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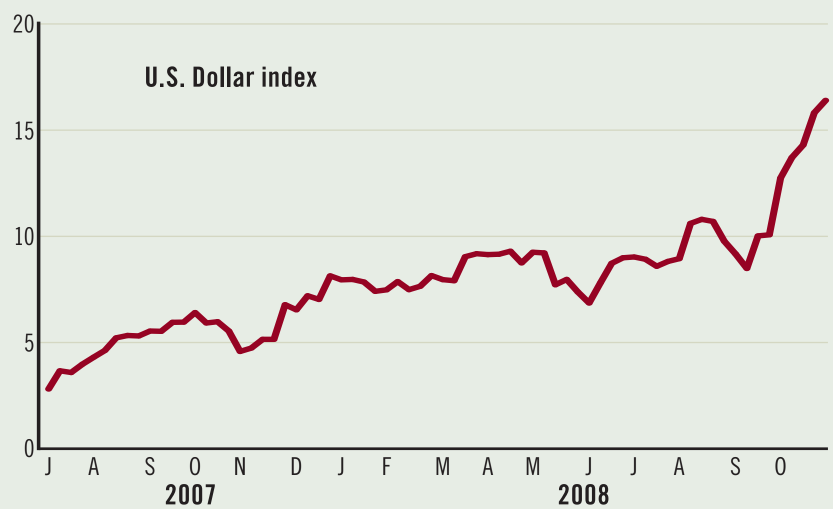
November 10, 2008
Pensions&Investments
THE INTERNATIONAL NEWSPAPER OF MONEY MANAGEMENT

Investing

Currency managers jump into volatile markets to score big

By Drew Carter

Soaring dollar The dollar's value is skyrocketing in the most dynamic currency market in years.



Source: Bloomberg LP

Some currency managers netted huge returns by pouncing on opportunities created by historic volatility in recent months, while others headed for safety on the sidelines, waiting for a sense of normalcy to return to currency markets.

Among the winners were A.G. Bisset & Co. Inc., Rowayton, Conn.; First Quadrant LP, Pasadena, Calif.; and Putnam Investments, Boston.

But Record Currency Management Ltd. PLC, Windsor, England, and Mellon Capital Management Corp., San Francisco, ran into performance headwinds.

For the three months ended Oct. 31, the U.S. dollar rose more than 18% against both the euro and the British pound, while the Japanese yen rose nearly 40% against the Australian dollar. Median currency manager returns for the quarter and year ended Sept. 30 — the latest available —were -0.72% and -0.28% respectively, according to eVestment Alliance LLC, Marietta, Ga.

The dollar and the yen had been undervalued for some time, said Donald G. Feeney, chief operations officer at A.G. Bisset, which manages $2.5 billion in currency for institutional clients. "What we weren't anticipating was that the move would be so dramatic."

Putnam's "returns in October were equal to a year's returns. That gives you some sense of how volatile things were," said Parker King, team leader for currency at Putnam Investments, which manages $35 billion in active currency, about $20 billion of which is institutional. Putnam brought down risks in its portfolio "and still had massive returns." He wouldn't provide performance data.

At A.G. Bisset, unleveraged returns topped 14% in the first 10 months of the year, and more than 8% in October alone. "We've had some stellar months in the past, but this is definitely not typical," Mr. Feeney said. A.G. Bisset has an unfunded leveraged fund set to be rolled out in December.

First Quadrant saw "good, strong" returns in September and October, which added to an already good year, said Dori Levanoni, partner and co-director of global macro at First Quadrant, which runs about $14 billion in currency for predominantly institutional clients. Currency returns have been double to quadruple their targets.

"Being an alpha manager, you shouldn't have too many environments where you do poorly," Mr. Levanoni said, adding the strategy aims to do well in periods of high volatility and low volatility.

Rate convergence

Global convergence of interest rates has been a key element of global currency moves. Interest rates, already low in the U.S. and Japan, have been dropping elsewhere, at times more quickly than expected. Last week, for example, the Reserve Bank of Australia cut its overnight target rate by a greater-than-expected 0.75 percentage points to 5.25%. In London, the Bank of England dropped the rate by 1.5 percentage points to 3%, the lowest since 1954.

Also, there has been a flight to quality that has boosted the dollar and the yen, which then benefited from currency investors snatching them up as they unwound other positions, experts said. "There are a lot of things pointing to a defensive stance," Putnam's Mr. King said.

Similar to other markets worldwide, currency markets saw historic levels of volatility, especially in October.

