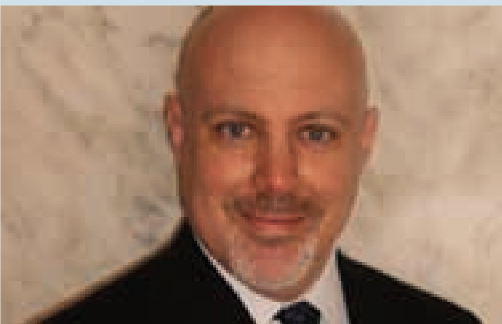
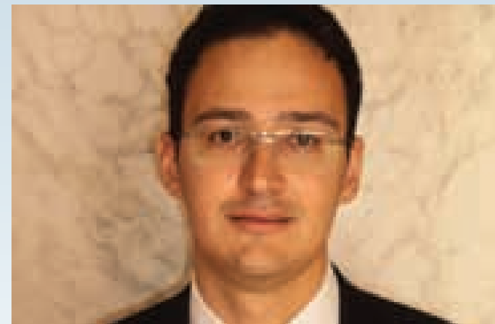
FX TO THE FORE: RISK & RETURNS IN A POST CRISIS ERA





Attendees:

Top row from left to right

COLIN CROWNOVER, head of currency management, State Street

JOHN MURRAY, vice president, FX fund services (sales), BNY Mellon

MOMTCHIL POJARLIEV, head of currencies, Hermes

Bottom row from left to right

THANOS PAPASAVVAS, head of currency management, Investec Asset Management

BOB NOYEN, chief investment officer, Record Currency Management

THOMAS KRESSIN, senior vice president, portfolio management, PIMCO

Left to right, Thomas Kressin, senior VP, portfolio management, PIMCO, Bob Noyen, chief investment officer, Record Currency Management, Thanos Papasavvas, head of currency management, Investec Asset Management, Francesca Carnevale, Colin Crownover, head of currency management, State Street, John Murray, VP, FX fund services (sales), BNY Mellon, Momtchil Pojarliev, head of currencies, Hermes

OVERVIEW: ROUGH WINDS SHAKE DARLING BUDS

THANOS PAPASAVVAS: HEAD OF CURRENCY MANAGEMENT, INVESTEC ASSET MANAGEMENT:
Currency management was introduced back in the early 1980s out of the global fixed income business as another source of returns. For quite a long time equity managers tended to keep away from this asset class, but since the launch of the euro and the stock market corrections in 1999 and 2000, the focus has been much more to use currency management as a way of managing underlying risk and as another source of generating returns. The aim was to "unbundle" the currency risk from equity risk. More recently, and as the industry has moved towards alternative investments, currency management has been used to target absolute return strategies in an environment which allows long and short exposures. The investment into this asset class can be via segregated accounts or off the shelf pooled vehicles targeting differing levels of risk and return. The preference among pension funds and consultants has been pooled vehicles, due to their limited liability. Over the past few years the industry's performance has varied with the underlying managers' differing styles, but has maintained an overall low correlation with other asset classes. We are seeing a continuing demand for currency management from the UK, Europe and the United States, which is coming round to favouring the asset class as another way of adding returns.

BOB NOYEN, CHIEF INVESTMENT OFFICER, RECORD CURRENCY MANAGEMENT:
We have noted a heightened awareness of the risks associated with currency. In 2008 we experienced levels of volatility unseen since 1973 and corporations and institutional investors now appreciate that currency is a tremendously risky asset class. Investors who passively hedge, particularly UK institutional investors, have found themselves having to fund large outflows from their passive hedging programs; this is particularly a problem for fund managers who are hedging relatively illiquid underlying assets. In addition to finding ways of settling loss-making currency contracts, they find themselves with all sorts of untended consequences such as the rapidly deteriorating credit quality of counterparties. If you are managing a currency mandate you now have to manage credit which up to that point was not an issue. There is growing institutional demand for active currency risk management to combat the risks associated with passive hedging; it turns out that even passive programs need to be managed by a specialist. It has created opportunities for us, particularly in the US. Unsolicited enquiries from the US now abound on currency strategies ranging from passive to more active approaches on currency overlays. As an industry, we continue to be acutely aware of risk, particularly systemic risk in the banking system. The currency market has survived relatively intact from the global financial crisis compared to other markets but we are not out of the woods yet. We have, for example, yet to see the longer-term impact of quantitative easing on the financial markets.

