The Pros Make It Look Hard

One of the great pleasures of watching a true professional in any field is how they can make a difficult task look easy. This is not the case for currency traders as evidenced by the performance data for six widely followed indices for currency-only money managers. These indices are:

- The Barclay Currency Traders Index (CTI), an equal-weighted composite of managed programs that trade currency futures and/or cash forwards in the interbank market. This index includes 106 managers at present;
- The BTOP FX Index, a subset of the CTI that accounts for no less than 50% of its investable assets. It seeks to replicate the overall composition of the currency sector of the managed futures industry with regard to trading style and overall market exposure;
- The Center for International Securities and Derivatives Markets (CISDM) asset-weighted index. This index reflects the dollar-weighted performance of currency commodity trading advisors (CTAs) who trade currency futures/options and forward contracts based on a wide variety of trading models. CTAs must have at least $500,000 under management and at least a 12-month track record to be included in this index;
- The CISDM equal-weighted index, which measures the average performance of the above set of advisors;
- The Parker index, a performance-based benchmark that measures both the reported and the risk-adjusted returns of global currency managers. It is the first index to analyze unleveraged, or risk-adjusted, manager performance to calculate their alpha, or incremental performance added, of managers. It is equal-weighted to preclude unrepresentative distortions from large-manager performance. The Parker FX Index currently includes 66 programs managed by 45 firms located in the US, Canada, UK, Ireland, and Switzerland. These programs manage over $15.7 billion in currency assets split between 46 systematic and 20 discretionary traders; and
- The AFX index, which replicates the trading actions of an active manager and thus attempts to provide a more realistic benchmark for active currency traders.

With the very prominent exception of the CISDM equal-weighted index' performance over the 24-month period preceding the time of this writing, the performance of these indices is either negative or insignificantly positive. If the pros have had such a difficult time in the market, how can individual traders hope to succeed?

Currency Index Returns

	3-Mo	2006 YTD	12-Mo	24-Mo	36-Mo
CISDM (Asset)	-2.92%	-5.40%	-5.04%	-1.13%	1.16%
BTOP FX	NA	-3.78%	-5.04%	-1.13%	1.16%
AFX	0.07%	-2.81%	-3.18%	-2.73%	-3.93%
Barclay CTI	NA	-1.53%	-1.21%	2.36%	NA
Parker	-1.34%	-1.34%	-0.72%	-2.80%	-0.90%
CISDM (Equal)	1.71%	-0.44%	0.25%	7.82%	3.12%

Making A Tough Game Tougher

We have to ask whether the professional traders have made life unnecessarily difficult for themselves. A currency trader can get lost in all of the interlocking factors affecting the markets, such as macroeconomic fundamentals, geopolitics and each country's yield curve. This 24/6 market, famously dubbed "the currency bazaar," by Andrew Krieger, cycles almost $2 trillion per day throughout its global network. Yes, it is deep and liquid, but that in itself has some drawbacks, such as the presence of orders in the $100 million and higher range.

Anyone swinging such orders about is likely a very sophisticated investor, and indeed this is the case. There are an estimated 8,000 hedge funds and 1,800 CTAs loose upon the land; only 124, or approximately 1.3% of this total, can be described as "currency-only" funds. These traders approach the markets through the usual variety of trading styles across more than 30 different commonly traded currency pairs and with targeted trade durations from minutes to months. Some are discretionary traders, while some hew to rigidly constructed quantitative systems. The

majority of these traders are trend-followers; but countertrending or mean-reverting strategies are employed by many short-term quantitative traders. Many longer-term traders rely on interest rate “carry” strategies to earn more in the currency lent than in the currency borrowed. And the most sophisticated of traders construct both plain-vanilla and exotic option strategies to achieve narrow return targets.

But through it all, one reality remains: The low percentage of currency-only traders is either a tribute to the virtues of intermarket diversification or evidence of just how difficult it is to reside only in the currency markets.

Simple Solutions

Alexander the Great may not have known all the buzzwords of modern management consulting, but he was a terrific simplifier. Legend has it he solved the intractable Gordian knot by cutting it with his sword. Currency traders, including the many spiritual successors of the NASDAQ day-traders of the 1990s, can duplicate this solution by replacing a wide array of currency pairs with the simple dollar index (DXY). The reason we should cut the knot is simple in a market that gravitates towards complexity: Nearly all traders, whether they choose to admit it or not, really bet on whether the U.S. dollar (USD) is going to rise or fall. Then they search out vehicles with which to express this opinion.