"Some of the things you're seeing are just unbelievable," Mr. King said, pointing to the pairing of the Australian and U.S. dollars, where annualized volatility has been as high as 70%. "You're talking about a pairing that's usually at about 10%."

"When conditions are more volatile, you'd hope the better currency managers would be able to take advantage of that," said Diane Miller, principal at investment consultant Mercer Ltd. in London.

But not all currency managers dove into the autumn currency fray. "We're happy to be patient and wait for a more stable environment," said Mike Shilling, chief executive officer of Pareto Investment Management Ltd., London.

But watching can be painful. "With hindsight, you can always see some great opportunities," Mr. Shilling said. Pareto manages $50 billion, about half of which is for U.S. institutional investors.

He said Pareto's performance was "OK" in the last few months; he would not divulge performance data.

"There is a trade-off in this type of environment," Mr. Shilling said. "There are big movements, which, if you are aggressive, you can get a lot of alpha, but it's very risky."

Goldman Sachs, whose funds have produced excess returns of roughly 60% their volatility targets, or 2.4% on 4% volatility, also sat out the fall flurry.

"Our performance in September and October was close to flat," said Sam Finkelstein, London-based head of fundamental currency and emerging markets at Goldman Sachs Asset Management. "We do have a responsibility to prudently manage risk, and scaled down our positions. "Since August, the main theme in the portfolio has been deleveraging," Mr. Finkelstein said.

PARKER KING said Putnam's October returns were equal to those of a year.

Carry trade hit

Especially hurt by the volatility were managers using the carry trade, where currencies of countries with lower interest rates are shorted in favor of long positions on currencies at higher rates, experts said.

"That all works as long as the low-yielding currency doesn't go up," Mercer's Ms. Miller said. In recent months, the dollar and yen, both low-yielding, rose significantly against currencies with higher rates, such as those in Australia, New Zealand or the U.K.

"A simple bilateral carry strategy would have been hammered" in recent weeks, said Adrian Lee, president and chief investment officer at Lee Overlay Partners, Dublin, Ireland, which manages $8 billion in active currency for institutional investors. The carry is part of Lee Overlay's strategy, which combines seven fundamental signals, a technical signal and a subjective signal. Year-to-date performance has "been probably flat to slightly negative," Mr. Lee said. "When risk is not rewarded, it's hard to make money on currency."

Carry did drag down at least one manager. Record Currency Management reported a 2.5% loss on investments in the quarter ended Sept. 30, bringing assets under management equivalent to $47.8 billion. A Record spokesman declined to comment on October performance, citing regulatory rules.

But in an Oct. 21 statement on the firm's website, Record Chairman and Chief Executive Officer Neil Record wrote: "The quarter to Sept. 30 has been exceptionally challenging. The two main challenges have been the renewal of strong 'anti-carry' (forces) … and the resurgence of serious concerns over both the solvency and liquidity of many of the world's major banks — our trading partners in the foreign exchange markets."

Mercer's Ms. Miller said risk control processes were "the big thing that would have helped currency managers. That would have reduced risk before things got so volatile."

Record's performance also was mitigated by (the firm's) risk-control processes," Mr. Record's statement said.

Diversification over multiple currencies also helps, Mr. Lee said; Lee Overlay is always trading 32 currencies. "If you trade enough diversified currencies, you can probably avoid some of these global carry problems," he said. "They never all move the same."

Separately, Mellon Capital returned -1.76% in the quarter ended Sept. 30, according to data from eVestment Alliance. October returns were not available.

Mike Dunn, spokesman for Mellon Capital, said in a voicemail message that "technical funding issues in the capital markets that resulted from the Lehman collapse were one of the main causes of underperformance in the third quarter."

Dollar turnaround

Forward currency markets are still somewhat seized up, impaired by the huge jump in the London interbank offered rate. Although the rate has come down considerably since its peak, "liquidity in (foreign exchange) still seems poor to me," Mr. King said.

Thomas Kressin, Munich, Germany-based senior vice president and portfolio manager for Pacific Investment Management Co. LLC, said the crisis in currency mirrors the rest of the financial crisis.

"The movements we've seen can be characterized by two phrases — global deleveraging and global risk aversion," Mr. Kressin said. "This global deleveraging in the markets isn't over yet. It's going to continue" so liquidity will not likely improve before January.

The U.S. dollar will continue to be supported by convergence of both growth and interest rates globally, Mr. King said: In other words, slowing economies and falling interest rates worldwide will boost the dollar and the yen. Lower liquidity will also create a demand for dollars. ■