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FX·Invest

Foreign exchange – the new safe-haven

If anyone needed any more reason to seriously think about employing a foreign exchange policy, then September should just about have done it.

The worsening crisis in the eurozone, compounded by the rating agency downgrade of the US, had already led to the kind of risk sell-off not seen since October 2008. But so desperate became the search for a safe haven, that the seemingly unstoppable rise of the Swiss franc forced authorities there to peg the currency to the euro, in a shock move on September 6 that wiped off nearly 9% from the franc in 15 minutes (see page 18). But does central bank intervention really damage trend-followers? Insch Capital Management's Christopher Cruden and Purnur Schneider believe to the contrary (page 24–26).

Certainly, the continued search for cover – and yield – has led to a plethora of investable emerging markets currencies indexes aiming to offer diversification away from developing economies (see page 18 to 20). But while the emerging markets have largely played into the hands of decoupling theorists post-crisis, risks clearly do exist. Russell Thompson, chief investment officer at emerging markets specialist The Cambridge Strategy, discusses his disciplined approach to risk management – which saw his Asian currency fund up almost 6% during a tumultuous September – on pages 22–23.

With all eyes on Asia to pick up the slack, we look into the development of the electronic market-place, and what the implications of regulations demanding proof of best execution will have on the single and multi-dealer platforms in the region (pages 14–16).

Already in the US and Europe, dealers say clients are increasingly demanding more intelligent ways to execute trades into the market, leading to a proliferation of execution algorithms (pages 10–12). Taking it a step further, the Royal Bank of Scotland has rolled out a world first – an algorithm that automatically hedges gamma sensitivity of foreign exchange options for clients (page 8).

Ultimately, in an environment when correlation between asset classes is becoming more pronounced than ever, foreign exchange presents not only a way to generate uncorrelated returns, but also to protect what yield might have been obtained in international asset portfolios.

Saima Farooqi, Editor

CitiFX launches multi-manager platform for investors seeking currency alpha

■ **CITI LAUNCHED A NEW** multi-manager platform called CitiFX Access on September 14 that aims to facilitate investment in foreign exchange managers via multi-strategy benchmark and actively managed indexes licensed from industry index sponsors.

Anil Prasad, Citi

The sponsors include BarclayHedge, Parker Global Strategies, Absolute Return Strategies and Quaesta Capital, which will work with Citi to create a range of investable products for investors seeking to capture FX alpha.

The returns of these indexes are driven by the performance of the currency programs – of which 35 programs estimated to account for more than 50% of the assets under management in currency funds will be represented.

Institutional investors will be able to invest in the BarclayHedge BTOP FX Index and the Parker Global Currency Manager Index. Meanwhile, Absolute Return Strategies will provide diversified currency alpha by actively allocating to different trading styles, and Quaesta Capital will offer a thematic approach via its Global Growth, Momentum and Market Neutral multi-manager indexes.

At launch, Anil Prasad, global head of foreign exchange and local markets at Citi in London, said that with cross-asset diversification drying up, all potential sources of returns need to be considered and liquidity becomes an increasingly important criteria.

Other products available include the Alpha Blend family of indexes, created by John Dean, chief executive at Absolute Return Strategies. It consists of eight to 10 managers with an emphasis on low downside risk by allocating to uncorrelated trading styles. Pablo Frei, head of FX multi-manager programs at Quaesta Capital, has taken a different approach by developing style-centric indexes that aim to match specific needs of clients.

Citi will make the indexes available to institutional clients through index swaps and funded structures. The bank said the platform will address the portable alpha and alternative investment needs of real money managers, sovereign wealth funds, high-net-worth individuals and pension fund portfolios.

FX-linked products gain traction in Hong Kong

■ **THE CLAMPDOWN BY HONG KONG'S** securities regulator on some forms of structured products, including those referencing equities, coupled with market uncertainty in the US and Europe has bolstered investor demand for currency-linked structured products in Hong Kong.

The Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011 implemented in May this year requires advertisements and offering documents for structured products to be authorised by the Securities and Futures Commission – the local securities watchdog. However, offer documents made in respect of currency and interest rate-linked instruments are exempt from the ruling.

"Right now, investors are not positive on equities and long-term investments are not in demand," says Angel Wu, head of products and solutions for Asia at ABN Amro Private Banking in Hong Kong. "In the post-Lehman Brothers environment, interest has been for short-tenured instruments in Hong Kong, Singapore and Indonesia. Currency-linked products will continue to be popular as current bond and equity yields are at an all-time low."

Investors had held structured product investments issued by Lehman Brothers or referencing the defunct investment bank, which saw their value plummet. The public backlash resulted in new tighter structured product issuance rules, which some market participants say makes equity-linked products harder to sell than currency-linked products in Hong Kong.

However, this is not such a problem in rival private wealth centre, Singapore, where the treatment of 'sophisticated' investors is different from Hong Kong. "In Singapore, private banking clients are exempt from regulatory approval and the selling process is different to a private versus retail client," Wu said.

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In brief

Integral releases first hosted FX ECN aggregator

Integral is in the process of adding Reuters Matching to its list of electronic communications networks on its foreign exchange aggregator, FX Grid, according to officials. FX Grid enables traders to access liquidity on EBS, Hotspot, CME and Bloomberg Tradebook. The system is offered as a service hosted by Integral and charges fees based on trading volume. Go-live details were unavailable.

Liquidity aggregation wins out in FX

The deeply fragmented foreign exchange market has resulted in wide adoption of liquidity aggregation systems, indicates research from technology vendor, StreamBase.

According to a survey of 135 sell- and buy-side FX traders, around 94% of respondents currently have some liquidity aggregation capabilities in their FX trading systems, compared with 65% in 2010. The vendor found 34% of respondents plan to improve or add liquidity aggregation capabilities in their FX trading systems, compared with 26% last year.

Of those surveyed, 31% of respondents plan to improve or add algorithmic order execution and management capabilities in their FX trading systems.

FXall offers EQA buy-side benchmarking tool for transaction cost analysis

INSTITUTIONAL FOREX TRADING platform FXall has formally launched its new buy-side benchmarking tool, Execution Quality Analysis (EQA), after a 12-month period of client testing and development.

EQA is a form of transaction cost analysis (TCA) technology developed exclusively for institutional foreign exchange traders to help them analyse their strategies and identify opportunities to improve performance.

The EQA product reviews the results achieved using the execution mechanisms and liquidity providers available on FXall, providing a comprehensive summary of spot, forwards and swap trades executed during a given time period. It covers the most actively traded currency pairs, according to FXall's New York-based chief executive, Phil Weisberg.

"We have been piloting this for some time with a select group of clients and getting their feedback, and we feel we have arrived at a standard set of reports, endorsed by clients, so we are ready to distribute it more widely," says Weisberg.

TCA in equity markets has been increasingly popular on buy-side trading desks in recent years as it enables traders to prove best execution. Although a number of providers have made efforts to extend their TCA offerings to FX, it is far more challenging to do TCA in FX than in equities, says Weisberg.

"The standard TCA methodology in equities is based on robust data from all venues. When you're trying to accomplish the same objective in an over-the-counter market such as FX, you have additional complexity, as there are so many more ways in which trades can be executed and the market data is much more fragmented. In developing EQA, we were conscious that bad data is worse than no data at all, so we have really tried to hone our reports to make sure they are genuinely useful for clients," says Weisberg.

EQA is FXall's first exclusive product in this space, although it has previously provided data for a similar venture. In May 2010, New York-based e-trading provider Investment Technology Group (ITG), which specialises in TCA for equities, launched ITG TCA for foreign exchange, based on benchmark data provided by FXall.

Earlier this year, ITG revealed it was working on a second phase of the product as clients had demanded a broader set of benchmark data than that provided by FXall. "We have discovered from talking to our clients that the desire for a foreign exchange TCA product definitely exists, but the demand for breadth and depth in that service is certainly more than we would have anticipated working solely with FXall," ITG managing director Ian Domowitz said earlier this year.

CLS makes Butor European regulatory head

CLS GROUP HAS APPOINTED Gabor Butor as head of European regulatory affairs, a newly created role.

Butor will join the executive management team in London and report to Alan Bozian, chief executive of CLS Group, and president and chief executive of CLS Bank. CLS Bank is a multi-currency cash-settlement system that eliminates settlement risk in the FX market.

Butor will look to develop relationships with key regulators in Europe, at a time when policy-makers are finalising their rules on derivatives trading, clearing and data reporting.

The European Parliament and Council of the European Union are both close to completing their versions of the European Market Infrastructure Regulation (Emir), which will then be combined into a single version, in consultation with the European Commission.

Butor was previously financial services European Union adviser for Hungary's Ministry of National Economy.

Kiel joins UBS Global Asset Management

RICH KIEL, GLOBAL HEAD OF post-trade services at Thomson Reuters, has left the firm to join UBS Global Asset Management as managing director and global head of investment risk solutions.

Kiel relocates from London to New York and reports to Curt Custard, head of global investment solutions at UBS Global Asset Management. He had been at Thomson Reuters for five years.

UBS Global Asset Management declined to comment.

VanderMeulen joins multi-asset brokerage

EISSO VANDERMEULEN HAS JOINED the prime-brokerage origination and structuring team at Newedge to help expand its foreign exchange prime-brokerage business.

VanderMeulen reports to Jonathan Gane, head of origination and structuring for the Americas, and Andy Waterworth, head of fixed-income and currency strategies in London.

VanderMeulen is based in New York and joins from futures brokerage RJ O'Brien, and was previously head of FX prime brokerage at ABN Amro in Chicago from 2000 to 2008. Before joining ABN's prime-brokerage team, he was head of credit trading and has also worked as a relationship manager in the Dutch bank's financial institutions group, covering insurance and asset managers. He started his career in 1989 in commercial lending.

Thomson Reuters extends Elektron hosting to FX

THOMSON REUTERS IS TO EXTEND the reach of its Elektron proximity hosting and connectivity service to include the Matching spot trading platform as well as other third-party FX liquidity pools and pre- and post-trade applications.

