained, managed to a benchmark and more difficult to measure) does not make sense in the discipline of implementing portable alpha. Just because currency exposure can be actively managed without changing the underlying international asset exposures, does not mean this is optimal.

The essence of portable alpha is to separate risks, remove constraints and understand sources of return, not mixing objectives or managing to benchmarks.

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