



Max Darnell
Partner
Chief Investment Officer



Ghene Faulcon
Associate
Derivatives Research



Dori Levanoni
Partner
Co-Director of Global Derivatives

What to Make of Active Currency Managers' Recent Underperformance¹

Doesn't this sound like a familiar story? After currency managers en masse delivered some of their strongest active returns in 2003, a good number of investors took action and put active currency mandates in place for the first time... only to see currency managers in general deliver disappointing performance.

The basis upon which investors decided to initiate these active currency programs was, of course, founded upon much more than a year or two of good performance. The long-term historical performance of active currency management is, in fact, unusually impressive and has been well documented by many.² The *average* currency manager has, in fact, delivered positive alpha. There aren't many categories of active management that can lay claim to such a feat.

Nevertheless, the outcome has to be frustrating. Both Mellon Analytical Solutions (MAS)³ and Parker

Global⁴ report that active currency managers have, on average, been underperforming for quite some time now. MAS shows that the period of underperformance began in the first quarter of 2004 which means that currency performance overall has been underwater for two and a half years now (ten quarters). According to MAS, performance in eight of those ten quarters has deepened that shortfall. Parker's results show the same outcome at the quarterly level, and reveal with monthly data that the performance peak was reached in December of 2003 for discretionary managers and in February 2004 for systematic managers.

In the spirit of full disclosure, we should point out that we've underperformed in our active currency mandates recently, too. Our underperformance stands in marked contrast to the crowd, however, in two very important respects. First, our underperformance has only occurred very recently. Unlike the results reported by MAS and Parker Global, we were able to deliver to First Quadrant's clients positive results over the 2004-2005 period. Our performance shortfall has only spanned five months (April-August 2006). Second, it's not only that our mean alpha has been positive when the average manager's mean alpha was negative, but also that

¹ Just prior to publication of this article, we found that James Binny at ABN AMRO had previously published a paper that covers some of the same points and comes to some of the same conclusions. James, who had been given a draft of the paper to read so that he could approve the use of his data had been too modest to point out the overlap, so we had to make this discovery by chance. In the spirit of "he who publishes first gets all of the credit," we need to acknowledge that James, therefore, deserves the credit for the common ground. In our opinion, this remained worth distributing as (1) there are several non-overlapping points to be made, (2) it brings some of the overlapping observations up-to-date, and (3) this is a message that we think deserves more widespread attention. The reader should take some comfort that two parties working independently came to very similar interpretations of the issues and the data. If any of our readers should like to see a copy of James Binny's paper, please look for "Currency Management Style through the Ages," *The Journal of Alternative Investments*, Winter 2005, vol 3, n 3.

² See Brian Strange, "Do Currency Overlay Managers Add Value?" *Currency Performance Analytics*; Janine Baldrige, Brian Meath, and Heather Myers, "Capturing Alpha through Active Currency Overlay," *Russell Research Commentary*, May 2000; Bill Muysken, "Discussion Paper on Currency Management Issues," William M. Mercer Investment Consulting, October 2000; Bill Muysken and Eriko Takeuchi, "Results of Survey of Pension Plans on Currency Issues," William M. Mercer Investment Consulting, September 2000.

³ "MAS Currency Overlay Analysis," Mellon Analytical Solutions, Q2 2006 Report. Performance being referenced is the performance of 50% hedged mandates as we think that the symmetry typically afforded such mandates allows for the purest measurement of skill-based success. The 100% hedged and 0% hedged performance outcomes are not too different, and there client mandated constraints tend to play a more significant role in the performance outcome. Permission to cite report given by Louise Bennett, Strategic Relationships Consultant (bennett.l2@mellon.com, +44 (0) 20 7163 6769). MAS information disclaimer: The performance analysis and other information in this (report and/or press release) are based on historical data and are intended for informational purposes only. Past performance is not a guarantee of future performance. This (report and/or press release) does not constitute investment advice, nor is it an offer or recommendation of any security, investment product, service or firm.

⁴ Parker Global Strategies, <http://www.parkerglobal.com/pgs/>.

the behavior of our alpha over this period has been quite distinct. From January 2004 through June of 2006, our monthly correlation with overall currency performance in Parker's database has been a *negative* 27%. Even this year when we've underperformed along with the others, our correlation has remained negative – deeply negative, in fact (although measuring a correlation over six monthly observations is necessarily statistically *insignificant*). Our low correlation is something that we'll return to briefly below, but it is not the focus of this note. Our main focus here is to shed some light on what this underperformance of the average currency manager does and doesn't signify.