Thomson Reuters Elektron, launched in April 2010, aims to reduce latency and increase efficiency for speed-sensitive clients by hosting the matching engines of platforms, service providers and clients in a cloud-based architecture.

To date, Elektron has mainly focused on eliminating latency for equity traders by connecting the matching engines of exchanges, but the extension to FX is a natural development because of the growth of high-frequency trading in the asset class, according to officials at Thomson Reuters.

"The foreign exchange market-place is hungry for better performance, lower cost, better execution and more transparency, so it's a natural step to bring these two capabilities together to deliver a more complete trading solution and support the most advanced FX trading strategies," says Jon Robson, president of enterprise solutions at Thomson Reuters in London.

Robin Poynder, Thomson Reuters

While the first step in the extension of Elektron to FX will be to provide connectivity to Thomson Reuters Matching, the vendor is also inviting other FX liquidity pools to join the venture.

For the operators of Thomson Reuters Matching, the extension of Elektron marks a possible boost to its business and its ability to meet the needs of high-frequency trading participants seeking the quickest possible execution.

"The models used today by high-frequency traders are based on exceptionally fast decision-making and the ability to execute sub-millisecond. The more we can drive latency out of the connectivity process, the more efficient they're able to be and the more they can refine their models to trade in the way they want to trade," says Robin Poynder, head of FX and money markets for Europe, the Middle East and Africa at Thomson Reuters in London.

But Elektron is not the first proximity hosting service to target the FX market. In 2006, Thomson Reuters Matching's main competitor, Icap's EBS, launched i-Cross, a similar service for spot traders in North America, Europe and Japan. In a similar way to Elektron, i-Cross reduces latency for EBS users seeking to trade on the platform or simply to access its market data services.

In an effort to further cater to the requirements of high-frequency traders, Icap began quoting decimalised prices on major currency pairs on EBS in March. This is a step Thomson Reuters has resolutely avoided taking, citing a lack of client demand.

While the primary aim of extending Elektron to include Thomson Reuters Matching is to appeal to high-frequency users, Poynder believes it will also benefit manual users by reducing bottlenecks for customers accessing the platform from outside the main FX centres. As Matching currently operates in 45 countries, there is a need to ensure access is equally efficient wherever it originates, he says.

"Manual users will benefit from the increased liquidity we believe this change will bring. It will be a key step in melding together the different communities that use the platform across 45 countries. Enabling that wider community to connect alongside high-frequency users is very important," says Poynder.

Short volatility strategy pays off in August

CURRENCY MANAGERS GOING SHORT volatility in August would have been top performers, benefiting from a spike in volatility towards the end of July from the dual effect of the US and European sovereign debt crisis, according to research from Royal Bank of Scotland.

The bank's naive simulation of the currency strategy generated a return of 4.9%, with all short straddles, with the exception of CAD, put on at the end of the month making a profit.

In August, the US dollar gained against most currencies in the midst of softening global economic data, as well as from market turbulence exacerbated by the S&P downgrade and ongoing European sovereign debt concerns. CAD and AUD suffered the most against the greenback, alongside SEK, GBP and CHF. However, EUR did manage to post a marginal gain, together with bigger ones from NOK and JPY.

The value strategy also offered a gain of 1.5% with only a long yen position against USD. The NOK position was short and was the biggest loser. All other currencies followed their spot movements and posted gains, with CAD and AUD being the stand-out winners.

Biggest losers were trend-followers, which made a loss of -5.9% as a result of the large amount of volatility last month. "However, the strengthening yen and the fact that its position was held throughout the month meant it came out as the biggest winner, whereas AUD was the biggest loser," says Theodore Chen, in the quant solutions group at RBS in London.

Chen says that in the yield strategy, it was a game of two halves for the two main drivers of its P&L. Both NOK and AUD posted losses in the first half of the month, but NOK more than erased its deficit to end up with a gain in the second half. AUD had a big fall largely due to the unwinding of its carry trade position from risk aversion.

Hong Kong regulator moves to authorise renminbi products under RQFII

THE SECURITIES AND FUTURES Commission (SFC) is poised to authorise retail products issued as part of the renminbi qualified foreign institutional investor (RQFII) scheme announced by Chinese vice-premier, Li Keqiang, on his visit to Hong Kong in August. The RQFII programme will allow foreign investors to use offshore-raised renminbi to buy mainland securities, with an initial limit of 20 billion yuan ($3.1 billion).

SFC acting chief executive, Alexa Lam, says she believes the renminbi bond market will take off when the new foreign direct investment measures are in place permitting renminbi raised or borrowed in Hong Kong to flow into the mainland for direct investment.

"The RQFII will add breadth to Hong Kong's existing product range. More importantly, it gives the Hong Kong pool of renminbi a new form of direct access into the mainland A-share and bond markets," Lam says. "This may in turn attract more outside investors, and their liquidity, to the Hong Kong renminbi platform. Although the initial quota is small, the expectation is that once the products are launched and the mainland regulators become more comfortable with the initiative, the quota size, and the scope of quota recipients, will grow," she adds.

"The RQFII will add breadth to Hong Kong's existing product range" Alexa Lam, SFC

SFC chairman Eddy Fong says the upcoming products under the scheme are likely to be of low risk, adding the SFC would not impose additional restrictions on the products.

Meanwhile, the People's Bank of China announced that 80% of the total designated 20 billion yuan of RQFII will be invested into mainland bonds. Priority on bond issues will be granted to Hong Kong-based operations of mainland fund management companies and securities firms, the central bank officials add.

Joanna Munro, chief executive for Asia-Pacific at HSBC Global Asset Management, says there is a growing demand for renminbi bonds globally. "Our existing RMB Bond Fund has grown to around $500 million in size, and in addition to other RMB products for North America, we will be launching a Luxembourg-domiciled RMB bond fund later this year, which will be sold across Europe," she says.

HSBC targets booming global demand for Asia products

HSBC HAS APPOINTED APRATIM Chakravarty as managing director and head of offshore Asian product distribution, global markets Asia-Pacific.

In the newly created role, Chakravarty will enhance the existing Asia asset class product offering to meet the increasing demand for Asian FX, rates and credit products among clients outside Asia-Pacific, the bank said on September 20.

"This is a new role born out of an initiative to capitalise on the increased global demand for Asian assets and products among investors within the developed markets. HSBC is strongly positioned to connect Asia's markets with the world and we will continue to tailor our finance solutions to meet the evolving needs of customers globally," says Gordon French, head of global markets, Asia-Pacific in Hong Kong.

"HSBC is strongly positioned to connect Asia's markets with the world"
Gordon French, HSBC

Chakravarty is based in Hong Kong and reports locally to Monish Tahilramani, deputy head of global markets, Asia-Pacific and head of regional trading, and Justin Chan, deputy head of global markets, Asia-Pacific and head of Hong Kong trading. In EMEA and the Americas, Chakravarty is accountable to the respective regional heads of institutional and corporate sales.

Before taking on his new role, Chakravarty was in Jakarta, where he had been head of global markets since 2007. Prior to that, he was head of corporate sales for India.

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RBS launches gamma hedging algorithm for forex clients

A push for greater automation in forex options trading has seen the Royal Bank of Scotland release a new algorithm designed to automatically hedge gamma sensitivity of foreign exchange options. Mark Pengelly reports

ROYAL BANK OF SCOTLAND (RBS) has launched a spot forex trading algorithm designed to help clients automatically manage the gamma sensitivity associated with forex options portfolios – a task it claims can absorb 20% or more of an option trader's time when gamma hedging is conducted manually.

"It is an algorithmic trade engine that understands gamma," says Tim Carrington, the bank's London-based global head of FX.

Dubbed RBS Agile, the tool can be used in various ways, but the simplest application is to monitor the gamma of an option's position and automatically buy or sell spot FX to ensure the gamma remains within predetermined boundaries. Gamma measures the change in an option's delta relative to a change in the underlying.

The bank is not doing this altruistically – the algorithm is plugged into FX Stream, its existing electronic forex trading platform, so it will help drive volume to RBS trading desks. In addition, competition over the provision of algorithms is becoming a new battleground for dealers, as more markets and products – including over-the-counter – switch to electronic trading (see pages 10–12).

"Banks need to offer more of a one-stop-shop approach to clients. Clients are no longer going to want to transact with 11 different banks. They're going to look at banks that can offer them a broad suite of products – and banks can no longer rely on price to be the differentiator," says Carrington. He claims RBS Agile will be the only algorithm of its kind available to clients.

That will probably change, however.

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Tim Carrington, RBS

"It's an interesting product and it's something we'd like to offer," says one New York-based forex e-trading head at a major dealer. He adds the bank's own options traders use a similar in-house tool to help manage gamma.

Likewise, RBS Agile started life as a time-saving device for RBS options traders, and Carrington says it helped reduce the workload substantially, freeing traders to focus on clients. In normal conditions, around a fifth of a trader's time can be spent on spot trades to balance up the gamma position – with that burden increasing as markets become more volatile, he says. "Firms don't always trade gamma on a mathematical basis. Some traders typically spent a lot of their day hedging gamma when they could better optimise their time bringing value-added expertise to clients."

The bank has already tested the product with a small group of clients. "It's a very positive and promising tool, which will probably be useful for a number of players in the industry," says one volatility trader at a New York-based asset manager.

The firm has been using the product to hedge its options portfolio – and has been pleased with the results, the asset manager says. "It takes inputs about the level at which we would trade. When our delta gets to a certain level, it transacts hedges in the spot market. The product automatically does a lot of the things we would do intra-day in terms of hedging, so it takes away a lot of the work we would otherwise have to do," he says.

Another agrees. "I have been in the industry for six years, and this is the first time somebody has proposed a product like this. It's a small change but it makes a big difference," says a trader at a major Canadian pension fund.

Although Carrington expects the bulk of clients to use RBS Agile to hedge their options exposures, its ability to understand the spot implications of gamma means it can also automatically replicate the payout of an option by executing a series of spot forex trades. "One of the advantages is that it allows you to trade synthetic options portfolios. You don't necessarily have to trade the underlying options," says Carrington.