As Alexander would have said, if you want to trade the dollar, then trade the dollar. Just as most stock traders really bet on whether the market is going to rise or fall and minimize their asset-selection risk by trading an index suggest as the S&P 500 or Russell 1000, currency traders should minimize their selection risk by trading the DXY.

The DXY is a basket of 6 major currencies; Euro, Japanese yen, British pound, Canada dollar, Sweden krona and Swiss franc. Each currency is liquid and has a reliable structured interest rate market; collectively they create an index that represents the directional flow of the USD on globally with tight, efficient low cost bid-ask spreads. Futures and options on the DXY trade at the New York Board of Trade, which in turn is the primary marketplace for price discovery. DXY spreads are 2-3 pips wide, far narrower than what could be achieved by trading each currency individually.

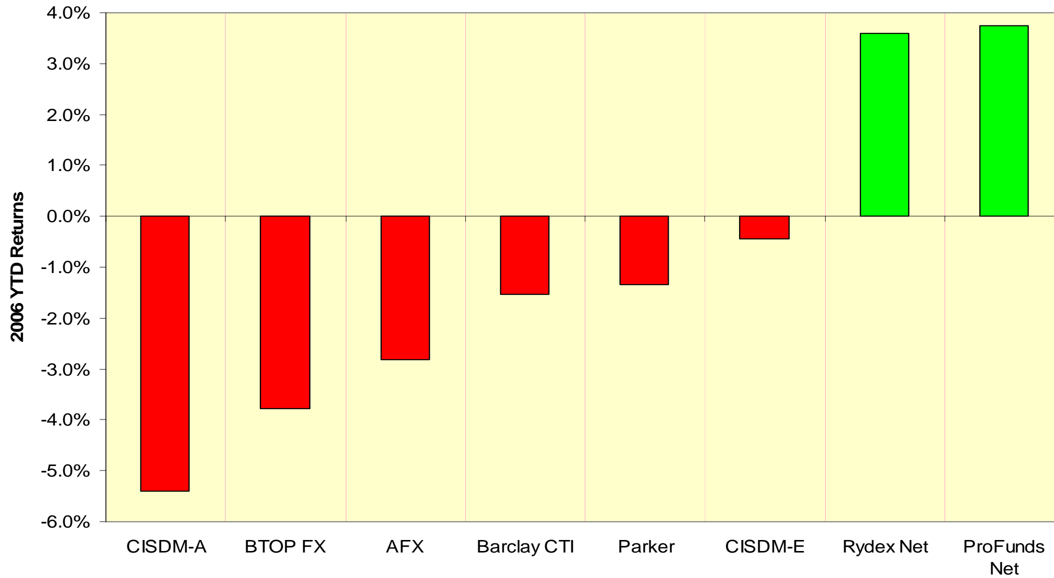
Of course, just as traders can over- or underweight stocks in an index, they can over- or underweight currencies in the six-currency DXY and the more active investor can even arbitrage the member currencies against the DXY. In addition, a currency manager with multiple cross-rate exposures can use the DXY futures and options as a hedge.

Performance

Now let’s turn to longer-term performance. As we noted above, professional currency traders have not turned their sophistication into profits in recent years. Two index-oriented mutual fund pairs, one from ProFunds and one from Rydex, have. Both fund families offer DXY-long and DXY-short funds to meet the needs of active traders. If we combine the long and short funds from each fund groups, we replicate closely the long/short performance of active fund managers.

Moreover, the gains from the winning DXY orientation exceed the losses from the losing DXY orientation on a systematic basis. As a result, the combined results both are positive and outperformed the currency managers who actively trade unique currency pairs. The average of the DXY-benchmarked funds outperformed the average performance of the currency indexes by 6.2%. The two extreme performance comparisons of DXY funds to individual currency index returns are:

- ProFunds (net) DXY funds outperformed the CISDM asset-weighted currency index by 9.15% for the first 7 months of 2006, and
- ProFunds (net) DXY funds outperformed the CISDM equal-weighted currency index by 4.19%.



