

# CURRENCY AS AN ASSET CLASS

*As investors look beyond traditional hedging opportunities, currency trading grows into a stand-alone asset class.*

---

Investors have typically employed currency trades as a hedge against investments in other international securities. About a decade ago, however, some intuitive institutional investment managers began looking at currencies differently. Could currency-trading strategies provide consistent profit streams while enhancing absolute returns?

That potential definitely exists, says Wayne Bowers, director of global fixed income for Northern Trust in London. “Plan sponsors and other institutional investors have begun to look to currency trading as an active strategy,” Bowers notes. “The returns from currency markets generally are uncorrelated to traditional asset classes, and they can provide an additional source of alpha. That offers an attractive risk-to-return ratio for plan sponsors looking to better manage their liabilities through diversification and the need for additional alpha.”

Increasingly, investors have begun to look at currency trading as an asset class such as equity or fixed income. Reflecting a broader global trend, plan sponsors in the United Kingdom tendered £3 billion in contracts in the past year, according to the *Financial Times*. That’s not surprising given that global currency markets generally are considered the world’s largest, most transparent and most liquid markets. A survey published



“There is a definite move toward managing currencies, either to reduce risk or increase risk throughout a portfolio.”

– Wayne Bowers, director of global fixed income at Northern Trust

---

in 2005 by the Bank of International Settlements reported that average daily turnover in traditional foreign exchange markets reached US\$1.9 trillion.

## A Natural Outgrowth

Currency as a stand-alone asset class began gaining momentum between 2000 and 2003, when traditional asset classes saw several years of bear-market returns. Institutions looked to alternative investments with a steady rate of return, says Richard Levich, professor of finance at New York University’s Stern School of Business. “Many institutional investors discovered currency as an asset grouping, or a mechanism for trading strategies, that might produce profit even when more traditional assets like equities were doing poorly,” Levich says.



As a means of diversifying their portfolios, institutional investors are increasingly allocating more resources to global investments. However, the currency risk that is inherent in buying foreign investments generally requires investors to trade currencies as a hedge against those investments. Bowers explains, “Take a Swedish investor who seeks to buy U.S. Treasuries or Japanese stocks. That investor would sell krona, obtain the currency needed and, as a protection, hedge the native currency — i.e., sell the U.S. dollar or Japanese yen with a forward settlement date.”

Active currency trading rejects the old axiom that investors can ignore the currency risk inherent in investing in shares of a

foreign-based company because currency risk is built into the price of the stock. Proponents of active currency strategies ask: What happens if the yen appreciates significantly while the dollar depreciates? How does that affect the price of goods and services manufactured in one domicile and sold in another? And what if the company had an active hedging program used to minimize volatility to earnings due to currency fluctuations? Bowers notes, “Currency is not as straightforward as most people think. And there is a definite move toward managing currencies, either to reduce risk or increase risk throughout a portfolio.”

Institutions investing in international assets already have currency exposure, explains Robert Korajczyk, the Harry G.



quantification. When it comes to currencies, however, investors have found it difficult to obtain a so-called black box from a valuation standpoint that pegs the value of currencies to each other. “I’m not sure there is anything that is agreed upon as a benchmark,” Levich says. “There are a couple of firms that track how hedge and commodity-trading funds dedicated to currency are performing. However, as for a naïve strategy such as a buy-and-hold, there is nothing of caliber in the currency market.”

Bowers maintains that the same could be said for most alternative asset classes. “Yet,” he says, “as institutional investors moved into alternatives, they accepted that valuation cannot be as perfect as within traditional asset classes.”

### The Appeal of Currencies

Another appealing aspect of an active currency strategy is that currency returns offer a low correlation to other asset classes, making it useful for diversification. For the purposes of trading, electronic systems have been around for decades, and that means investors can enter and exit the market efficiently. Meanwhile, historical data continue to accumulate and are ready to be mined.

Investors seeking additional alpha can expand their search into inefficient markets as well as emerging markets. Generating

---

The returns from currency markets generally are uncorrelated to traditional asset classes, and they can provide an additional source of alpha.

---

Guthmann Distinguished Professor of Finance at Northwestern University’s Kellogg School of Management. “The question is, do you want to alter that in some way? Do you want to increase or decrease exposure over and above the exchange exposure you may have through international equities or bonds? You may want to lay off some of that risk — or take on more — depending on whether the expected return on currency is relatively high or low.”

### Lack of Benchmarks

With all the arguments for treating currencies as an asset class, investors might wonder why investment managers have been slow to view currency trading beyond its traditional hedging purposes.

Experts explain that investors typically seek certain standards for investment processes, which are usually derived through

alpha from established markets can prove elusive as volatility in those markets diminishes. Therefore, more volatility in emerging markets can mean greater return potential for managers skilled in exploiting those markets.

For investors considering an active currency strategy, Bowers offers several observations. “First,” he notes, “an active strategy allows managers to concentrate on currency pairs that produce alpha. The idea is to lift constraints from dollar or euro-only pairings to find potential for price movements among other currencies. The British pound vs. the Swedish krona is one example.”

