ABOVE AVERAGE?  
Measuring the Currency Managers

THE CURRENCY MANAGEMENT INDUSTRY HAS LONG SUFFERED FROM THE ILLUSION THAT IT UNDERPERFORMS – MAINLY DUE TO TROUBLES AT SOME HIGH PROFILE FIRMS. THERE IS MORE TO THE STORY THAN THAT OF COURSE, AND A NEW REPORT IS ATTEMPTING TO MOVE THE DEBATE ON BY ASKING THE THORNY QUESTION: DO PROFESSIONAL CURRENCY MANAGERS BEAT THE BENCHMARK?

Much of the debate surrounding the success or otherwise of the currency management industry stems from the fact that there is no designated benchmark against which to measure it. This is in part due to the long-held belief, which has more than a degree of truth in it, that because currency markets are uncorrelated with most other asset classes, there is no way to benchmark returns beyond what the money could earn in either cash or other assets.

A recently-released preliminary paper authored by Mnomchil Pojariliev of Hermes Investment Management and Richard Levich from the New York University Stern Business School, seeks to advance the debate by studying the performance of an index of professionally managed currency funds as well as a sub-set of individual managers, against the returns generated by four of the most popular strategies available to investors.

Into the bargain, the authors also, perhaps unwittingly, put forward arguments for some investors to place their money in exchange-traded funds (ETFs) rather than with professional currency managers. It should be stressed that this suggestion is only put forward as an alternative to those currency managers merely following one of the four basic strategies – carry trading, trend following, value trading and volatility.

A key ambition of the paper seems to be in raising the level of study into currency manager returns beyond previous levels, specifically the many studies that have identified all excess returns as alpha. If currency is an asset class as it is claimed in many areas, the authors suggest that a set of factors should be identifiable that correlate with manager returns. “In this paper, we measure the extent to which currency managers’ returns correlate with four factors that are intended to represent feasible benchmark returns from distinct styles of currency trading,” they state.

The authors investigate returns from funds in the Barclay Currency Trader Index (BCTI) as well as those of 34 individual currency managers between 1990 and 2006 and find that a “substantial part” of returns from both sectors can be explained by systematic exposure to the four factors, which are carry, trend, value and volatility. In other words, these returns represent “style beta”, the authors argue.

By studying returns over such a large period, the authors are able to dilute the impact of strategies that are “temporarily” popular. For example they note that the carry trade became much more popular after 2000, but the trend following strategy remained the most dominant factor. Equally, while managers suffered from being negatively correlated to the value factor (mainly defined as purchasing power parity or PPP) in the 1990s, since 2000 the authors find that manager returns are “positively and significantly related to the volatility factor”.

Overall, the study finds that 97% of the variability in monthly returns on the BCTI can be explained by the authors’ four factors. It is a slightly different picture when studying individual managers. The authors find that since 2000, eight of the 34 managers achieved statistically significant excess returns over the four factors’ returns.

As far as the BCTI is concerned, because all the funds in the index are absolute return the authors use the one month LIBID rate to proxy the risk free return available on the assets under management. They find that the mean monthly return on the index is 0.62%, which equates to roughly 7.3% per annum over...
the 17 year study period. This translates into a mean monthly excess return of 0.25%, which is similar to returns on the Citibank beta1 G10 Carry Index (which the authors use to proxy the returns from a carry strategy) and the AFX Index (which proxies the returns for trend following strategies) which averaged 0.15% and 0.21% per month.

The authors study returns of the BCTI versus all possible combinations of the four factors and report the results of the most relevant combinations rather than all. They find that the BCTI most reflects the trend strategy across both 1990-2000 and 2001 to 2006.

“The intercept term, our indicator of alpha after accounting for other systematic risk factors, is -16 bps in the first sub-period, in the second period, the intercept term is -11 bps,” the authors reveal. “Thus in both sub-periods, most of the variability in returns on the BCTI can be attributed to our four explanatory factors, with nothing attributed (on average) to excess performance or alpha.