JOHN MURRAY, VICE PRESIDENT, FX FUND SERVICES (SALES), BNY MELLON:
There are many investors out there with a long-term outlook and currency hedging tends to be of short duration. There's a conflict then in terms of how you support currency hedging. That simple fact will continue to influence clients now in terms of whether they need to change the strategies they have in place, be they active or passive. As a custodian we can support clients through analysis, management of passive strategies and through outsourcing services. For many investors, currency is not a core competence; however, currency management is very much more important to a lot of institutional investors than it was. It involves not only issues such as what cash means to them in real terms, and what strategies they need to employ to best manage those cash positions, but also there is market volatility to contend with. In that light, banks have seen huge turnover. But even

if a lot of the money has left the market, it was at least directional, even if technically it might have been the wrong direction for many. Equally, there is no clear sign indicating when that money will come back into the market, or whether it will come back directly into the currency markets. While currency and FX are sometimes regarded as a poor relation to the capital markets, when you talk about cross border investments FX plays a pivotal role in supporting those different markets. As a bank, we have certainly been challenged on credit and in a tight market the ability to conduct business in the first place is more difficult than it has been. Many institutions now impose much stronger credit conditions on clients, and clients in turn impose them on their counterparties, as the counterparty risk concerns have grown significantly since the second half of 2008.

MOMTCHIL POJARLIEV, HEAD OF CURRENCIES, HERMES: The past 20 months were very good for currencies as an alpha class. I'm saying an alpha class and not an asset class because, from my perspective, it doesn't matter if investors think currencies are an asset class or not. What matters is if they believe in your alpha generating capabilities in the foreign exchange market. Last year we saw a lot of black swans in the currency market. We saw five or six sigma type events, and the currency market had more black swans than any other. Moreover, covered interest parity, which is a fundamental arbitrage relation in international finance, broke down. The forward rates were pricing something completely different than the spot and interest rates; a lot of amazing things happened and this creates opportunity. Now investors realise that currency risk is huge and could impact their performance in other assets. For example, sterling-based investors who invested in the Japanese stock market last year would have been flat because sterling depreciated so much against the yen that offset all the losses from the Japanese equities. On the other hand, Japanese-based investors would have had huge losses. We are still in an exceptionally good environment for risk takers, which is good for investors and they should use it.

THOMAS KRESSIN, SENIOR VP, PORTFOLIO MANAGEMENT, PIMCO: What we are hearing around the table is that forex is a risk that needs to be managed by dedicated specialists. In this context we should discuss too, where the currency industry wants to place itself looking forward. Should active currency managers be considered as absolute return managers that compete against LIBOR? Or do we want to have a broader client base? forex might not be a separate asset class in the way we used to define asset classes. Nevertheless there are certain risk premia inherent in the forex market. Going forward, it is vital to create benchmarks for active currency management that are based on these risk premia. While this might be a challenging task, it should increase the overall interest and client base for the whole industry at the end. Let me add another point, which brings us back to the crisis last year. Interestingly enough, the forex market was one of the few markets, that did not (partially) shut down. During the crisis currency trades were initiated as proxy trades to hedge other risky asset classes that you couldn't exit anymore. That is why some trends we have seen in FX-space were even more pronounced than they would have been otherwise.

COLIN CROWNOVER, HEAD OF CURRENCY MANAGEMENT, STATE STREET: There are four important developments: first and foremost, we see a rotation towards specialist currency managers. This does not have to be a currency boutique but just a specialist currency team within a multi-asset manager, perhaps with that particular expertise. Why? Well, many of our clients thought that the manager of their underlying international assets was taking care of their currency risk. They found to their cost during the downturn that this was not the case. Two, we see a rotation geographically; there is an upsurge in interest from the US, where exposures to foreign assets were increased quite substantially over the last five to ten years, though perhaps not fully realising what could happen in a perfect storm. The same is true in Japan and we all saw its currency appreciate quite massively, for example, by 50% against the pound. Three, Thanos's points about currency being a good source of alpha and it holding up well are exactly right; even so, we are still seeing a rotation from our clients out of active and into passive strategies. It is certainly not universal, but even in the active space we are seeing clients rotating away from absolute return leverage strategies into lower risk strategies and, in particular, strategies that may focus more on medium- to long-run fundamentals. Four, more attention is being paid to the distinction between what I could call beta exposure, even if it is exotic beta, versus pure alpha trade, and that the carry trade that Thomas brought up is a good test case for that sort of distinction. It is hard to argue that a lot of the carry trade is alpha; clearly, a good chunk of that is beta.

LIQUIDITY: PRISONERS AND GLASS WALLS

BOB NOYEN: From a very high level perspective, it is not clear how the whole global financial market is going to evolve and it depends on whether or not we come out of recession in the next couple of years or whether we are going to muddle on, or perhaps deteriorate further. If we deteriorate, the pressure on the political class to start interfering and perhaps jolt the global economy into action may have a profound effect on financial markets. At the moment we have not seen some of the more extreme actions, such as protectionism, but the pressures continue. Right now there is a "covert" beggar thy neighbour policy being played out. Every nation is doing its damnedest to maintain currency competitiveness because it is a convenient policy for politicians rather than protectionism and it is pretty cheap to do. I do not know how that will play out in the long term.