Instead of buying an option, RBS Agile will purchase an amount of spot forex corresponding to the initial delta of the option it is replicating. This cash position will then be adjusted up or down, so the cash position always matches the delta the option would theoretically have. If the option finishes in-the-money at expiry, the client would have bought the full face amount of the replicated option. If not, the net cash position would be zero.

RBS Agile can also replicate volatility swaps with different fixings, allowing clients to trade hourly gamma against daily gamma, for example. Carrington believes this functionality will make volatility trading more accessible to buy-side clients that might lack the resources to do it themselves. "It will enable hedge funds and real-money clients to be more comfortable trading volatility, because they will be able to capture and manage the gamma effects more easily," he says.

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Fine-tuning execution

The institutional buy side is becoming more sophisticated in the way it executes FX trades, and algo platform providers are accelerating their investment in new technology to keep up with growing demand.
By Michael Marray

Foreign exchange market participants are predicting a period of rapid change in execution models over the next three years, as institutional use of new algorithmic execution strategies increases.

While a boom in algorithmic-driven execution strategies was predicted four years ago, the 2008 post-Lehman Brothers crash intervened, and for many pension funds, asset managers and insurance companies, fine-tuning their FX execution lagged as focus shifted to managing fixed income and equities portfolios in a highly volatile environment.

By the end of 2010, overall FX algorithmic adoption reached a mere 7%, according to research from Boston-based consultancy Aite Group. But, says Aite, this figure is expected to rise to more than 25% by the end of 2014, driven by the need for greater transparency and operational efficiencies (see box).

High volatility and poor returns in many asset classes has encouraged large institutional investors to scrutinise their costs more than ever, with an unwillingness to give up part of overall returns on poor FX execution. And the gains or losses to be made via execution strategies are even bigger in less liquid emerging market currencies.

Change is not just being driven by cost concerns, but also by regulatory initiatives such as the Markets in Financial Instruments Directive II, which require market participants to clearly show they are getting best execution across all aspects of a securities trade.

James Dalton, director in the algorithmic execution team, CitiFX Intelligent Orders in London, says it is still early days in FX for the algorithmic business, and predicts growth in this area to be exponential over the next 12 to 18 months. The US bank has been one of the heaviest investors in algo-driven FX products, having begun offering complex algorithmic-driven FX trading strategies since 2007. These include trading, risk management and reporting tools for clients ranging from more passive investors such as pension funds, to high-frequency trading shops.

"A buy-side customer may have a multibank execution facility that works well for 60% of its order flow, but may be using it for 100% of order flow. But institutional investors are now getting a better idea of how different types of flows require different execution solutions," he says.

Dalton notes that the 4.00pm London benchmark fixing calculated by data vendor WM, has been an increasingly heavily used execution tool for a lot of passive equity and fixed-income portfolios. The fixing is based on rates provided by electronic FX brokers, Thomson Reuters and Icap-owned EBS, 30 seconds either side of 4:00pm. But more institutions now want to get better execution via algorithms and not just take an average, he says.

"For a pension fund, a first step may be a pricing agreement around benchmark fixings, but they are now looking at taking it to the next level, which means executing at more opportunistic times ahead of the fixing with the help of algorithimic platforms," says Dalton.

An example is the bank's passive execution strategy called Silent Partner, which takes advantage of interbank and CitiFX liquidity. Having calculated the optimal execution horizon, the model consumes liquidity at a rate consistent with the market profile of the currency pair, using a historic granular liquidity map that looks at factors such as time of day, day of week or seasonality. It also dynamically takes advantage of surplus liquidity as it appears.

Another model, Liquid Slice, is a time-weighted price strategy, where the client enters the notional amount and duration of the trade. Liquid Slice then breaks up the order into appropriate clips and increments. The strategy is indicative of how advanced algo techniques developed for equities trading are transferring very quickly into FX.

A pioneer of algo execution strategies in the equities market, Credit Suisse leveraged its expertise to roll out in FX as part of its Advanced Execution Services (AES) platform in 2006. The platform uses a pure agency model that charges on commission as opposed to margin on clients' trades.

Jonathan Wykes, global head of AES FX sales at Credit Suisse in London, says there has been a move away from a simple interpretation of best execution compliance, where a pension fund would traditionally line up five banks and take the best price. "This approach fulfils their compliance obligations, but at the same time signals to the market exactly what they are doing, and allows banks to show what could be described as their worst best price," he says.

"Instead, real money and pension fund institutional clients are taking a wider view of best practice, and increasingly utilising algo strategies, which can be customised to the nth degree, for example splitting up a large FX trade according to set participation levels. The buy side has become very sophisticated, and it wants to be in control of its strategy, and be able to continuously fine-tune it."

The Swiss bank has been providing post-trade reporting for more than five years, but over the past 18 months, Wykes says, it has stepped it up to a new level in an attempt to make the OTC market more transparent for clients. Again, converting technology from equities into FX, the bank recently launched Instant Colour for FX. "It gives a detailed breakdown of performance, looking at the overall execution profile, the duration of the trade, and spread capture, for example how much of the trade was done inside the bid/offer spread," he says. "We provide extremely granular data for our clients to analyse."

Algorithmic strategies help trade along with the flows, and avoid a situation where a large order moves the market. The client agrees to a participation cap that might for example be set at 30% of flows at any given point in time.

Such concepts have been common on equities execution venues for some years, but in the FX market there is a shortage of information about volumes being traded, so there is a need for algorithms that estimate the volume going through the market.

Dealers offering algorithmic execution tools that only trade on the banks' own liquidity argue that in so doing, clients avoid the risk of trading on a liquity mirage, where the same liquidity is offered across multiple venues. This in part reflects the re-publishing of prices made by market-making banks, by high-frequency traders.

Barclays Capital was one of the pioneers of algorithmic execution in FX with the PowerFill suite of tools it began rolling out in 2006. The orders are only executed against the bank's own liquidity.

Marek Robertson, head of e-distribution for EMEA at Barclays Capital in London, notes that in the decade up to 2010, the FX market was characterised by ever-increasing liquidity, with tightening spreads as extra decimal places were introduced, while electronic trading brought in new participants. However, assumptions about liquidity have been tested by various market shocks since.

"When liquidity becomes challenged, clients want the ability to execute at price

State Street admits to SEC pricing probe

Boston-based State Street Corporation disclosed in its quarterly securities filing on May 11 that the US Securities and Exchange Commission (SEC) and a number of other US authorities are investigating its foreign exchange pricing practices.

"State Street is responding to inquiries from various regulatory bodies regarding its foreign exchange practices. We will co-operate fully with the SEC in its inquiry. We stand behind our business practices and will continue to defend ourselves against any allegations of wrongdoing," says a State Street spokesperson.

In the third quarter of 2010, State Street settled for $12 million with the State of Washington over a contract dispute concerning pricing of FX transactions during a 10-year relationship that ended in 2007. It is also embroiled in ongoing litigation with an Arkansas public pension fund and the State of California over claims it overcharged clients *www.fxweek.com/1562636*.

Rival custodian Bank of New York Mellon is also being pursued by prosecutors in Virginia and Florida, as well as a more recent class action lawsuit filed by the Southeastern Pennsylvania Transportation Authority in March, all relating to allegations of improper FX pricing.

"This is more than just an embarrassment to custodian banks; the litigation will be costly and the greater cost is reputational damage. But fund managers should also take responsibility for what has happened – they need to be savvier. The FX industry has changed dramatically over the past 10 years, but some of these contracts have not been negotiated or updated in years," says Javier Paz, senior analyst at research and advisory firm Aite Group in Salt Lake City.

rather than managing trades via algo tools, and at those times there are typically fewer electronic market-makers out there," says Robertson. "The market is bringing new challenges, and it is important for us to be there in all market conditions, delivering consistency and reliability to our clients."

Similarly, Deutsche Bank also executes algorithmic orders anonymously on behalf of clients into its own liquidity pool. It began rolling out algo-based strategies in FX through its AutobahnFX Algo platform in 2009. "Deutsche Bank has one of the largest global pools of FX liquidity, and we are also connected to a wide range of execution venues," says Cameron Mouat, head of algorithmic execution for FX at Deutsche Bank in London. "This enables us to find real liquidity, rather than execute against high-frequency market-makers."

Citi also has its Ripple model, which was exclusively designed to execute into liquidity drawn from the flows Citi sees directly from clients via its electronic price distribution network.

One of the risks highlighted by Aite to broader adoption is suspicion over the bank's intentions. "There is also the client's natural suspicion over the bank's ultimate intentions behind offering execution algos to clients. In this largely principal-based trading environment, a certain level of convincing is needed to push clients towards leveraging bank-provided algos, which could potentially tighten the spreads even more, thereby hurting the bank's bottom line on a per-transaction basis," says Sang Lee, consultant at Aite Group in Boston.

To that end, and like Credit Suisse, Deutsche Bank also offers many of its institutional clients access to its transaction cost analysis (TCA) product to provide greater transparency on their FX trades. Mouat says the bank is seeing more institutional clients using algorithms to minimise the potential cost of market impact. The bank has a model called Stealth, an opportunistic algorithm that uses advanced quantitative models to analyse market conditions in real time to reduce execution costs.

"The market is bringing new challenges, and it is important for us to be there in all market conditions"

Marek Robertson, Barclays Capital

One high-profile new entrant currently developing an algorithmic platform is Ogg Trading, run by David Ogg, who launched HotSpot FX in 2000 and sold it to Knight Capital in 2006. Ogg Trading has entered a strategic partnership with existing trading system provider Pragma Securities, and will launch before the end of the year. "The disparate pools of liquidity out there are fragmented, and have different styles of trading," says Ogg. "To take one example, a platform may have a last-look provision, while another will have no last look. It gets harder to intelligently aggregate and wrap trades."

Ogg says the single-bank platforms have become more sophisticated and have added new algorithms, with some more advanced than others. "But there is a lot of room for improvement in best execution, and there is a lot of new technology still to come," he says, declining to comment on his own strategies.