Interestingly, despite the talk that recent years have been more challenging for active currency management, our analysis shows that the average alpha return has been negative not only after 2000, but also in the 1990s. The average alpha is even “higher” after 2000 (-11 bps per month) than in the 1990s (-16 bps per month). After 2000 we have witnessed a substantial decline in the returns generated by the trend strategy. Thus, in the post-2000 period, beta returns have declined substantially, while alpha returns have remained similar.”

INDIVIDUAL FOCUS

As well as studying and benchmarking returns against the BCTI, the paper also performs the same task against 34 individual managers within the index that have a six year track record spanning January 2001 to December 2006.

“The average excess annual return for all 34 managers is positive, ranging from 0.80% to 22.98%. This broad range of outcomes highlights a well-known aspect of currency management. There is a lack of standardised mandates and risk/return profiles vary substantially across different clients,” the paper states. “Therefore it is very difficult to compare one currency manager with another.

When studying the individual manager returns the authors create an alternative Information Ratio mainly because of their assertion that the traditional method of computing the Information Ratio (typically the annualised excess return divided by the annualised standard deviation of the excess returns) can be misleading because it assumes that the risk free return is a good benchmark.

Having studied the returns of the 34, the authors find that only eight managers exhibit positive and significant alpha. They also find that the highest exposure remains, as is the case with the BCTI, towards the trend following factor, which is significant for 15 managers. The carry factor is significant for eight managers, while value is significant for only seven and the volatility factor for just five.

Elsewhere, 21 managers have a significant exposure to at least one of the four factors, nine to at least two factors and two have significant exposure to three factors. One manager is exposed to all four. “This implies that managers have been diversifying across different styles by having exposure towards more than one style factor,” the authors say.

Having noted that, they go on to reveal that 13 managers have no significant exposure towards any one style factor, and as such they may be classed as “true alpha chasers” or may offer strategies outside the four factors.

A POSITIVE RETURN?

In summary, the paper finds that the average monthly alpha of the BCTI is -9bps after taking into account the four beta factors. It also finds that the average excess returns generated dropped significantly from 36bps per month in the 1990s to just 8bps in the 2000s and that currency managers were not able to generate a positive alpha on average.

“Despite all the talk that the recent years have been more challenging for currency management, we have witnessed a decline only in the beta returns,” the authors state. “The average alpha has remained almost the same: -16 bps per month in the 1990 and -11 bps per month after 2000.”

It is not all bad news, however, for they stress that 24% of managers were able to generate positive and significant alpha between 2001 and 2006 (something that is important among the ‘what have you done for me lately?’ school of investors). The average alpha of this 24% of managers has been 104bps per month after taking into account the four factors influence or 12.48% per year. “This demonstrates that currencies have similarities with other asset classes whose returns can be related to risk factors,” the authors state. “Although, the average manager might under-perform, there exist some skilled managers who are able to deliver significant alpha.”

In conclusion, the authors suggest that the results “support the notion that the foreign exchange market offers opportunity for alpha generation. However, greater emphasis should be put on ‘active’ in currency management. Our factor model makes clear that all returns generated by currency managers are not pure alpha. A significant part of currency returns comes from exposure to a small set of factors that proxy the returns from well-known and easily implemented trading styles.

“Such realisation may lead to some re-pricing for “active” currency products,” they continue. “It will be difficult to justify a 2% management fee and 20% performance fee for exposure to currency style betas when exposure to equity style betas might be gained for 3 to 10 bps.”

The paper appears to support the contention often expressed in the industry that currency managers are suffering due to the dominance of trend followers which have declined in performance terms since 2001.

In terms of currency managers seeking to build assets under management, the message seems to be clear – be different. As the authors of the report note, exchange traded funds are increasingly
available to proxy the returns from basic currency trading strategies, therefore investors can capture these returns with minimal cost. “In our framework, professional currency managers who simply mimic the strategies embodied in our four factors are unlikely to earn alpha,” they state. They might as well add that those managers are equally unlikely to grow assets under management.

*The views in the paper are those of the individual authors and should not be interpreted as reflecting the views of Hermes Investment Management or New York University.