Coming back to the point about currency pricing, on certain days in the last six to nine months it was harder to justify

The marketplace is more volatile because a lot of capital has been withdrawn – Bob Noyen, chief investment officer, Record Currency Management

the benefit of passive hedging if you factor in an ongoing implementation cost of a passive hedge combined with the need for an effective liquidity management programmes. Now conditions have started to normalise, certainly in spot. However, bank A still does not trust bank B and the moment the tenor is extended beyond two days, some of the spreads start to widen and while some of the measures the policymakers have taken give us confidence that the financial market will survive, it hasn't been enough to date to fully restore confidence.

THOMAS KRESSIN: In the last couple of months we lost one important liquidity provider in Lehman through bankruptcy and other names through mergers. Going forward we will likely see more of that. This raises the question what liquidity in currency markets will look like in the future. In addition we have to deal with higher macroeconomic uncertainty too. In consequence I expect a higher volatility in currency markets than in the past few years. The question remains, what is the maximum return that you can reasonably target in such an environment? Even when you have a manager with a successful track record and a high information ratio, when volatility is as high, as we have seen over the last couple of months, chances are high too that he will be wiped out of the market if he takes too much risk. All successful strategies will have losing streaks, it is inevitable. That means that even if a strategy proves to be successful in the long run, if you reach for too high a risk/ for a too high alpha target, you will with a high degree of probability inevitably be forced to leave the market. I expect the question of maximum alpha/risk targets for active forex managers to be raised more often in this kind of uncertain environment.

THANOS PAPASAVVAS: This is an opportune time for currency managers. We see demand for both absolute returns and risk management. The reason? As an industry, we have managed to generate respectable returns and respectable risk management in a very difficult environment. If the asset class or alpha class, or whatever you want to call it, adds value to the pension fund response, it will be in a very different vein that we'll be talking about currency management in five years' time. We can bring to the table specific skill sets and show returns from those inefficiencies that exist in the currency markets.

THOMAS KRESSIN: I agree. What happened to the hedge fund industry in general might turn out to become an opportunity for the active currency management industry, in particular. Some hedge funds were pursuing strategies that were deemed to be pure alpha but, in fact, were nothing else than selling liquidity premia to the market. When the systemic risk materialised last year, this became obvious and a lot of them blew up. The forex market on the other hand offers huge liquidity under normal circumstances. And even during the crisis, FX-liquidity proved to be exceptionally well in comparison to most other asset markets. This liquidity aspect and the fact the the forex market is open for 24 hours a day has lead to the wrong conventional wisdom that the FX market comes closest to what is called an efficient market.

VOLUME: LION'S PAWS AND SORRY SEASONS

THANOS PAPASAVVAS: Actually, currency is an inefficient asset class because a significant portion of participants are non-profit seeking. In other words, not everyone who participates in foreign exchange does so for profit; for example, foreign equities and bond purchases have to be cleared, global treasures need to hedge foreign currency exposures, central banks intervene to "guide" their currency as another monetary policy tool at their disposal. The majority of participants in the FX markets are not alpha-seeking currency managers, so any attempt to regulate the market would be limited.

FRANCESCA CARNEVALE: Because of its OTC nature?

THANOS PAPASAVVAS: Exactly. I am not sure what the ratio is, but the latest survey of the markets is the BIS 2007, which is about just over $3trn and active managers are about 15% of that.

BOB NOYEN: There are several interesting developments. FX volumes have come down as a result of the implosion of the shadow banking system. Hedge fund strategies added liquidity and volume to the FX market and this volume has reduced sharply. To a large extent, the capital allocated to alpha-seeking strategies in currency as at 30th June, 2007 has gone. As a result, the proportion of profit seekers in the FX market has reduced, which means that the foreign exchange volume that is not profit maximising has increased as a proportion; this creates opportunity for alpha seekers. Trading opportunities will exist in our markets as long as the industry is allowed to innovate and regulation stays on the periphery. Collateralisation is a case in point. It is relatively new and the banks are now offering it to those better corporate and institutional FX clients. This is a great innovation because it allows us to return to a commoditised FX market that does not require credit spreads or credit margins embedded into the FX pricing.

However, if the US and the UK governments run their own banking systems, I do not know whether they will allow their banking systems to continue to innovate at the pace we have seen over the past 20 or 30 years. It could well be that the mindset that runs public utilities is going to run the banking system. I don't know what impact that might have on the banking system.