The FX market is in for a busy period of development over the next 12 months, as buy-side institutions review their FX relationships and look for new cost-saving strategies. Similarly, a draft of the European Market Infrastructure Regulation directive was voted on in the European Parliament in July, and is on course to be implemented in 2012, while the Markets in Financial Instruments Directive (Mifid) is being reviewed, which will result in Mifid II, probably in 2013. Spot FX is not impacted, though some FX derivatives are, but most large buy-side institutions have already embraced the idea of best execution for the FX component of their equities or fixed-income trades.

BarCap's Robertson says that while the bank has been offering clients algo tools to slice up orders and minimise market impact since 2006, "uptake has certainly increased in the past couple of years, thanks to the influence of equities, as well as regulatory initiatives such as Mifid."

And with total electronic FX volume expected to account for 70% of all FX trading by the end of 2012 – up from 68% at the end of 2010 – coupled with this increased use of algo strategies by institutions, there is currently plenty of business to go round for aggregators, multi-bank platforms and single-bank platforms, as they develop expensive fourth-generation FX tools.

Institutional FX trading platform, FXall, recorded a 37% increase in average daily volume for Q2, 2011 compared with the same quarter last year. Volume in July was up by 49% compared with July 2010, and $140 billion was traded on FXall in a single day on July 27, which was a new record for the company.

This trend towards ever-rising volumes of global FX trading is underpinning the heavy investment needed to be made by firms to keep up with technological change, and the growing use of existing algo platforms. FXInvest

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The multi-dealer route

The Asian FX derivatives business is expanding rapidly, driven by increased participation from financial institutions and hedge funds. While single-dealer platforms have increased market share over the past few years, incoming regulation could force FX derivatives trading onto multi-dealer platforms. Joti Mangat **reports**

Asia-Pacific is now the second-most active region for overall foreign exchange turnover with $1.2 trillion of daily turnover, of which $740 billion are forward instruments, including non-deliverable forwards (NDFs), according to the Bank for International Settlements' (BIS) Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity, published in December 2010. Meanwhile, the emergence of renminbi trading in Hong Kong has helped the city to account for 5% of global forex turnover, up 20% from 2007.

But how much of the Asian activity is happening online? Although the BIS survey doesn't break e-trading volumes down by region, it shows that more than 40% of global forex turnover is executed electronically, with single- and multi-dealer platforms splitting more than 50% of the market-place equally between them. Broker platforms make up the balance. While Asian dealers don't reveal the proportion of their forex business traded electronically, one Hong Kong firm estimated that NDF turnover had grown by 40% over the past three years, with much slower growth in forex options.

James Kow, director and electronic sales manager with Barclays Capital's Barx e-trading platform in Singapore, says investor demand for emerging markets currencies has been a major business development focus for the dealer. "The electronification of emerging markets, especially Asian EM forex has been a key area over the past year to 18 months. Global clients are looking to invest and trade in Asia and volumes in these products have increased. Electronic forex derivatives trading affords investors price transparency and efficient execution in challenging markets and fits a need that clients have been demanding for a long time," he says.

So far, dealers have achieved greater penetration with online NDF offerings than options, although several houses say they offer vanilla and exotic options, including NDF options (NDOs) on Asian forex crosses via electronic platforms. Asian forex NDF investors now include hedge funds, small banks, private wealth managers and corporate clients alongside global institutional players. "We stream seven Asian NDF currency pairs on Redi Trader and we see the market moving towards more electronic delivery," says Myles Bullock, Asia head of fixed income, currency and commodities e-commerce at Goldman Sachs in Hong Kong. "Clients are increasingly asking to trade electronically and that is driving demand for new products."

Otherwise, dealers agree that demand for electronic execution is increasing while demand for voice execution declines, although electronification of forex derivatives is an ongoing process. Yet, greater automation could be a positive outcome for risk management. "With a larger proportion of the pricing activity taking place on e-platforms, traders can spend less time on individual trades and more on portfolio-level risk management," says Shankar Hari, regional head of forex Asia ex-Japan at JP Morgan in Hong Kong.

Streaming or RFQ?

The deposit base for offshore renminbi deliverable in Hong Kong (CNH) has expanded to around $85 billion-equivalent so far this year, with daily turnover in CNH spot and forwards at around $2 billion-equivalent per day. Global investor interest in CNH underlying has resulted in a handful of dealers ramping up their service offerings. Hoping to capture demand among hedge funds and corporate clients, BarCap and Deutsche Bank launched competing offerings in April, with BarCap adding CNH options to its Barx platform on August 1, 2011. Kow adds that CNH forex products are available for local trading during London and New York trading hours as well as Asia.

Beyond the novelty of the underlying – free trading of CNH took off at an interbank level in 2010 – the risks arising from quoting CNH derivatives prices online illustrate the general risk management challenge for forex derivatives e-commerce. Asian currencies generally are less liquid than their Group of 10 (G-10) counterparts, reducing opportunities for price discovery, execution and reliable risk management. For example, the $570 billion of daily turnover in USD/JPY accounted for 14% of global forex turnover in 2010. Daily turnover in the most active Asian NDF underlying, USD/KRW, was less than $60 billion per day. The lack of liquidity is compounded by the absence of electronic pricing sources for local Asian currencies ruling out automated pricing and risk management tools. As such, both tasks involve a high degree of human intervention and limited use of algorithms. Without automated algorithms powering a platform's pricing engine, it's hard to publish live prices. Indeed, the significant level of human input required to generate streaming prices means Asian forex derivatives price quotes are seldom 'click-and-trade'.

Valerie Lee, head of e-business Asia Pacific with Société Générale Corporate & Investment Banking in Hong Kong, says the bank plans to make its single-dealer platform available in Asia, once more is known about how regulators will adopt provisions of the Dodd-Frank Act governing derivatives market-places. She says the relative illiquidity in emerging Asian currencies arises from the capital controls of regional governments. Until these are eliminated, Asia forex will lack liquidity and electronic pricing sources. When that time comes, however, the products will no longer be non-deliverable, but just forwards. "Dealers talk about streaming prices, but EM Asia NDFs will be subject to auto quotations at lower streaming thresholds than G-10, and different trading thresholds will generally apply to less liquid currencies. For larger amounts, forex derivatives products options quotes are actually priced by a trader," she says.

Given these constraints, dealers tend to prefer to quote online prices in relatively small sizes. For example, investors are typically able to transact G-10 forex derivatives online at the advertised price in sizes up to $100 million. Asian NDF investors, however, may only be able to trade at the published price in sizes up to $20 million, with stricter limits for less liquid products and smaller clients. Indeed, the least liquid underlyings are typically offered on a request-for-quote basis only.

Notwithstanding the pricing challenge, dealers are trying to achieve functionality that comes as close to executable, streaming prices as the underlying market structure will allow. BarCap, for example, says all the Asia NDF and forex option prices shown on Barx are 'dealable', if not streaming. In practice, this means users have a time limit in which they are able to execute at the posted price, after which they must refresh the page or are referred to a trader. "We do offer streaming prices for a majority of the products we have on the system," Kow says. "But it's unrealistic to expect us to offer streaming prices for all products. Like it or not, often there is no electronic pricing source that requires a manual pricing effort. We do, however, offer dealable prices that are executable rather than indicative."

JP Morgan's Hari argues that the reluctance by dealers to show their hands in fear of getting them bitten off – although appropriate at this time – could be holding the market back. "Banks and brokers need to get more comfortable with their pricing and risk management capabilities possibly by putting some quotes out there and getting hit. There are perhaps

A client facing limited resources may prefer an electronic trading venue that only requires the use of one screen

75–80 names (including aggregators) in the G-10 space that show streaming prices, while in the Asian currency space it is still only a handful. It might take several years for a pure G-10 provider to get comfortable with the pricing environment in Asia," he says.

Although dealers say single-dealer platforms have increased their market share among Asia forex derivatives users during the past few years, incoming derivatives regulation could send the pendulum back in the other direction. Provisions of the Dodd-Frank legislation in the US requiring NDFs and forex options be traded on swap execution facilities (Sefs) may fundamentally change the way single-dealer platforms operate.

Essentially, to qualify as a Sef under Dodd-Frank, an electronic market-place must make prices from at least five independent sources available to all users. Despite public debate between US regulators and other jurisdictions on the implementation of Dodd-Frank and its consequences for non-US jurisdictions, Asian regulators have been, "strangely quiet on the incoming derivatives regulations", according to Luke Waggindon, deputy global head of electronic markets at BNP Paribas in Hong Kong. "We don't know if we'll see a complete adoption or a complete non-adoption. Looking at Dodd-Frank, it seems NDFs and forex options will be 'in scope'."

Dodd-Frank favours multi-dealer

Assuming NDFs and forex options fall under Dodd-Frank and Asian regulators follow suit with local rules, single-dealer providers in Asia are exploring ways to comply. While it is possible dealers might merge their single-dealer platforms into multi-dealer Sefs, single-dealer platforms are more likely to look for a solution that allows them to use their single-dealer operations where regulations allow.

According to JP Morgan's Hari, MorganDirect's agent model offers a template for this. The platform aggregates prices from other liquidity providers and routes client orders to the best execution. Otherwise the platform is an exclusive environment providing access to the dealer's proprietary research, news feeds and other user tools. "We receive price feeds from external liquidity providers, such that if another provider beats our price we will keep pushing orders through to that provider so long as it offers best execution for our clients," Hari says.

Depending on the criteria Asian regulators give for Sefs, single-dealer feeds could point into multi-dealer portals or exchanges, which would allow them to continue supplying products and client segments expected to fall outside Dodd-Frank (eg, corporate end-users).

Regulatory convergence aside, other regional factors suggest multi-dealer platforms could soon be fashionable again. Dealers say users in India, for example, have begun to push back against single-dealer platforms, which they feel take advantage of their captive audience to show less than competitive prices.

