Special FX

An asset class worth exploring

The scale of the current financial crisis and the turmoil in traditional financial markets has focused investors' minds, Cormac Naughten suggests that foreign exchange – also known as FX or the currency markets – may be an alternative asset class in its own right

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If you watch Bloomberg TV or read the financial press nowadays, you cannot fail to notice the sheer number of adverts for a variety of FX platforms and the increase in coverage devoted to the opportunities afforded by FX trading or investments.

FX is the largest financial market in the world with some $3.2 trillion a day traded, according to the Bank of International Settlements' (BIS) last Triennial Survey in 2007. Together with this deep liquidity, FX also provides continuous price action with the market trading 24 hours a day aside from weekends. In addition, actively managed currency investments tend to have little or no correlation with stock and bond markets. Despite the recent equity market rally, for retail clients and their professional advisers who are looking to diversify portfolios, FX is now something to consider as part of an overall portfolio.

A changing sector

Yet this was not always so. The picture a decade ago was very different. Back then few retail investors thought of investing in actively managed FX strategies let alone trading FX themselves. Many financial advisers and the press spoke guardedly of both the riskiness of currency markets and the high levels of volatility as impediments to getting involved. So what has changed?

The answer lies partly in the development of FX itself - which still remains a relatively recent phenomenon – and partly in the evolution of new communication technologies. Up until the collapse of the Bretton Woods agreement in the 1970s, exchange rates were not free floating but rather fixed on rigid scales. Even after this, FX remained an exclusive club - the preserve of investment banks, hedge funds (or their forerunners) and large multi-national corporations.

Barriers to entry for retail clients were considerable with limited numbers of account providers and high minimum account/trade sizes. All of this is before you consider the high cost to non-bank participants in accessing the latest news and financial data in the days before rolling 24 hour news coverage - let alone access to free or low cost charting and technical analysis packages before the widespread availability of broadband internet access.

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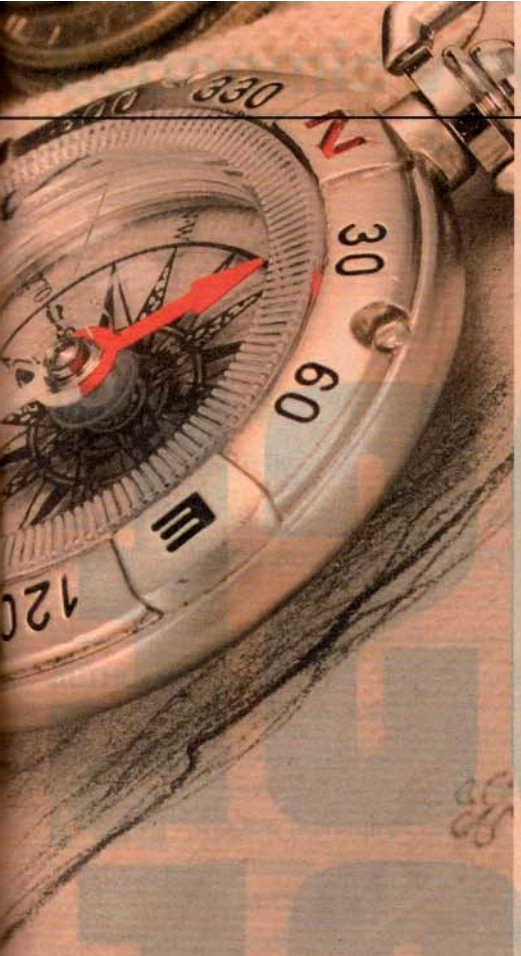
It is the internet which has democratised FX, allowing mass market access to this asset class via spread betting accounts with hundreds rather than thousands of pounds and margin FX accounts for thousands rather than millions. The number of online platform providers of both has exploded – just look at the adverts in the FT or the specialist investment magazines such as Shares or the Investors Chronicle or do an online search to get an idea. These accounts can be set up and traded almost immediately once funded and many tend to come with free access to charting packages, research and news feeds together with the actual



platform to execute trades instantly online at real time prices with very tight spreads.