COLIN CROWNOVER: I agree with the general point that the relative importance of profit maximisers in the currency market has gone down; in other words a larger percentage of the volume is for people who are just corporate or investor hedging, transactional volume and so on. However, we have not yet seen any evidence of volumes going down in the currency market. The Greenwich Associates study showed that last year currency volumes globally were up approximately 15% from 2007. While many of us think declining volumes will come, it certainly has not done up to now. It could be that in the increased volatility regime we find ourselves in, currency keeps enough incremental appetite for hedging strategies, so that we do not see a large decline in volumes. Second, while changes are afoot, they will look more like the collateralisation of the current forward market, as opposed to some exchange-traded solution. Exchange trade solutions do not work very well for FX, primarily because of all the wonderful customisation you can do for your clients in the existing OTC market, where I can pick a value date whenever the client wants cash flow. Therefore, I do not see sweeping regulatory changes to the FX market.

JOHN MURRAY: We saw this explosion of retail FX and now that has pretty much died. As a result, there are a number of providers and liquidity exchanges out there that have also maybe disappeared. You have also seen a more conservative view of the old traditional methods of execution returning and in terms of market regulation that will be tightened up going forward around certain types of participants rather than FX markets *per se*. That is because, as you have all said, they actually work very well. One of the changes you are seeing is that risk premium counts, that transitional cost has skewed slightly wider today, and that is a price many participants are willing to pay. They recognise it is a smaller market; their liquidity is not as deep as it may have been and it is a lot more conservative. Moreover, we have seen FX as more straightforward in terms of the collateral requirements we demand of our clients before we can do business with them. That actually imposes much more on our clients, particularly if they are trying to innovate. Equally, regulators are imposing much stronger conditions. We see a flight to quality and strength as a big institution; a lot of our clients come back to us because of our balance sheet quality. Overall our business as a whole hasn't changed too much. We have seen a lot of outflows, the volatility quite rightly has been tremendous, and as a transactional business we know our counterparty. You may see some reshaping in terms of who clients would go to for their FX business in future, but the FX business itself is stable. It is probably a bit more costly today, but so is everything else.

THOMAS KRESSIN: Is it more profitable?

JOHN MURRAY: Well, yes, that goes without saying but there is definitely a market sense that the risk premium attached to FX business has gone up; it is a given today. We definitely have seen a lot of clients come out of the market, to a degree; there is a lot less business being conducted right now than there has been.

BOB NOYEN: The foreign exchange market is now very much a two-product market: Interest rates and FX spot. The FX banks aren't yet set up in a way they can readily price credit risk. For example, they can't really price an FX swap with their estimate of the underlying risk. How that is going to evolve, I do not know.

VOLATILITY: SWART-COMPLEXION'D NIGHT OR SPARKLING STARS?

BOB NOYEN: In the fourth quarter of last year we experienced a period of exceptionally high currency volatility, five/six times greater than what we had come to expect as the "norm". This "norm" period, between 2003 and 2007, exhibited exceptionally low levels of volatility, a result of monetary policy which created a weak dollar, relaxed attitudes towards risk, and created a bubble in all risky asset classes. Going forward, we will probably see volatility come down but unlikely to the abnormally low levels seen during 2003-2007.

THANOS PAPASAVVAS: Those famous last words, "policymakers have learnt".

JOHN MURRAY: Remember, every time we had the finance ministers on the line they were talking about keeping volatility down; they just accentuated that. The results from that decision are clearly illustrated over the past two years. Going forward, policymakers will not wish to bring volatility back to the lows we had.

THANOS PAPASAVVAS: We need to differentiate between two things: first the currency move *per se* and, second, how fast it moves within a defined period. Neither the ECB nor the Federal Reserve has a problem with a depreciating or an appreciating euro if the speed of the move is not excessive. What central banks are concerned about is excessive volatility. That is the issue here.

COLIN CROWNOVER: If it is a rupture in the market that hasn't quite healed, then you might expect the transaction costs to stay at relatively elevated levels for the foreseeable future. If it really is more of a volatility issue—and we have done some analysis at my shop on this—it looks to us like most of the increase in transaction costs can be simply explained by the much higher volatility in the markets. It is rational for market makers to charge a higher spread if they are facing more volatility and a greater probability they are not going to be able to lay off that trade at a profitable price. I tend to think what we have seen is a temporary spike in transaction costs due to high volatility. The £20m question is does volatility come back down to something more normal? Moreover, will transaction costs normalise or do we stay at elevated levels? Is that the reason why maybe transaction costs will stay high in the future?