Darkest Before the Dawn?

The widespread underperformance of currency managers naturally leads investors to ask whether the opportunities in the currency markets may have been arbitrated away. Has, for example, the increased level of active currency management led to more efficient markets? Or, perhaps, has there been some sort of structural or behavioral change that has extinguished currency managers' ability to add value?

While these are important questions to ask, we should look also to prior experience with similar episodes from other areas of active management. Recall, for example, global macro in the late 1990's. Global macro was broadly disappointing in 1998 and 1999 – so much so that people like George Soros and Julian Robertson seemingly came to question whether or not their approaches to investing might have ceased to be relevant. Recall valuation in the late 1990's as well. Valuation underperformed so miserably, so consistently, and for so long (around three years!) at the end of the bubble, that serious people wrote serious articles about the demise of conventional means of valuing stocks. *Just as unsurprising to us is the fact that both global macro and valuation have subsequently provided some of the best returns available anywhere.* Sometimes it really is darkest just before the dawn.

Active Returns Necessarily Wax and Wane

What we think recent performance signifies is merely the cyclical nature that exists in the effort to capture and profit from market inefficiencies. We see no evidence

that something structural has changed, and given the astounding depth of the currency markets, it seems very unlikely that the relatively small amount of capital – relative to the depth of the market – newly employed actively in the currency markets would have extinguished the opportunity set.

Individual market inefficiencies necessarily go through phases of expansion and contraction. Consider what it means to profit from inefficiency: an inefficient price – a disequilibrium price – must move in the direction of fair value, or equilibrium value⁵, in order for an investor to profit from this inefficiency. This movement represents a contraction of the market inefficiency. Should that price subsequently move away again from its fair value – either by reversing and moving back in the direction of its original disequilibrium price, or by passing through equilibrium to become cheap if it had been expensive or expensive if it had been cheap – the market inefficiency would be said to have expanded.

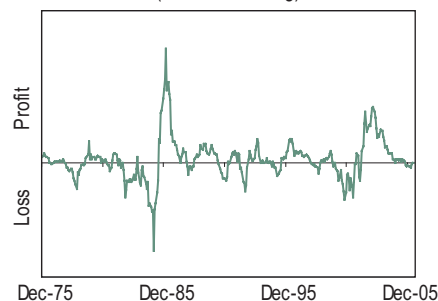
Note that the expansionary phase will tend to be an unprofitable phase for an investor who is seeking to profit from the convergence of inefficient prices upon their fair value. There are a few possible scenarios to consider here. Particularly if the price were close to fair value to start with, the investor may have had been taking no risk with respect to this asset; or the investor may have been taking a small amount of risk if the size of the mispricing prior was sufficient to attract only a little attention to this small opportunity for profit; or the investor may have taken risk on incrementally as the price grew further and further from fair value.

The outcome of the first scenario – the one where no risk is taken – is obviously going to be that the investor realizes neither profit nor loss when the inefficiency develops (expands). The outcome of the other scenarios is that the investor realizes losses as the inefficiency develops. Investors will tend to experience all three of these scenarios as avoiding loss entirely implies an ability to perfectly time the payoff associated with the market inefficiencies, and we know of no one who would claim to do that.

Even more interesting is the fact that those inefficiencies will tend to move through these cycles of expansion and contraction in clusters. For example, look to the condominium market here in the US which has experienced a much more extreme price appreciation than most other forms of real estate. The prices of condominiums in places such as Miami, Las Vegas and Santa Barbara had all gone through a phase together in recent years of rising well beyond their fair market value (expansion of the market inefficiency), and now they are all beginning to go through a phase of fairly rapid decline back towards their fair market values (contraction of the market inefficiency). This tendency to cluster is why we see phases in the market when growth stocks, or value stocks, or stocks with good earnings quality, for example, will do well or poorly as a group much of the time. We find that market inefficiencies in the stock, bond, currency and commodity markets behave similarly.