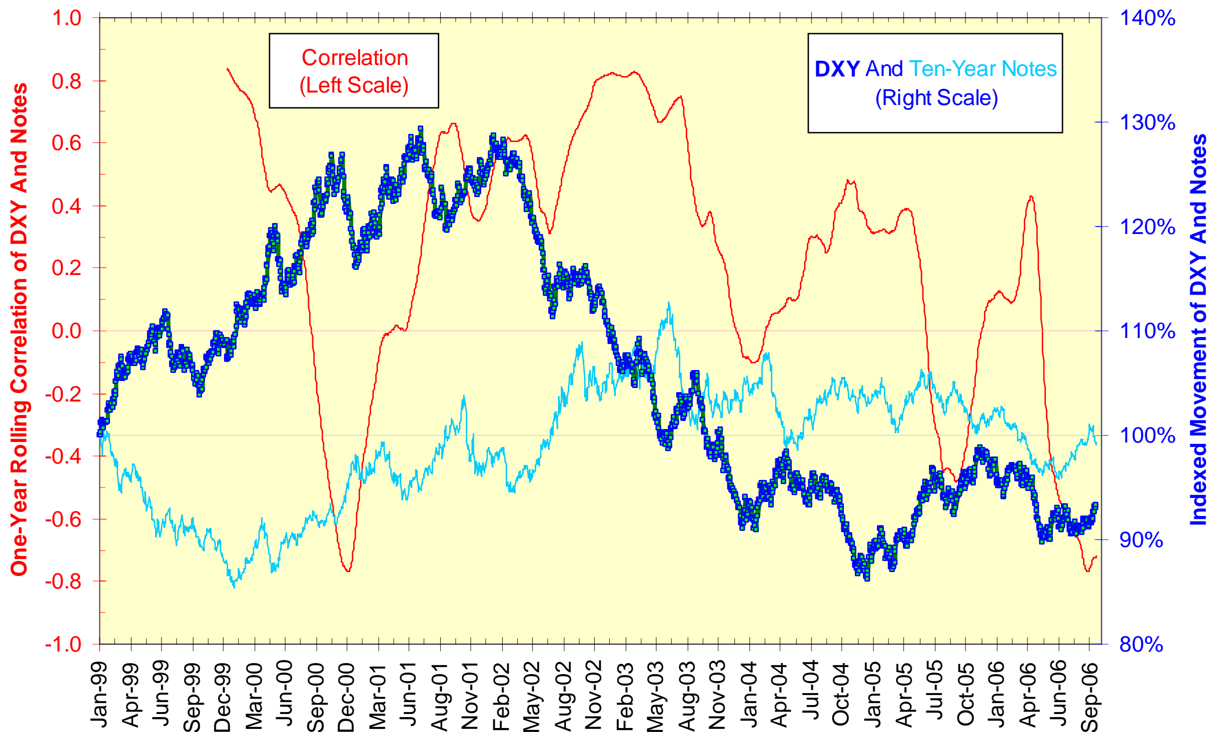
Intermarket Relationships

Few variables in finance are blamed or credit improperly for influencing other markets as much as is the USD. How can we be so confident in others' ability to get it wrong? One way is to display a set of one-year rolling correlations along with prices indexed to January 4, 1999 = 100% of the DXY against other key markets. If a market such as the DXY is causal of another's movements, the correlation between the two should both be stable and should never switch signs. This is most certainly not the case with the DXY.

The unstable correlations we see in the charts below create trading opportunities. They also provide useful analytic information for those who focus on the non-DXY markets and who may wish to sidestep the poor analysis so widely available in the public media.

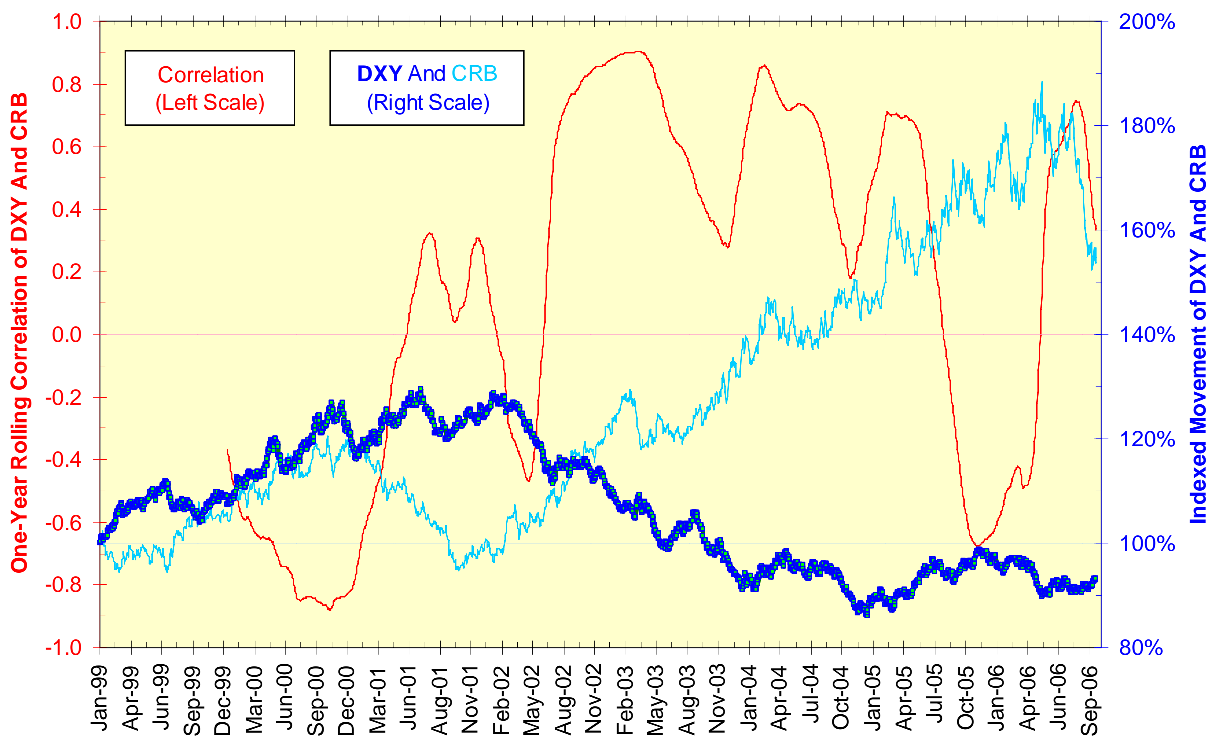
The correlation between the DXY and ten-year notes is an excellent case in point for the observations above. It presently is highly negative; that is a stronger DXY is associated with higher bond prices. Such was not the case from mid-2001 though 2003 and again from the spring of 2004 through mid-2005. A trader aware of these shifting tends should be able to profit therefrom.