How best to access the market

The key issue for many advisers and their clients now is how best to access this market – whether to attempt to direct their own trading or to employ professional currency managers. Experienced traders or willing enthusiasts with well thought out strategies that give them a perceived edge, allied to tight risk management skills to control losses, have seen highly profitable opportunities in the last few years. Unfortunately they would seem to be the minority if you believe the hoary old cliche amongst FX professionals that 90% of retail clients suffer a total loss of funds when their FX trading is self directed. Certainly the average life span amongst retail traders has traditionally been limited in duration for reasons such as lack of expertise and resources and for many simply the lack of time to devote to trading a 24 hour market.

The alternative is to gain exposure to FX as an asset class via a professional money manager with a managed FX product. In the last decade the variety and sophistication of these products has increased dramatically and there are many alternatives. For professional advisers looking to provide best advice to their clients, these products need to be evaluated carefully in order to provide the best match with the individual client's requirements and risk tolerances.

A multitude of choices

There are now many specialist currency funds and hedge funds available, although many of the top performers have high minimum investment requirements of at least $1 million. Not only does this exclude many retail clients but advisers also need to bear in mind the ease of redemptions in the current climate and that many funds do not offer investors immediate access to their funds. For investors, looking for such liquidity can be prohibitive.

Turbulent markets combined with risk averse clients have enhanced the attraction for some advisers of capital protected products, with the twin advantages of lower minimum investments from £50,000 upwards and the security of capital protection for 100% of the investment provided by a leading bank or financial institution. The price paid for this is often tying up funds for periods of up to five years, with the likelihood of redemption penalties for early withdrawal. When taken together with initial entry charges of anything from 2-5% and associated annual management fees on top, this can diminish the attraction for clients who may wish to have rapid access to their capital.

It should also be remembered by advisers - and communicated clearly to their clients - that capital protection and a guaranteed return of 100% of the client's capital at maturity are two slightly different things. As the recent examples of products with either AIG or Lehman Brothers as the provider of the capital protection illustrates, the strength of this protection is only as strong as the underlying provider. A number of private banks have discovered to their cost that their sales process did not cover this point adequately.

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In addition to immediate access, security of funds is also high on the agenda for many investors following the widespread coverage of Ponzi schemes such as those run by the likes of Bernie Madoff. Managed accounts can offer a solution which allows clients to resolve many of these difficulties. Clients can secure:

- Control over their funds - immediate access to and hence control of their funds by having accounts set up with online platforms in their own name and then allowing the currency manager to trade via a Limited Power of Attorney.
- Security of funds by choosing the platform the account is traded on. For example, dbFX is the retail platform of the mighty Deutsche Bank – the world's largest FX bank.
- Account transparency as trades can be monitored on the platform allowing profit and losses to be seen both easily and quickly.
- Notional funding – rather than depositing the full investment amount, the client can use cost free leverage to deposit say 10% as initial margin.

But the risks of trading losses through unsuccessful investment management still remain. Whilst these risks to capital are unavoidable unless the client wishes to have some form of capital protection and is prepared to pay the price for this, a robust due diligence process for vetting and selecting the currency manager(s) can reduce this and other risks such as fraud.

Whatever the type of managed product, advisers should ask a number of questions about any prospective manager. Although by no means an exhaustive list, advisers and clients should be aware of, or consider the following:

- Track record – does the manager have a history of managing actual currency investments or are they presenting a new programme with back-tested proforma results. If so the adviser will need to reflect whether such investment results are likely to be replicated.
- Expertise – what is the background of the investment team? Where have they worked previously and how credible are these institutions?
- Longevity – how long have the members of the team been managing currency investments? How long has the firm itself existed?
- Operational stability – does the management firm have a proper operational infrastructure? Is there actually a "team" or does the whole firm rely on one or two individuals without adequate cover?
- Financial stability – check the firm's accounts to check on their financial resources.
- Regulation – is the firm authorised and regulated by the FSA (for UK firms) or by a home based regulator? Are they or client accounts covered by the UK's Financial Services Compensation Scheme? If the product itself is not regulated then ensure the client is aware of this before they invest.

FX is a continually evolving marketplace. As such, FX as an asset class will offer both advisers and their clients even greater opportunities as more and more new products are developed. It remains just one of the many asset classes they should consider but could be regarded as a complementary part of a balanced portfolio providing much needed diversification in uncertain times.

Whilst some will wish to harness this under their own steam, for the majority - particularly those looking to invest larger amounts – their advisers will play a crucial role in the selection of a professional manager and the most appropriate product. ■