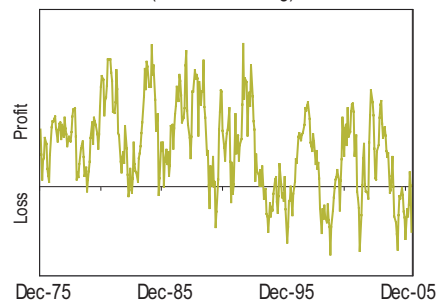
Amongst currency managers, there are some relatively common strategies utilized by investment managers broadly. Trend following strategies are the most common, while relative value strategies and so-called

The Cycle of Profit from Exploiting Relative Value (12 month Rolling)



Source: ABN AMRO

The Cycle of Profit from Exploiting Trend Following (12 month Rolling)



Source: ABN AMRO

⁵ By "fair value" we do not only mean "long term fair value" (a la PPP). Instead, we imagine adding together all the underlying forces at play in the currency markets—both long-term and short-term, both macroeconomic and microeconomic—to determine where a currency *should* be. That is the "equilibrium value" of the currency.

⁶ Thanks to James Binny (james.binny@uk.abnamro.com) at ABN AMRO in the FX Analytics and Risk Advisory Group, who has allowed us to use this non-publicized data.

“carry trades” are also widely used. Each manager, of course, will seek to fine tune their own use of such approaches to enhance the returns that may be harvested from each of these approaches, so we can’t make a blanket statement about the performance of these strategies. We can, however, look to naïve, or simple forms of these strategies to gain some understanding for what’s affecting currency managers in general. ABN AMRO⁶, for example, keeps track of the performance of “naïve” forms of these strategies. It is quite apparent in the two examples on page 2 that both relative value and trend following undergo “cycles” of profitability. It would be fair to assume that in general, currency managers overall undergo quite similar cycles.

The implication is that the investor is subject to these phases of contraction and expansion which lead them through the phases of profit and loss that we see clearly in the charts on page 2. What can one who aims to produce a more stable, more consistent profit do about this? We can diversify our risk taking across multiple market inefficiencies that have unrelated (i.e. uncorrelated) cycles of expansion and contraction. This is, of course, the benefit of a multi-strategy approach to investing. Indeed, one reason why active currency management has been so successful in general is due to the ability of managers to rely, whether they mean to or not, upon multiple, uncorrelated sources of alpha. As the table below shows, the historical returns associated with these three naïve forms of these commonly used strategies are very close to zero on average.

Correlations of Return
(Jan 1975- June 2006)

	Relative Value	Trend Following
Trend Following	-15%	-
Yield Capture	-8%	18%

If one is skilled in not only exploiting several different market inefficiencies simultaneously, but in shifting the risk between them across time in accordance with the relative opportunity they offer, i.e., being “tactical” in their use, then the results can be even better.

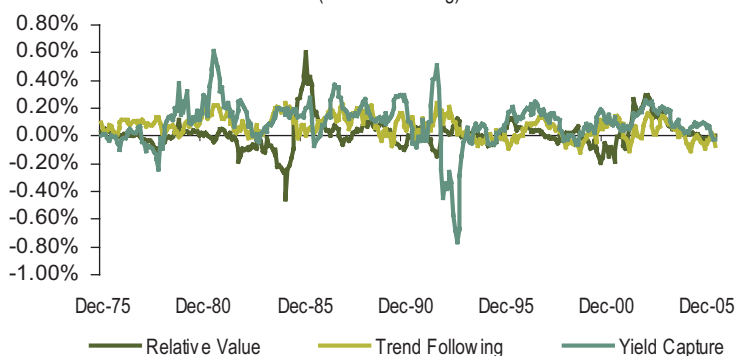
The Trouble Lately

What a correlation of zero means is that objects will move independently of each other. Uncorrelated market inefficiencies then will sometimes go through

their phases of expansion and/or contraction at the same time. Only if they were negatively *related* could we be assured that they won’t go through such phases together. This concept is often not well understood. Often it is assumed that uncorrelated assets or inefficiencies (i.e., unrelated) won’t display the appearance of short-term correlated behavior from time to time. That’s a misunderstanding of what it means for two assets or two inefficiencies to be uncorrelated or unrelated.