Elsewhere, the Japanese earthquake and tsunami in March illustrated the continuity risk of limiting trading relationships to single providers. Despite significant infrastructure improvements across the region some clients continue to suffer from poor resourcing, especially in information technology. A client facing limited resources may prefer an electronic trading venue that only requires the use of one screen. "Dodd-Frank requirements that currency options and NDFs must be mandatorily cleared… suggests that multi-dealer portals will be the preferred model of execution because they are more likely to be qualified as swap execution facilities. There are various ideas around this scenario in the market, and it very well may happen," Lee concludes. FXInvest

Switzerland strikes back in currency wars

The Swiss central bank has set a minimum value of 1.20 Swiss francs to the euro, forcing investors to search for the next safe haven. Nikki Marmery reports

BRAZIL'S FINANCE MINISTER, Guido Mantega, warned the world was entering a new currency war exactly one year ago. Anyone who doubted his view then, must surely agree now, after a shock move from the Swiss National Bank (SNB) in September.

The central bank announced on September 6 it would no longer tolerate the massively overvalued Swiss franc, which has gained 40% against the euro since the beginning of 2008. As concerns about the debt-ridden eurozone rumbled on throughout the summer, the Swissie peaked at 1.0075 against the euro as money flowed out of the eurozone and into safe-haven Switzerland.

Now, the SNB says it will buy unlimited foreign currency to enforce a minimum value of 1.20 Swiss francs to the euro and stave off the safe-haven flows.

With the ongoing threat of currency intervention in Japan, the possibility of more quantitative easing in the US, and no end in sight for the eurozone's massive debt problems, the question FX investors are now asking is: where is the safest place to put their money?

Gold is still the obvious safe haven, and has hovered near its record highs of $1,920 an ounce reached on September 6. But gold is relatively illiquid and, says Simon Derrick, chief currency strategist at Bank of New York Mellon in London, "there is a vast amount of money out there that needs to be invested somewhere safe and secure."

Another logical move is Scandinavia, with its big-budget surpluses and positive rates outlook, says Kit Juckes, head of FX strategy at SG CIB in London.

Norway in particular is a good prospect for a safe-haven currency, say some analysts. "It is in every sense a better safe-haven currency than Switzerland," says David Bloom, head of FX strategy at HSBC in London. "It has a better current account, better budgetary position and better GDP." The downside is that it lacks a sophisticated financial structure set up for massive foreign investment. "You can't just go to your private bank and say you want to invest in Norway in the same way you can with Switzerland. There's very little to buy, for one thing," says Bloom. "When you have a budget surplus, you don't have plenty of bonds sloshing about because you don't need the money."

Swiss National Bank: shock move

Adam Cole, global head of FX strategy at Royal Bank of Canada (RBC) in London, adds that liquidity in the currency itself is severely limited. "Daily turnover is around one third of that in Swiss franc and liquidity is particularly challenged outside local hours."

Other obvious destinations supported by commodity-producing economies include Australia. "We will see a bounce of money going there," says Derek Halpenny, head of foreign exchange research at Bank of Tokyo-Mitsubishi UFJ (BTMUFJ) in London, pointing out that it still has the highest interest rates in the developed world at 4.75%. "If the US were to surprise on the upside and China has a soft landing, there is the potential for the Aussie to hold up well. But we could see rates go lower, so Australia still looks like a dangerous trade to me," he adds.

One – perhaps not so outlandish – suggestion for a new safe haven is in selected emerging markets. Some Asian and Latin American currencies saw lower volatility over the summer than the majors (see related article on pages 15–17). But for want of anywhere better to go, perhaps the most likely beneficiary of the SNB's action will be the US dollar. "Perversely, much as in 2008, the dollar is the place the safe-haven money flows to," says Derrick at BNY Mellon.

BTMUFJ's Halpenny agrees. "One of the beneficiaries will be the US dollar. In terms of the best place to park your money, I still think a 10-year Treasury earning 2% is going to outperform."

This view would only be strengthened if legislation similar to the 2005 Homeland Investment Act (HIA) were to be brought in again in the US, which some analysts think is becoming increasingly likely. RBC did some recent analysis of flows back into the US after HIA six years ago. Combined with an analysis of current destinations for outbound US direct investment, the bank concluded that euro, sterling and Swiss franc were likely to be the biggest losers on the other side of dollar strength.

The risk to a dollar-positive story, however, is if the Federal Reserve were to announce a third round of quantitative easing, which would send the US dollar spiralling downwards again.

Such a move would also be seen as a further offensive in the global currency war – and that would increase the likelihood of more intervention from other central banks trying to stem their currency's rise as the dollar plummets.

Already, Switzerland's move has put pressure on Norway and Singapore as flows have diverted there. And the pressure on the Swiss franc was in turn worsened by the multilateral intervention to weaken the Japanese yen earlier this year. "Everyone wants a weaker currency to help with exports, but not everyone can have one. In a zero interest rate world, you haven't got an interest rate policy, so you might as well have a currency policy. And if the markets get too aggressive buying Norway and Singapore, the Norges Bank and Monetary Authority of Singapore will act," warns HSBC's Bloom.

A new safe haven?

As G-7 economies start to look more volatile than some emerging markets, Nikki Marmery investigates whether the new rash of emerging markets indexes could offer some respite

As the summer's rout in global stock markets showed, financial markets remain highly erratic. The after-shocks of the financial crisis that started four years ago have seen the debt problems that then plagued banks and corporates spreading to governments.

The US lost its Standard & Poor's AAA rating in August to AA+. But in Europe, graver dangers lurk. As Greece struggles to avoid bankruptcy, the biggest sign yet that the debt crisis is spreading to Europe's largest economies came on September 20, when S&P downgraded Italy from A+ to A.

The same day, Reuters reported that Bank of China had even stopped trading FX forwards and swaps with some European banks, for fear of counterparty risk.

All of a sudden, the 'developed' world no longer looks as safe as it once did.

Conversely, there has been a shift in how emerging markets are seen by investors desperately searching for yield. Some are even being described as 'safe havens' – an unthinkable development in previous financial crises.

The ultimate safe havens – the Swiss franc, gold and US Treasuries – retain their cachet of course. But their appeal is much reduced. The Swiss National Bank has said it will buy "unlimited" FX to keep the Swiss franc above 1.20 per euro. US Treasuries have so far done well out of the eurozone crisis, but all dollar assets are at risk if the US announces a third round of quantitative easing. And gold, which peaked at above $1,900 per ounce on September 6, has been unusually volatile since, as investors sell on the gains.

All this means markets once considered off-limits in times of crisis are back on the radar.

"In Asia in particular, real economies are much more balanced; they lack the leverage common in G-7 economies," says Mike Moran, senior FX strategist at Standard Chartered in New York. "This is a big distinction between emerging markets and G-7 right now. Emerging markets, particularly in Asia, have the policy ammunition to address any upcoming shocks to their economies, whether those shocks are domestic or external. In G-7 economies, interest rates are already so low, and the public sector balance sheet already so bloated, there is much less flexibility to protect the economy from further shocks."

Another big difference in this, compared with previous crises, has been the emergence of China. "That has been a game-changer for the region," says Moran. "Although so much of Chinese growth is driven by demand, there is also a more stable core driving Chinese growth, and Asian economies have been diversifying, tapping into that rather than the US-centric export growth model that was the case before the Asian crisis (in 1997–98)."

One way of tapping into this trend is via a range of products now being developed to bring emerging markets FX to a wider investor base.

Indexes are seen as an efficient, effective way to get exposure to emerging markets currencies, while retaining an easy exit if things get nasty. And there is a wide range available, depending on whether a client wants to buy a simple static currency basket, or a more complex carry, momentum or volatility strategy packaged into index format.

HSBC is one of the banks that has been developing this product. In July 2010, it hired Tamas Korchmaros, now head of FX indexes in London, from rival Royal Bank of Scotland (RBS), with a remit to create an FX index business from scratch. Starting off with a series of 43 separate single currency indexes (that's 42 currencies, plus gold), the so-called Smart index series (which stands for static market access return tracker) can be used as building blocks to create any number of composite indexes with a particular view – one that for example, takes advantage of trends in Asian, LatAm, Middle East or Bric (the group of fast-growing economies of Brazil, Russia, India and China) currencies.

This can be done on a bespoke basis. For example, one client, HSBC's own Private Bank in Geneva, wanted to create a product it could sell on to its own clients, so it asked HSBC to create an index of 20 emerging markets currencies, which the Private Bank then dynamically manages, by shifting the allocation to each currency every week (see box). Another client, a fund of funds that focuses on fixed income, wanted to create an index of currencies as a source of diversification. Because this client was more focused on bonds, an index was appealing because it looks like what they are used to in the fixed-income world. "It gives them extra comfort to engage," explains Korchmaros.

Other examples of bespoke indexes might include an FX index that replicates the country weightings of an equity or global bond index so that the underlying investment is fully hedged for currency movements. Or for bespoke corporate hedging: "Imagine a multinational that has exposures in different countries," says Korchamaros. "They could individually hedge these exposures – or we can create an index that follows their currency exposure. If the allocations change – say if they dispose of assets in some markets, we can change the index."

Investors can, of course, achieve all these ends by buying various currency products over-the-counter. But what the index format brings to the table is more transparency, instant evaluation and ease of use, developers say.

"A lot of our clients are still doing static baskets," explains Korchmaros. "If we can replace that, even with a static index where they have more transparency, or a dynamic index, where they have an element of control, that is value added.

"If you are bullish on Asia, say, you could enter into a structured note that has a maturity of five years. If, two years along the line, your view has materialised and you want to take profit, you would have to sell the note and buy a new one. With an index, you keep the same wrapper, and you change the currency underlying. It's much more efficient."

Another emerging markets index on offer is the Bric Time Select Index from RBS, which offers investors access to the currencies of that group of countries.

Launched in September 2010, the index takes its signal from the crossover of long-term and short-term moving averages, and takes a view once a month on whether to invest in the basket of four Bric currency forwards pairs (all against the US dollar). Data in the index has been back-tested to March 2000.

The index has a range of risk management features to minimise downside:

- First, it only takes a position when the signal is positive – if it is bearish it disinvests.
- Second, it takes only long positions. "Emerging markets tend to benefit from risk-positive environments and a stable global economy. When shocks come, the turn in sentiment and investment flows can be violent and brief," explains David Popplewell, FX structurer at the bank in London. "Timing these turns to benefit from a short emerging market position is a risky business we felt was out of place in this strategy."
- Third, a volatility control mechanism increases exposure to the Bric currencies in periods of low volatility and reduces exposure as volatility increases.