We need to leave our niche and become marketers – Thomas Kressin, senior VP, portfolio management, PIMCO

BOB NOYEN: Have you done the analysis on the spot and the forward spreads?
COLIN CROWNOVER: Spot spreads are completely what you'd expect given the level of volatility, acknowledging of course we have not seen this level of volatility before, but you extrapolate from past events. The forward points was the one component of transaction costs where you could truly say they were higher than the underlying asset volatility would have indicated, but most of that happened in roughly the month following the Lehman Brothers bankruptcy. Since that point they seem to be consistent with the volatility of the underlying market. It is still very rich.
BOB NOYEN: The forwards took the brunt of the spread widening. This has to do with the illiquidity and volatility but it is primarily a function of the impaired interbank market.
THOMAS KRESSIN: The distortions in the forward market certainly had to do with financing needs and credit risk. During the climax of the crisis banks probably used it too, as a kind of mechanism to prevent new business with certain counterparties that they would not want business with.
BOB NOYEN: Because they didn't want the business. They do not want any credit business because somebody from high up said: "Shrink the balance sheet.
THOMAS KRESSIN: Exactly. In general, this is a big issue for both our industry and the macro economy as well.
MOMTCHIL POJARLIEV: It is unfair to blame the policymakers about everything, especially for the high volatility. I've spoken to a couple of policymakers and they were not sure why volatility was so low. I think some market participants were responsible for the extremely low volatility by selling options, for example. If you are selling options and putting pressure on volatility, it comes down. Actually I am not complaining about high volatility at all, because it creates opportunities. In fact, many people complained between 2004 and 2006, because volatility was extremely low.
COLIN CROWNOVER: It is not the volatility of the currencies *per se* that creates a profitable or unprofitable environment but the amount of movement you can predict as a currency manager. I would not speak for all currency managers, but a lot of managers I talk to find that relatively low to medium volatility environments are actually easier for them, even though the opportunity set is clearly lower in a more volatile market. They find it easier to predict movements and currencies in those environments because they respond more to institutional fundamentals that drive the markets, whereas in the experience that we have just had there were some days where we have all been challenged to figure out what exactly was driving the market besides panic. That is an important distinction.

STRATEGIES: GREEN MEADOWS AND HEAVENLY ALCHEMY

THANOS PAPASAVVAS: I was having a discussion with a consultant who asked does PPP really work? Until 2007 a significant number of market participants had left "valuation" on the sidelines, with even a few academic papers written specifically to support that. However, we have seen more recently that value has come back to play with a vengeance. Do we see different drivers affecting currency markets at different market environments? Yes we do as markets go through cycles and different factors impact investor behaviour and exchange rates.
THOMAS KRESSIN: In my opinion the critical point to watch for with respect to the potential currency impact of all the different conventional and non-conventional central bank easing measures around the globe will come, when the global economy gets traction again. Will central banks be able to take the excess liquidity out of the system without any major disruptions? Or how how much of this liquidity will stay there and become inflationary? PPP will be very quickly back on the agenda of currency managers, when inflation rates start to diverge. Looking at all the uncertainties with respect to the unprecedented policy initiatives, the potential for reregulation, protectionism and so on discretionary investment styles are likely to become much more important than they have been over the last ten years.
COLIN CROWNOVER: We have definitely seen an uptake in appetite for valuation-based currency strategies and, normally, after the level of volatility we have seen in the markets of late, you'll see a lot of the extremist valuations completely eroded. Currencies have gone from being extremely overvalued, such as sterling was a little over a year ago, to being extremely undervalued. You can now play the opposite of the trade in an historically short period. We do think there is a lot of appetite there as some of the short-term strategies have been found out to be, at least partly, risk-creating beta trades. People are a little less concerned about making money every quarter and a little more concerned about their long run results because they have witnessed what a shorter investment horizon can do.
THANOS PAPASAVVAS: The question is whether, in this market you can survive as a pure PPP currency manager. It would need to be either a multi-strategy currency manager who combines different sources of alpha or a consultant

who combines managers with different styles. Maybe one of the managers is underperforming for a given period of time, but the other managers are compensating for that.

THOMAS KRESSIN: Which means ideally, that you would diversify on your own and use different uncorrelated strategies.

THANOS PAPASAVVAS: There are different schools of thought. Some currency managers combine a multi-strategy approach while others prefer to specialise on their own.

MOMTCHIL POJARLIEV: What is also very important is the sizing of the positions, not only the timing, because market timing is extremely difficult. You do not want to be stopped out exactly when you want to be adding to the position. The right calibration of risk is something very important. I had a feeling that until recently people were worried mainly about getting the direction right. Market timing is very challenging and you have to think hard about position sizing and calibration of risk, especially if you are a value manager.