The Dollar Index And Ten-Year Notes

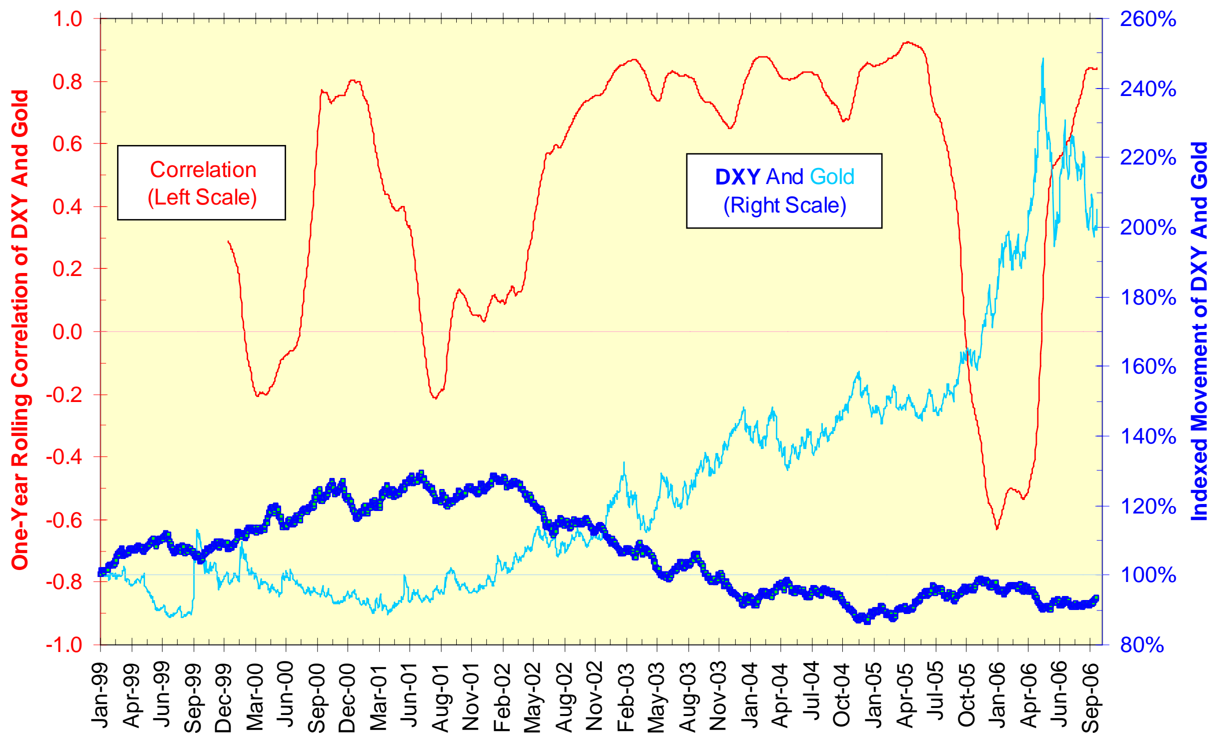


We can make a similar statement with regards to commodity prices as represented by the Reuters/Jefferies CRB index. At present, a stronger DXY is associated with higher commodity prices; the precise opposite was true in the second half of 2005 and during several earlier periods. Those who blithely attribute higher commodity prices to a weaker dollar have some explaining to do.