This logic naturally extends to groups of market inefficiencies as well. The likelihood that multiple unrelated market inefficiencies experience a contraction and/or expansionary phase simultaneously is, of course, lower than for any pair, but it does happen from time to time. We have seen precisely this occur in the currency markets over the recent period, *and therein lay the crux of the problem!*

The Unrelated Behavior of Market Inefficiencies in the Currency Markets
(12 month Rolling)

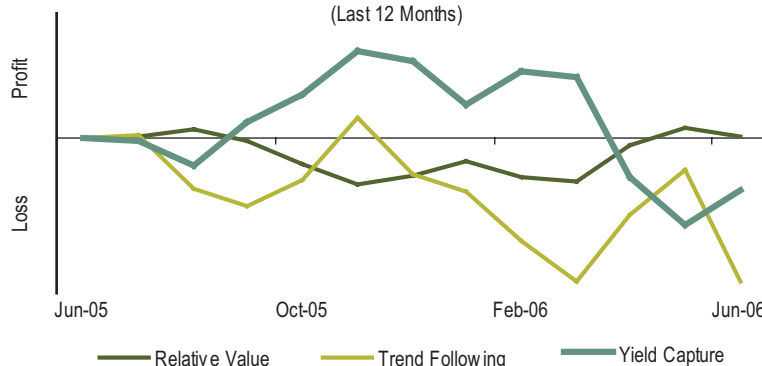


Source: ABN AMRO

What should be apparent in the chart above is that the reason why active currency management has delivered such a high consistency of returns is that first of all, even naïve forms of the three commonly-used strategies add value most of the time, and that, second, when one doesn’t, the success of the others tends to more than offset any shortfall from the underperforming strategy. There are rare exceptions to this, of course. In the late 1970’s you can see that two of the three would have dragged results below zero. In late 1984 to early 1985, as the dollar soared, relative value underperformed strongly enough to drag overall performance underwater. In 1993, losses from the carry trade were large enough to more than offset gains from relative value and trend following.

Interestingly, and importantly, recent experience has been disappointing because while none of the strategies has suffered significantly, they have each either delivered no alpha, or delivered very modest losses. It appears to be an unhappy coincidence - one that should be expected to occur, but occur infrequently. There does not appear to be anything out of the ordinary about this, and it leaves us with no reason to think that the ability of currency managers to add value has degraded in any way.

Cumulative Returns to Individual Market Inefficiencies
(Last 12 Months)



Source: ABN AMRO

In Brief

What we have seen recently in terms of currency managers in general struggling to add value should not surprise us. The underperformance is the result of the three inefficiencies most often exploited by managers all delivering losses at the same time as they coincidentally go through the expansionary phase at the same time.

The fact that we at First Quadrant have not undergone the same cycle simply highlights the fact that our approach to managing currencies is quite distinct from most other currency managers. Much of our alpha comes from sources that are out-of-mainstream. We don't use a trend following approach because we think we've been able to identify explicitly some of the fundamentals that serve as the root cause of trend following. By focusing on the cause (the fundamentals) rather than the effect (the trend), we're not buying and selling the same currencies at the same time as the trend followers a good portion of the time. We don't use the carry trade either, as there again we believe we've identified what it is that makes the carry trade work when it does, and makes it fail when it does. We use that relationship instead, and that means that we are often positioned differently than those who use the carry trade.

We do use relative value as most managers do. Like all managers, we have our own unique approach to valuing currencies, but the fact of the matter is that we have some degree of common exposure to the performance of valuation in the currency markets. Valuation has not worked this year, and that has been a contributor to our own performance being disappointing at the same time that other managers' performance has, on average, also been disappointing. That will happen from time to time.

This leads to a final point that we think deserves focus in closing. When performance in an active strategy is poor, it is important to know why so that one can judge whether a recovery is more or less likely to lie ahead. For some inefficiencies,

their expansion represents a stronger promise of reward than others. For some, like valuation, they aren't particularly sensitive to changes in the state of the world, which means that if the inefficiency has built up, it is highly likely to ultimately contract and deliver its expected reward. While other inefficiencies develop or expand, changes in the state of the world can have a greater impact upon whether the reward is ultimately realized or not. Take momentum, which is more subject to this risk, as an example. When momentum has failed to work, the opportunity has usually just passed by. The alpha lost is alpha forever lost. The fact that valuation has underperformed this year, means, on the other hand, that the opportunity has built up and is highly likely to be realized (i.e. the alpha lost is alpha saved).

We can't know when dawn will come, but come it will for currency managers in general, we're sure.

First Quadrant, L.P.
800 E. Colorado Boulevard, Suite 900, Pasadena, California 91101
626.683.4223
Marketing Services: FQ_Updates@firstquadrant.com
www.firstquadrant.com

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