THOMAS KRESSIN: It is certainly very credible, the idea of going forward to have a very clear distinction between alpha versus beta. The benchmarks can be decided, by the industry, or the consultant, or pension funds. That is certainly a very transparent way going forward. Will this put us very much in the same vein as the other asset classes which have had a similar experience, with the equities, the hedge funds, the commodities, because of the heavy beta assigned to that asset class? Should we, as currency managers, try to maintain our total return alpha mentality or shouldn't we move down the road of the beta strategy and generating a return on top of that?

EXPANSION: COMPARING APPLES, PEARS AND SUMMER DAYS

THANOS PAPASAVVAS: It is certainly very credible, the idea of going forward to have a very clear alpha versus beta and the benchmark can be decided, by the industry, or the consultant, or pension funds. That is certainly very transparent going forward. Will this put us very much in the same vein as the other asset classes which have had a similar experience, with the equities, the hedge funds, the commodities, because of the heavy beta assigned to that asset class? Should we, as currency managers, the currency management industry, try to maintain our total return alpha mentality or do we move down the road of the beta strategy and generating a return on top of that?

THANOS PAPASAVVAS: Right now we do have the differentiation between currencies as an asset class versus other assets? Do we move down and pick currencies as a beta class, as a beta style asset class, with some alpha on top?

COLIN CROWNOVER: We are already moving in that direction because many of the banks produce investable beta indices, whether it is carrier or value or momentum. We are already heading in that direction. Prices will come down and, as they do, they may end up looking just like other beta products where you have fee compression and

We have not yet seen any evidence of volumes going down in the currency market – Colin Crownover, head of currency management, State Street

you shouldn't be charged much more than some notional value for the expertise. I would like to see us move to more like an equity or a bond world where you control the explicit risk factors. Of course, we do not have as wide a set of risk factors in currency, but we have some that we have already discussed. You control those and limit the exposure of those and then what you are left with is going to be much closer to pure alpha and we should be able to offer quite attractive fees that compete with the fees you'd get for alpha products across other asset classes.

THOMAS KRESSIN: Absolutely. To me, it is the only chance for this industry to grow out of its niche business. No institutional investor will allocate the majority of his/her capital to absolute return strategies. Active currency managers need to grow out of the absolute return universe and become some kind of beta manager too. In that respect it is key to discuss the economic rationales behind the notion that there are certain structural risk premia in currency space, just like in bond or equity space.

MOMTCHIL POJARLIEV: If we want to grow the industry we have to convince the investors there is beta in the market because, if you do not convince them, you cannot sell alpha. If they do not believe there is beta, they are not going to buy the alpha, or they are going to buy it but it is not going to be a huge business.

COLIN CROWNOVER: Momtchil, I have a question for your statement that you do not think you'll be able to sell alpha without beta. I am curious because certainly there was a lot of popularity in market neutral equity strategies which, if executed correctly, should be zero beta, but provide alpha. Now, we know a lot of those managers weren't doing what they were supposed to be doing but there were ones that did. I am curious: why couldn't we have an analogue for the currency markets as well, where somebody might say, yes, carry has a risk premium in the

long term and maybe I'll get that from a beta manager relatively cheaply, but here's a manager who has analysed what the risk premium should be in the carry trade, based on whatever factors they think relative versus what they actually receive, and making alpha trades around that.

MOMTCHIL POJARLIEV: In principle, you should be able to sell alpha without any beta; this is why I said currency is an alpha class. If you can prove you can generate alpha, that is enough, you do not need the beta. Unfortunately, if you look at the industry, you get the example of market neutral, long/short equity funds. Somehow we don't have long/short frozen orange juice funds. There might be managers who might be able to generate alpha from frozen orange juices, but this alpha would be difficult to sell. Investors are not sophisticated enough. So, if we want to move this industry to the same level where the equity market industry resides, then you have to try to promote the idea of beta. I believe that the concept of alpha and beta apply in FX. The return of any investment portfolio is a combination of alpha and beta return. Currency portfolios are not different. Investors should pay high alpha fees only for the alpha return, beta return could be obtained cheaply.

THOMAS KRESSIN: It is a good strategic goal for active currency management to reach the size of the equity market, but I doubt that we are going to accomplished in our working lifes. The investment case for currencies is intellectually very challenging: What are you actually investing in? What are the risk premia that you get paid for? In fixed income you lend money to someone and charge him with an interest rate. In equity space you even become part of one company's owners and receive a claim on the company's profits. But what do you do as an active manager in currency space? What do you provide in terms of economic utility?

BOB NOYEN: To say that "a market is volatile so we can generate alpha", is questionable. You can generate alpha out of currency; by definition that is true, but it is not necessarily sustainable. Cumulatively alpha is a zero sum game regardless of volatility because for the positive alpha generated there is also negative alpha lost. Unless you can identify a participant who is willing to act as a risk or capital provider delivering some kind of utility to another participant, you do not have a sustainable source of alpha.