The index is targeted at professional and retail private placement customers – customers that might otherwise have bought a straightforward Bric basket, explains David Popplewell, FX structurer at RBS in London.

The index format, however, makes it easier and more accessible to these clients because it comes packaged complete with oversight from RBS analysts. "These types of trades, based on momentum, carry or an economic view, require a fair amount of monitoring because they can be complex and time-sensitive. It makes sense for people not actively monitoring that market to have something that does that for them," says Popplewell.

He describes the typical customer as: "People who think there is more strength coming from the Bric group, but who are looking for a degree of risk protection and some automation, because they don't trade currencies daily themselves."

Bric appeal

Since forex is likely to be peripheral to the day-to-day activities of clients like this, indexes expressing better-known themes, such as the Bric trade, are likely to be more appealing than lesser-known trades, he says. "It's very transparent; it's very simple. It's very easy for investors to get an idea of what it is, how it works and how they expect it to behave. We designed it to make sense rationally as a trading strategy."

During this summer of unexpected volatility, the index has exited the trade repeatedly. "It has been pretty hectic for this group of currencies, this summer," says Popplewell. It disinvested from June

"A lot of our clients are still doing static baskets. If we can replace that ... that is value added"

Tamas Korchmaros, HSBC

Not flagging: the currencies of the Bric group are holding up well in RBS's Bric Time Select Index

to July. Then in late July, the signal flagged growing strength in the Bric currencies, bringing the index back in – only to get hit in the tumult in early August, when it exited again.

Navigating this minefield, the index returned 2.72% over the past year. "It has avoided the largest drops," says Popplewell.

RBS is also developing a smart carry model, which will take short positions, and a momentum-based strategy with a basket of commodity or Europe, Middle East and Africa currencies.

Other emerging markets FX indexes on offer include the Dynamic Gems (global emerging markets) series from Barclays Capital; IncomeEM, which exploits carry in emerging markets, and VXY-EM, an emerging markets volatility index, both from JP Morgan, and various other offerings from Citi, Deutsche Bank, Credit Suisse and others.

While these index developers would stop short of describing emerging markets as a *bona fide* safe haven, they do argue these indexes offer a good hedge for investors in times of crisis.

"Extreme events are coming round more frequently than they have in previous decades," says Popplewell at RBS. "In previous crises, there would have been more obvious safe havens to place your money in. Now, to have some investment in a group of emerging markets currencies is a sensible hedge because they may end up being a new safe haven – relative to the tumult seen in the dollar market, for example."

Belal Khan, director of foreign exchange strategy at HSBC Private Bank in Geneva, which developed its own bespoke EM index in collaboration with HSBC, adds: "If you look at many of these emerging markets currencies, 90-day volatility is less than the majors. At the same time, the yield is more attractive. Some people are calling these safe havens, but more time needs to pass. In a systemic risk event, the jury is out on whenever they will be able to maintain their low volatility."

Given these concerns, investors may want to seek out dynamic indexes, in which a rebalancing agent continually switches allocations, so they can switch to less volatile markets. "In a crisis period, these indexes can be very reactive and quickly adapted to a changing environment," says Korchmaros at HSBC.

That could prove to be crucial, if, as some people fear, the summer's volatility was just a precursor to the next big market shock.

As Luis Costa, emerging markets strategist at Citi in London sees it: "When push comes to shove, if we are heading to another massive disruption *à la* 2008, most portfolio managers would still be getting out of emerging markets and buying real safe-haven assets – Swiss francs and US Treasuries." FXInvest

Case study: a bespoke index for a global private bank

One of the clients for whom HSBC has built a bespoke emerging markets index is HSBC Private Bank in Geneva.

The private bank wanted to offer a "clean, efficient, effective solution" to clients to enable them to participate in emerging markets currencies in a transparent, controlled and dynamic way. Tapping into the index business HSBC has already built in London means the Geneva-based private bank can offer such products to its own clients, based on its own views and research, and remain in control of allocation – despite not having the infrastructure to support a full index business itself.

Belal Khan, director of foreign exchange strategy at HSBC Private Bank in Geneva explains how the collaboration works.

"The FX Committee meets weekly every Tuesday morning, and by the end of the day we submit to HSBC London a spreadsheet where we input our allocation. Two days later they implement the changes.

"Clients want to know where the opportunities are in emerging markets, so we go for currencies where there is growth and strength and for fiscally responsible countries. It's not one particular strategy – but put together it's a very compelling yield story."

It needs to be a dynamic index because emerging markets are so changeable, says Khan. "You need to be able to change the portfolio to reflect changing trends and where there is likely to be relative outperformance."

Among the 20 currencies in the basket available in the index are both Chinese units – CNY, the onshore yuan, and CNH, the deliverable offshore version. "We don't necessarily allocate to both, but we want access to both so we have the option," says Khan. "There are situations where CNY could potentially offer better opportunities, so we need the option to switch."

Since its launch in June, the index has weathered a stormy summer, closing at 99.7902 on August 30, from its start at 100. Like HSBC's other indexes, back-testing goes back to December 2004. "We launched just as risk aversion was growing quite rapidly," says Khan. "But it has held up very well. The calls that have turned out well are the strong calls on key currencies in China and Latin America, and also removing and reducing allocations in countries that started to turn negative."

These included currencies that suffered as a result of the eurozone weakness and political story in Europe, he explains, such as Poland and Hungary. The index also launched with a strong allocation to Mexico, but that was removed when the US slowdown soured its neighbour's prospects.

So would the bank consider launching more indexes? "This has all been very positive for us, from the working relationship with HSBC FX and Global Research in London to the ease of setting it up with our structured product team and bringing a value-added product to clients," says Khan. "We do have other currency allocation strategies we are looking to implement via an index – we run a global currency allocation strategy of 30 currencies – 10 developed and 20 emerging – that can be easily packaged into an index product." Regional strategies in Latin America and Asia are also an option, and can be customised for clients. "For example, a Brazil-based client might want an index with Brazil taken out, because they are already very long Brazil; we can easily customise that. That is what is so wonderful about an index-based product."

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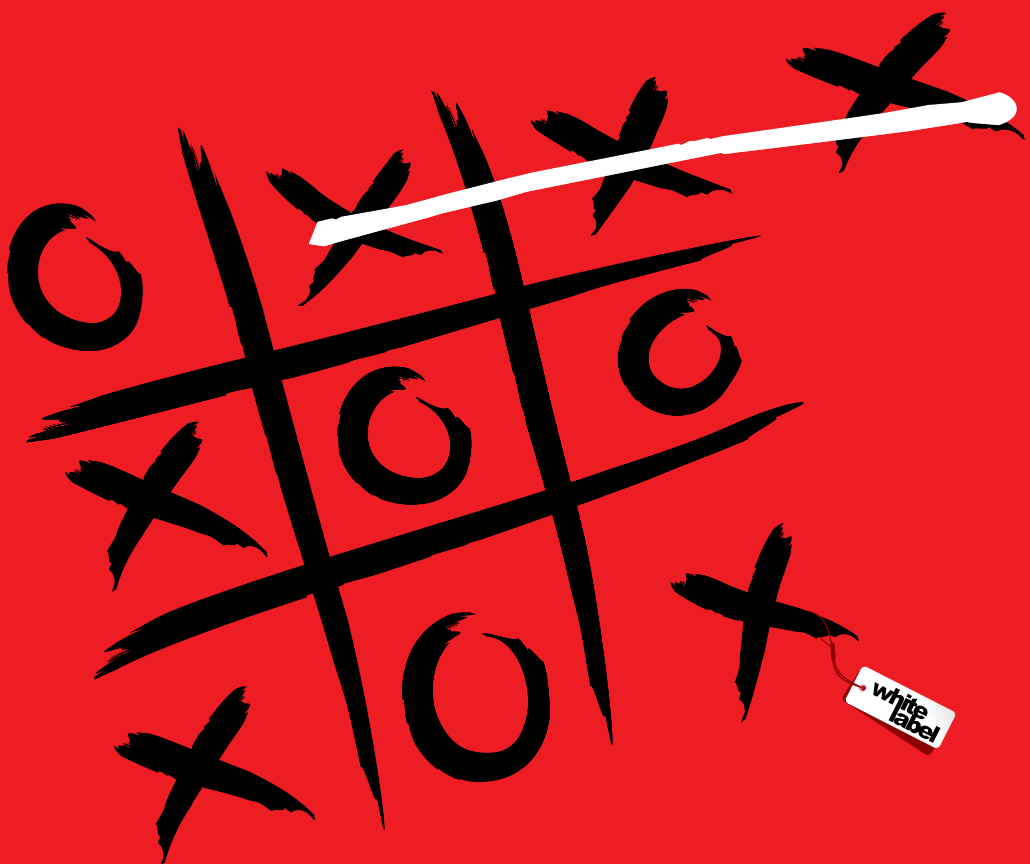

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The trick's in the tail

The Cambridge Strategy's focus on tail risk sets it apart from other asset managers. Saima Farooqi talks to its chief investment officer about emerging markets risk and reward

Asian currencies have been the poster-child for emerging market resilience during the tumult of the eurozone debt crisis. But with a worsening global economic outlook, the recent sell-off in the fundamentally strong currencies has acted as a staunch reminder of the need for an effective risk management policy when trading emerging markets.

With $150 million of assets under management in EM strategies, risk management is at the core of the investment approach at London-based asset manager, The Cambridge Strategy. The company was set up by chief investment officer Russell Thompson and chief executive Peter Henricks in 2003, to take advantage of a combined 50 years of experience trading emerging market assets at buy- and sell-side institutions.

Since then, the duo has rolled out three main currency alpha programmes – the Extended Markets, the Asian Markets and Global Emerging Markets – which use systematic models, looking at factors such as time zones, currencies and regions, to generate trading signals. For the past 24 months, the trading models have been strongly skewed to the firm's systematic technical strategy, which performs well in a high-volatility environment.