The Dollar Index And The Reuters/Jefferies CRB Index

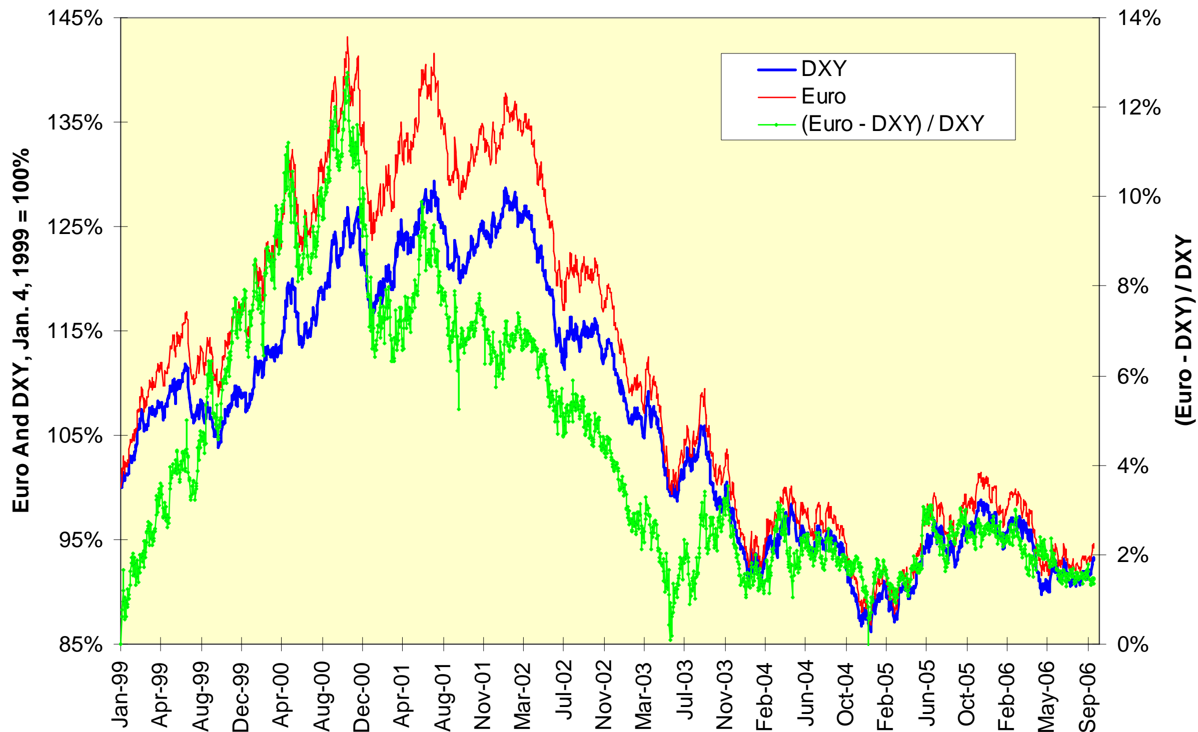


We can extend the relationship noted for the CRB index to the single commodity of gold. Gold commonly is regarded as a way to protect against dollar weakness, and yet it has been strongly positively correlated with the DXY of late and for most of the 2002-2005 period. In fact, only during the apex of the gold rally in late 2005 – early 2006 did the two markets exhibit the expected negative correlation.



More Than The Euro

It would be easy for skeptics to say the DXY is little more than the euro in disguise and with the euro's 57.6% weight in the DXY, that sentiment is understandable. But sentiment is not fact. If we index the euro and the DXY since the former's introduction in January 1999, we find long periods of divergent performance between the euro and the DXY. The spread between these performance indices as a percentage of the DXY has risen and fallen as a function of the euro's strength. This means the two markets are quite different in what drives them higher or lower. A singular focus on the euro will result in a USD-focused trader missing large moves in, say, the Canadian dollar or Japanese yen.



Too many traders confuse being fancy with being effective. If you want a simple-to-trade, liquid expression of your dollar opinion, one linked heavily to other markets in surprising ways, forget the fancy stuff; where has it gotten all of the trading professionals who would rather face exile than do something understandable by the common man? It does not take a rocket scientist to trade DXY futures and options effectively – or to trade the ProFunds or Rydex DXY-oriented funds effectively – nor should it. This is a business that pays you for being right, not for elaborate explanations of why various external factors through you off-guard. Don't make it any harder than that.