THOMAS KRESSIN: This brings us back to the question of the economic role of active currency managers. Certainly we are liquidity providers, but I would also suggest that active currency managers smooth currency volatility and promote market efficiency too. The currency market is the only market I can think of that is dominated by non-profit driven participants. And they are in most of the cases pure liquidity seekers. We are the ones providing risk capital, bidding against central banks or against the hedgers of the world and providing them with the counters.

MOMTCHIL POJARLIEV: On average, alpha is negative because you have transaction costs and management fees. This is not just the case in currencies; this is the case for all asset classes. This is why the profession of an active portfolio manager is unique. The average active portfolio manager is completely worthless. This is not the case with other professions. For example, if you are sick, of course you want to go to the best doctor, but even if you go to the average doctor he's going to do a fine job. But if you invest with an average active portfolio manager he's going to cost you a fee without adding any value. It is difficult to generate alpha, to add value. This is the reason why alpha should be expensive, because only the best can deliver alpha. Therefore it is very important to know how to measure alpha properly.

This is an opportune time for currency managers –Thanos Papasavvas, head of currency management, Investec Asset Management

JOHN MURRAY: Our clients come to us today looking very much at cost, asking what's the cheaper option? They've gone back to basics. We have been through this cycle before, where it was very quiet, and clients start to look at their providers to ask, well, how much is it costing us? Some have decided to move more towards a passive model which opens up providers in terms of custodians and other institutions being able to provide that service where there is a fee but it is a much smaller fee. Clients in this instance drive the model, telling the provider this is what we want you to do on our behalf and it is rules based. There is a small fee attached to that and it is really about currency maturity. They are trying to mitigate any exposure they have and in these conservative times clients may be opting out of riskier solutions for a period. That is not to say it is going to change in a very short space of time. Right now, institutional and pension players are more conservative because they have more basic concerns about cash and they've got to support these types of model-driven strategies and they've also been burnt of late.

STP: FREEDOM AND SWEET HOURS

JOHN MURRAY: Technology affects the FX markets, or will do, and the technology is quite mature now in the multi-bank platform. For institutional clients, real money managers, it is a very mature market for foreign exchange. From a bank perspective, the back-office infrastructure has

matured as well. The larger banks, the big foreign exchange providers, have focused on that sort of processing capability in the last few years, their ability to provide straight through processing (STP) also counts. It is crucial, particularly for the gentlemen here. Bloomberg also has a big role to play; it is on the desktop and it makes perfect sense to branch out into the different asset types. Additionally, there is more competition in the data space, which is good. Some 80% of business from our clients is electronic and that is not going to change. The only change I would envisage is what the buyside technology requirement will bring. Banks, such as ours, will always have to bow to the demands of our clients in terms of how we service them. Right now, from a buyside perspective, I am not sure how much technology has changed. It may be just from the risk management perspective, the tools that are available to them and how much they have changed in the past few years. However, these guys are much more reliant on real-time, certainly real-time research and pricing.

BOB NOYEN: Straight through processing, making the administrative process less risky and more efficient, has grown apace. We are integrating our platforms with that of custodians to download exposures and send transactional information back; that works very well. There has been promise of an electronic execution engine that would do away with the need of the human element, but the events of the last six months have proven that they are not there yet. It has been a fantastic improvement in streamlining the admin but in terms of making the marketplace itself operate electronically, forget it. Another thing is that if you analyse data, you'll see that the average transaction size in the interbank market has halved. At the moment $10m or $20m can be turnkey. I do not know if the electronic systems can cope with those evolutions in the way that the market clears, and I certainly believe that in the next couple of years things will keep evolving and that is why we are keeping our traders employed. They are extremely powerful in adding value and making sure that we do not get caught out by the odd feature of an overly system-reliant marketplace.

COLIN CROWNOVER: The biggest advantage from the growth in electronic trading is that it is more of an information flow, as opposed to a dealing benefit. As a portfolio manager, I can see real-time streaming dealable prices and FX Options allows some users to price a portfolio instantaneously. I can also do risk management looking at implied volatility; there are all sorts of fantastic things I can do with portfolios today that I couldn't do five years ago. That said, we still do most of our dealing by picking up a phone and calling a couple of brokers, and then putting those trades into a multibank platform because of the STP advantages and its ability to allocate across multiple clients. Nowadays, it is critical, given the drying up of liquidity. As one of the largest currency managers our size is too big to effectively deal on those kind of platforms. Even for platforms that list the next best price and the next best price, I can't see what I would

Currency management is very much more important to a lot of institutional investors than it was – John Murray, VP, FX fund services (sales), BNY Mellon

end up dealing with and I do not have enough people where I could have traders in there clicking all day trying to get a large trade done in clips of two, five, or ten.