"We do have signals within that though, which are mean-reverting signals. But our allocation between our technical strategy, which generally does well in a high-volatility environment, and our fundamental strategy, which does well in a low-volatility environment, is strongly tilted towards our technical strategy. The allocation of risk is more than 70% in our technical strategy right now," says Thompson.

The firm's real differentiator, however, lies in its disciplined approach to risk management once trades are on the books by focusing on tail risk. "We have three variables that affect the amount of risk we take – the absolute level of our returns, absolute level of the volatility and the relative value of the tail risk, and how our tail risk is stacking up against what we would expect it to be and what it has been historically. So when you get significant event risk coming into markets and you start seeing tail risk rising, we actually take risk off the table," says Thompson.

This systematic approach is what led the company to generate 5.5% in returns from its Asian currency programme and limited losses to -2.0% in its global emerging market portfolio in September, in a market defined by a heavy bout of risk aversion.

During the period, the BRL, ZAR, CLP and MXN lost 6.9%, 6.8%, 4.3%, and 3.7%, respectively, against the USD.

"Using extreme value theory and mathematical statistics such as omega functions, the model tries to estimate the amount of tail risk. If you're in a market that is exhibiting normal levels of tail risk, which then starts exhibiting high levels of tail risk, where the risk reward starts changing against you, then we will be taking money off the table," says Thompson. "That's really what's been happening in our emerging markets strategy and that's why to a certain extent it's a loss limiter."

While Thompson stresses the majority of risk-taking is based on the systematic models, the firm's portfolio managers also have the ability to take trades around the model to mitigate against event risk and – vitally for emerging market strategies – liquidity risks. The risk limit allotted to the traders is dependent on the target daily level of eVAR, which is the company's extreme value level of value-at-risk. "That is a targeted daily level that allows us to hit or get close to our projected annualised level of volatility. In general, the portfolio managers will be looking to take 10–20% of risk in terms of added value."

This market information piece of the firm's investment approach curtailed potential losses from the Swiss National Bank's September 6 surprise announcement that it would cap the franc's surge versus the euro at 1.20, "using unlimited currency interventions if needed". "We had been strongly long the Swiss franc for a number of months, and about three weeks ago we reduced our Swiss franc longs. Our models still wanted to be in them but we reduced our Swiss franc longs significantly," says Thompson. "In fact, in some cases we were short Swiss francs after it became apparent there was a significant chance of event risk in the Swiss franc with the potential currency board."

> **"We have a traffic light system, where we use our own proprietary signals to monitor the credit-worthiness – and that can make a significant difference"**
> Russell Thompson,
> The Cambridge Strategy

While some $4 trillion is turned over in foreign exchange markets globally per day – making it the most liquid of all asset classes – as EM specialists, Thompson says liquidity drying up is a key risk. "We have liquidity risk against every single currency we trade, and when we start seeing warning signs outside the systematic models, our portfolio managers are expected to make informed judgement calls as to how we can best protect our interest from a liquidity perspective and an event risk perspective."

Thompson highlights the importance of the relationships with its nine liquidity-providing banks in managing this risk. "We have long-standing relationships with our panel of banks and we enjoy good liquidity and very competitive prices from them," says Thompson.

But not even these relationships are left to chance, with Cambridge monitoring the credit-worthiness of the banks it trades with and, importantly, the prime brokers it uses. "We have a traffic light system, where we use our own proprietary signals to monitor the credit-worthiness – and that can make a significant difference," says Thompson. "We were out of AIG seven days before there were issues with it, because of our traffic light system. We had clients with managed accounts with AIG who we called up and advised should be closing down those managed accounts, and at least one did."

It also seems the focus on risk managing and alpha generation exposures is spreading. Thompson notes that having begun as an alpha fund manager, Cambridge is seeing increased demand for currency overlay, particularly from Australian institutional investors. "There is a realisation that when it comes to currency, even if you are not going to go the whole hog and say it is a separate asset class, certainly a lot of people now are accepting the risk you are taking on when you're investing in an international equity or bond portfolio is not just equity or bond related. You have to try to isolate and manage the currency risks you are taking on," says Thompson.

"And certainly, if you are a dollar-based investor and you have an international equity or bond portfolio, you are in a very nice place in the cycle if you are looking for a medium-term level to try and hedge your international currency risk from where you are now, considering where the dollar is." FXInvest

BIOGRAPHY

Russell Thompson co-founded The Cambridge Strategy in 2003, and is the firm's chief investment officer. Prior to establishing the firm, Thompson was head of currency trading for Asia for AIG Trading, the investment banking arm of AIG. He was responsible for all aspects of currency and interest rate trading, including trading, risk management, personnel and compliance. He also traded and managed the successful AIG Proprietary Asian Currency Fund.

Prior to joining AIG, Thompson worked for HSBC in Hong Kong, where he held a variety of roles including HKD currency arbitrage, proprietary trading and market making in Asian currencies and forwards, and running the DEM, CHF, AUD and ZAR forward books. He founded and co-headed the non-deliverable forwards desk, which through the turbulent Asian Crisis in 1997 produced record profits for the bank. Thompson began his career at Midland Montagu in London in 1989 as a business analyst, and quickly moved to being a derivatives and money market trader, assuming responsibility for trading and hedging the medium-term sterling mortgage swap book, and the Latin American brady bond portfolio.

Thompson has a BSc (Hons) in economics and is a member of the Association of Corporate Treasurers.

Intervention: friend or foe?

If the trend is your friend, is central bank intervention your enemy? The answer is not so clear cut, say Christopher Cruden and Purnur Schneider, not least because of the breadth of interventions, which challenges attempts at uniform analysis

As summer progressed, we witnessed renewed intervention by the Swiss National Bank to weaken the strong Swiss franc. Periodically, central banks intervene in foreign exchange markets to influence exchange rate levels or to restore currency stability. When this happens, adherents of "systematic, trend-following" strategies may see their performance affected. Here, we will try to establish whether past episodes of central bank intervention have had an adverse impact on the profitability of trend-following strategies.

Trend-following strategies have been used in active FX investment for decades, many times very profitably. Trend-following enables participation in a currency's movements, whether driven by macroeconomic fundamentals such as growth and inflation, interest rate differentials, or slow incorporation of information.

As big market players, central banks seem to believe they have the ability to counter or influence currency prices through intervention. But is this true?

Central banks are most likely to intervene in FX markets for two reasons:

1) to prevent excessive currency appreciation/depreciation
2) to counter currency overshooting and reduce excess volatility associated with disorderly market conditions

In the first case, if the intervention is successful, trend-followers may experience short-term losses. Obviously, a trend-follower can make losses when trends reverse abruptly. In the second case, intervention may actually help them by smoothing trends.

To verify our conjecture, we examine some noteworthy historical interventions in G7 currency markets. We distinguish the effect of intervention through a simple event study procedure by first splitting historical periods in two – prior to intervention and during/after intervention. Then we examine the change in the first two moments of the daily distributions of four indicators:

I. Returns on the currency pair in which the intervention takes place;
II. Strength of trends proxied by ADX (J Welles Wilder, 1978);
III. Returns on a naive systematic long-term trend-following strategy – DB Momentum Excess Returns Index;
IV. Excess returns from trading in the currency pair subject to

intervention of a sophisticated strategy – Insch Kintillo, a proprietary systematic medium-term trend-following trading strategy.

A number of difficulties arise in the empirical study, such as the large variety of interventions. First of all, intervention may have several possible purposes. Second, it can be performed through different channels: outright currency sale or purchase, currency swaps, liquidity injections, communication. It can be unilateral or co-ordinated among central banks. And finally, it can be sterilised or not. Intervention episodes are few and far between, and there is often little or no resemblance between them in size, purpose or economic environment.

Intervention is sometimes officially announced, other times not announced but confirmed upon request, or even performed in secret. Identifying unannounced interventions is difficult, due to the large variation among different countries when it comes to practices of disclosure and transparency regarding currency intervention.

Some of the empirical shortcomings in analysing interventions are:

a) Interventions are rare events;

b) The decision to intervene is endogenous, driven by extreme economic conditions;

c) The behaviour of the exchange rate in the absence of intervention cannot be observed.

Any conclusion regarding the effectiveness of intervention should be qualified in the light of these shortcomings.

Noteworthy historical interventions and their effects

A. Co-ordinated intervention on the euro, September 2000

On September 22, 2000, the US Treasury intervened in a co-ordinated effort with the European Central Bank, Bank of Japan, Bank of Canada and Bank of England, to support the value of a falling euro. The operation succeeded in lifting the euro against the US dollar by approximately 4% over five days. After this, the euro continued to depreciate until mid-quarter, appreciated towards the end of the year, then resumed its downtrend in 2001.

B. Bank of Japan intervention, 2003–2004

Between 2003 and 2004, the Bank of Japan sold yen totalling US$315 billion to slow the appreciation of the currency. The impact was almost imperceptible on the direction of the yen.

C. Bank of Australia intervention in 2007

The Reserve Bank of Australia (RBA) has intervened in the currency markets almost continuously over the past 25 years. In the summer of 2007, the financial crisis hit markets in a dramatic fashion, and the unwinding of the carry trade was one of its symptoms. The RBA responded by buying Australian dollars for the first time since 2001. While the intervention lasted around three months, it managed to support the currency at the cost of diminishing the Australia Official Reserves from above A$80 billion to A$30 billion.

D. Swiss National Bank intervention, 2009–2010

The Swiss National Bank performed an enormous and terribly costly amount of intervention between 2009 and 2010, with balance sheet losses of almost Sfr35 billion. The volatility of the euro/Swiss franc cross was diminished during the intervention window, but the appreciation trend for Swiss franc could not be reversed.

E. Bank of Japan intervention, September 2010

The Bank of Japan intervened again in September 2010 by selling ¥2.12 trillion (US$25 billion) in an attempt to weaken the currency from a 15-year high against the US dollar. The intervention was unilateral, and met with hostility by other central banks. It was unsterilised in an attempt to boost its effectiveness and at the same time to conduct monetary easing by injecting liquidity. However, the yen continued to appreciate to a new high on November 1, 2010, of 80.51 (against US$).