“Second,” Bowers continues, “an active currency strategy exploits the benefits of fundamental and technical analysis. There are a number of ways to attempt to predict currency movements. Fundamental analysis can provide significant insight, but the bulk of the currency plays result from technical

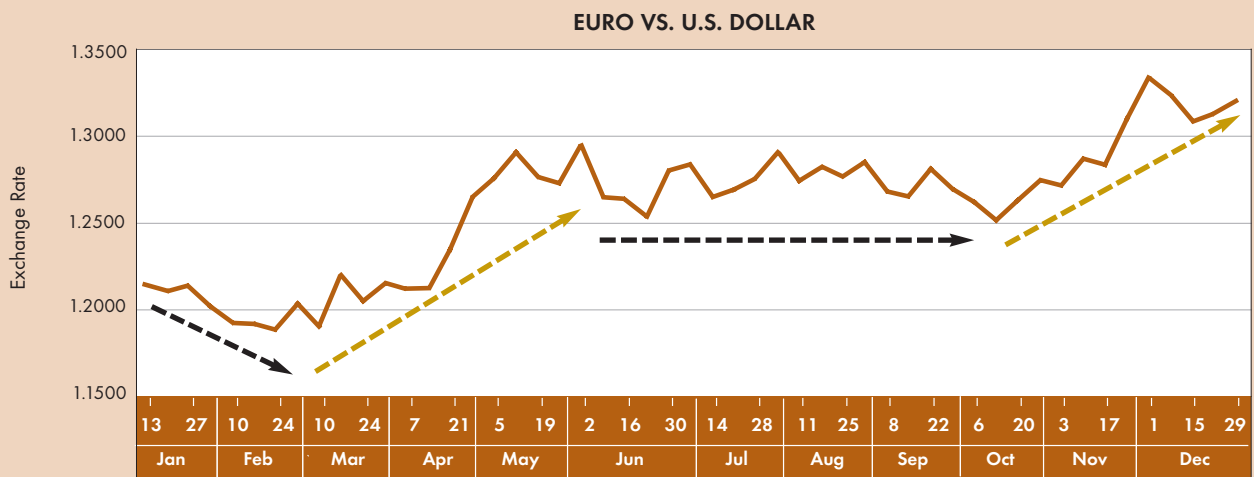
analysis — examining historical patterns of currency trading, the price characteristics of one currency vs. another or trend line deviations.” Because currencies are particularly difficult to value, the market relies on both fundamental and technical analysis to generate acceptability levels and fair value.

As investment portfolios expand beyond home country holdings, Northwestern University’s Korajczyk believes that currency strategies are definitely something investors should

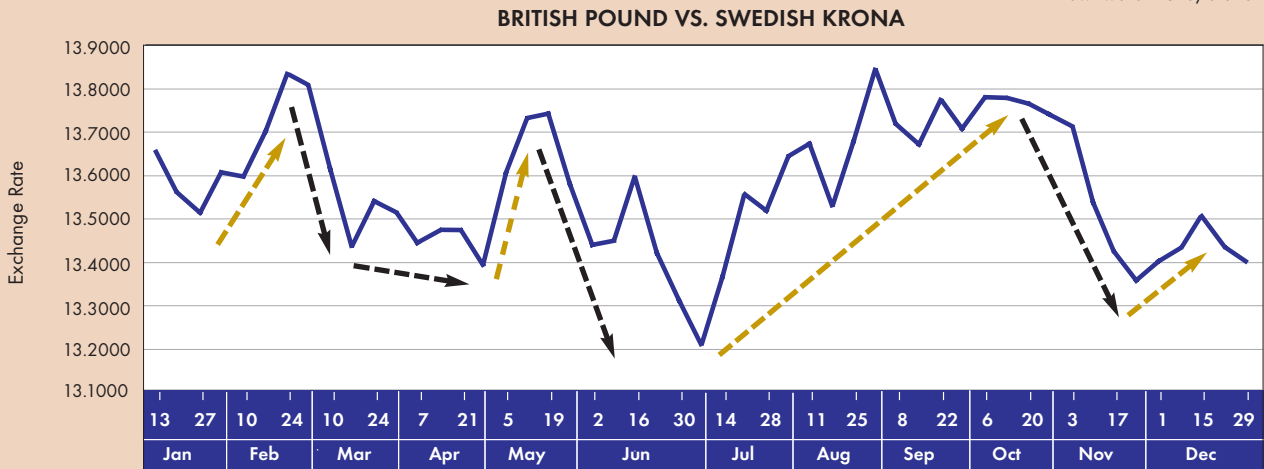
consider as part of their portfolios. He explains, “A particular strategy or position might reduce risk in one portfolio or increase risk in another. You have to take into account not only the benefits of return but also how currency trading interacts with other assets in the portfolio.” If managed correctly, an active currency strategy can serve as a potential solution for an investor seeking to increase diversification and generate alpha through allocations to alternatives. ❖

## Currency Pairs and Alpha Potential

The exchange rate between the euro and the U.S. dollar has held in a fairly stable price band for significant periods, limiting opportunities to extract alpha from the relationship. The more frequent price changes witnessed in the British pound vs. Swedish krona relationship, however, presented opportunities to apply technical analysis and investing skills to generate alpha.



—> Upward Trend  
- - -> Downward Trend/Static



Source: Bloomberg. Data shown represents the mid-week exchange rate price point for the currency pair.