THOMAS KRESSIN: Electronic trading has gained huge importance for us due the big chunk of our maintenance trades. It is very helpful for all this daily rebalancing and cash flow business, for example, as it serves two purposes. One is you can prove that you do best execution. STP on the other hand enables you to deal with a much larger size of trades than in the past.. However, I agree, the big tickets in general are still done over the phone.

THE WAY AHEAD: SWEET LOCKED-UP TREASURE

THOMAS KRESSIN: We need to leave our niche and become marketers. Our industry hasn't been really good in marketing our business. We need to be more vocal in terms of opportunities and why there is money left on the table in currency markets. We also need to explain that investing in active currency strategies means adding another uncorrelated source of revenue. As long as you believe in Markowitz this is a valuable contribution as you move up the efficient frontier. We need to clarify why there are systematic risk premia in currency space, what they are based on in terms of economic background, and prove that our industry makes money in relation to certain benchmarks. That is then the beta that comes in, for as Momtchil pointed out, only a few managers really generate alpha and that would be a zero sum game. We

I am not complaining about high volatility at all, because it creates opportunities – Momtchil Pojarliev, head of currencies, Hermes

need therefore to make sure that people are aware that there is a beta in the market, and there are systematic risk premia that you can exploit.

FRANCESCA CARNEVALE: How will banks work more closely with the FX industry to ensure that opportunities in generating alpha or in better risk management techniques, in managing currency exposure, are integrated into mainstream asset management strategies?

JOHN MURRAY: It depends on the level of sophistication of the investor. The bigger institutional investor will have already developed their own house capabilities and have the right guys, the right tools to make those decision. The smaller institutional investor will not see it as effective and may look at the more passive route; they may even outsource. This is a non-core function still, though increasingly they will see the value that currency has, but they might also see that there are banks that are maybe the better place to provide that level of service provision and analysis. However, there is room for everyone. Even so, when you look at a sophisticated institutional investor, they are going to formalise some FX strategy around the approach they are taking and in that regard we have noted a shift back to a more passive requirement. That in turn does play to custodians because they have all the information the client would use themselves to administer their risk. Why not?

We work, for instance, with clients who have to make their funds attractive to their investors. They will offer a hedged portion and an unhedged portion to clients, which is why we have seen a proliferation of hedge share prices. You'll have funds that support both. Some investors want to be exposed to currency risk, others do not. We are seeing a blend there right now and that is not going to change dramatically. If anything, we'll see this balance of currency active management, though passive for the moment, will return to prominence.

THANOS PAPASAVVAS: The key point is that the FX industry has to work hand-in-hand with consultants and pension funds trustees to make sure we can provide exactly what the trustees and consultants require. In other words, it is an educational process to make sure that the end user of our services understands why they are employing us. Are they employing us to manage their risk or to add a level of return? Moreover, we need to clarify what services we can offer. Some managers prefer to have passive and dynamic hedging mandates, whilst others only manage active. Of those active managers, some will have a bias towards beta, and so on. As the industry evolves and the various participants play to their strengths, consultants can work with the specialists over these regions to provide the end-client with the most optimal solution to fit their specific requirements.

COLIN CROWNOVER: The balance is more tilted to educating the clients or prospective clients. We find, for instance, two common misperceptions in the currency markets: one, liquidity equals efficiency, which it does not. Two, is the zero sum argument. You cannot dispute that any relative asset class, such as currencies, has to be zero sum in aggregate. We can make arguments that, as managers, we have some positive alpha and there is some class of participants in the marketplace that have negative alpha, and many of us do exactly that. However, the misconception about zero sum is, again, with the relative asset class. If I just form my portfolio by throwing darts at the dartboard, of course the expected return will be zero, but that is irrelevant for an investor. If I am, say, a Japanese investor and I've watched the yen go from 300 in the 1970s to just below 100 today, try telling me that my currency is a zero sum game.

BOB NOYEN: It is absolutely essential for the FX market to be recommoditised. Over the last year we have had to become credit experts. We were not really obliged to before, but the people we indirectly hired to do the credit work, such as S&P's and Moody's, have arguably not done such a decent job. For the FX market to function in an efficient manner, we need to develop a mechanism that will align the interests of all participants and return confidence to the marketplace. One such a mechanism is two-way collateralisation, which can help to reintroduce competition back to the marketplace and reduce the cost of trading.

In terms of looking forward, we feel that one outstanding opportunity lies in the emerging currency world. I think that the trend of globalisation will continue to see new and successful nations participate in the global economy; the western world will become relatively poorer and the emerging world will become relatively wealthier. There are sound currency strategies that can exploit these trends and this means tremendous opportunity in the next couple of years.