The Swiss National Bank performed an enormous and terribly costly amount of intervention between 2009 and 2010, with balance sheet losses of almost Sfr35 billion. The volatility of the euro/Swiss franc cross was diminished during the intervention window, but the appreciation trend for Swiss franc could not be reversed

F. G7 and Bank of Japan co-ordinated intervention, March 2011

G7 governments co-ordinated to control the yen appreciation in March 2011, after the Japanese earthquake and tsunami disasters. The intervention was considered successful initially, but its effect lasted for less than a month. After April 7, the yen resumed its appreciation due to renewed uncertainties in global markets.

G. Swiss National Bank (SNB) intervention, August 2011

Between August 3 and August 17, 2011, the SNB announced three sets of measures to weaken the Swiss franc. First, it expanded banks' sight deposits at SNB from Sfr30 billion to Sfr80 billion; it further increased the value from Sfr80 billion to Sfr120 billion and then again to Sfr200 billion. As a result of this, the Swiss franc fell by 10% against the euro from the August 10 peak of 1.38, for six calendar days.

It remains to be seen how long Swiss franc weakness will last. Will this intervention be more effective than the previous ones? We doubt it. Central bank interventions of the recent past have had almost no impact on currency rates and an ambivalent impact on the strength of trends. They have had little or no impact on the trading returns of two trend-following strategies (one naive, one sophisticated).

The results may differ from one intervention to another because of different intervention purposes, the size of operations and the amount of co-ordination. Most probably they differ because of

Figure 1: Euro vs US$, co-ordinated intervention of Sep 2000

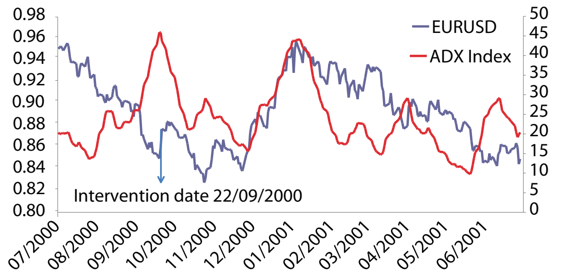


Figure 2: US$ vs yen, BoJ intervention, Jan 2003 – Mar 2004

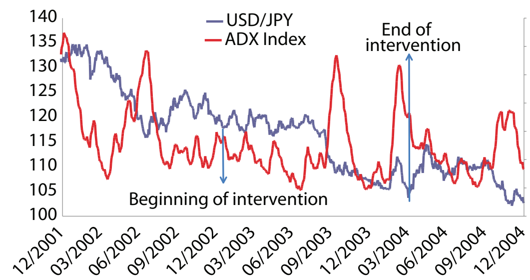


Figure 3: A$ vs yen, BoA intervention, Aug – Oct 2007

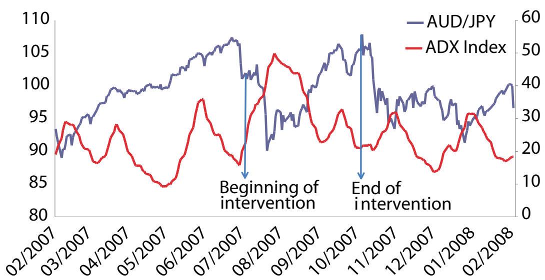


Figure 4: Euro vs Sfr, SNB intervention, Feb 2009 – Jun 2010

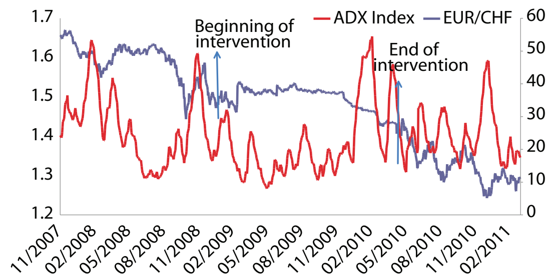


Figure 5: US$ vs yen, BoJ intervention, Sep 2010

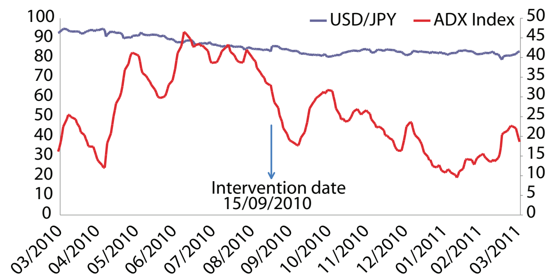
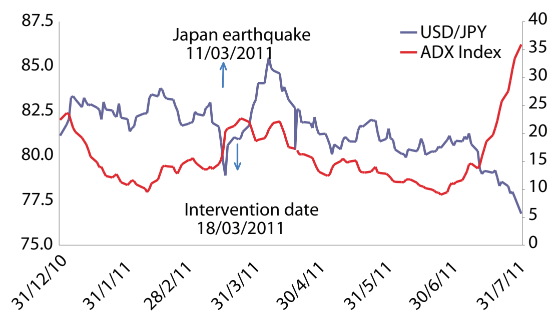


Figure 6: US$ vs yen, G7 co-ordinated intervention, Mar 2011



Source: Insch Quantrend

Central bank intervention impact on:	Desired exchange rate movement	Exchange rate volatility	Trend strength ADX indicator	Trend strength ADX volatility	DB Momentum Index returns	DB Momentum Index volatility	Insch Kintillo returns	Insch Kintillo volatility
A	No change	No change	Down	Down	Down	No change	No change	No change
B	No change	Down	Down	Down	No change	No change	No change	Down
C	No change	Up	Up	No change	No change	Up	No change	Up
D	No change	Down	Down	No change	Down	Down	No change	Down
E	No change	Up	Down	Up	Down	No change	No change	No change
F	Short-lasted	No change	Up	No change	No change	Down	No change	Down
G	Will it be "different" this time?							

the economic conditions around the intervention date.

However, what is starkly notable about interventions is the lack of effect they have on the trend direction. Which is the best way to intervene? Simply not doing it?

Regarding trend-following strategies, central bank intervention acted on the one hand as an 'enemy' by temporarily weakening trends (in four cases out of six), but just as often as a 'friend' by reducing the various measures of trend volatility.

The profitability of the Insch Kintillo system was not affected by intervention in any of the six cases. Its volatility increased only in one case, but it was significantly lowered in three cases. FXInvest

Christopher Cruden is chief executive at alternative investment manager, Insch Capital Management in Zug, Switzerland, and Purnur Schneider is associate director at research company Insch Quantrend in Lugano, Switzerland

Esma consults on exchange-traded funds and Ucits structured products

European Union regulators are looking at how they should extend rules regarding Ucits exchange-traded funds and structured Ucits products. By Margie Lindsay

THE EUROPEAN SECURITIES AND Markets Authority (Esma) has issued a discussion paper setting out policy guidelines for Undertakings for Collective Investments in Transferable Securities (Ucits) exchange-traded funds (ETFs) and structured Ucits products.

The Ucits format has been used as a vehicle to implement a variety of strategies, including those used by hedge funds. Because of the proliferation of new products based on Ucits, Esma is examining the impact these innovations may have on investor protection and market integrity, particularly as Ucits products are not intended to be complex and are aimed at the retail market.

Esma believes the current regulatory regime does not take sufficient account of the specific features and risks associated with Ucits that are ETFs or structured funds. It is concerned that particularly complex products, which may be difficult to understand and evaluate, could be sold to retail investors.

According to an Esma statement, the authority thinks the existing requirements are not sufficient to take account of the specific features and risks associated with these types of fund. It has also raised the issue of potential systemic risk inherent in these types of fund and their impact on financial stability. Feedback received by Esma to its discussion paper will be used to develop draft guidelines for these funds.

Steven Maijoor, chairman of Esma, says the organisation is seeking views in order to "improve the transparency and quality of information provided to investors buying Ucits ETFs and structured Ucits".

He wants to see specific safeguards developed for activities such as securities lending used by Ucits ETFs or for complex strategies used by some structured Ucits. "To preserve the integrity of the Ucits brand and to protect investors, it may be necessary for Esma to issue warnings to retail investors about the risks of these products, or even to limit the distribution of certain such funds to retail investors. In this context, Esma may need to ask for appropriate powers for inclusion in the relevant sector legislation," he says.

Steven Maijoor, Esma

Esma says Ucits ETFs should use an identifier in their name and in their fund rules, prospectus and marketing material that identifies them as an exchange-traded fund. The authority also wants the prospectus of index-tracking ETFs to contain a clear and comprehensive description of the index to be tracked and the way exposure to the index is gained by the ETF.

The information provided to investors in the prospectus of synthetic ETFs should at least include details on the underlying of the investment portfolio or index, the type of collateral that may be received from the counterparty and the risk of counterparty default and the effect on investors' returns, notes Esma.

For securities lending activities, Esma suggests collateral received should comply with the criteria for over-the-counter transactions contained in the guidelines on risk measurement and calculation of global exposure and counterparty risk for Ucits originally adopted by the Committee of European Securities Regulators. Esma also says investors should know about the collateral arrangements used by the ETF.

For actively managed ETFs, Esma wants to make sure investors understand what this means and the risks that could arise from the investment strategy.

The prospectus of leveraged ETFs should disclose the leverage policy and the risks associated with it, notes Esma, as well as a description of how the daily calculation of leverage impacts on investors' returns over the medium to long term.

Esma is also considering the possibility of making Ucits ETFs give all investors, including those who acquire units on the secondary market, the right to redeem units directly from the Ucits.

For structured Ucits, Esma believes guidelines should be developed concerning total return swaps and strategy indexes.

For structured Ucits gaining exposure to complicated investment strategies, the regulator says it wants the structured Ucits' investment portfolio that is swapped and the underlying to the swap to which the Ucits obtains exposure to comply with relevant Ucits diversification rules.

Finally, Esma thinks the role of the counterparty to the total return swap should be subject to specific safeguards. For strategy indexes, it proposes policy orientations on the appropriate frequency of rebalancing the index and how their composition should be disclosed.

Responses to the discussion paper were due by September 16, after which Esma is developing draft guidelines for Ucits ETFs and structured Ucits. The proposed guidelines will be subject to a public consultation that will be used by Esma to finalise them. FXInvest

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