New Dollar Index, Same Old Problems

Actual solutions have no substitutes. Consider the problem of, say, opening a jar in an environment other than one of those bizarre job interviews where the HR clown is looking for some answer involving you transforming yourself into a parakeet and flying the jar to some exotic locale where it will be opened by the local shaman. Your answer should be, "Twist the lid counterclockwise." End of story.

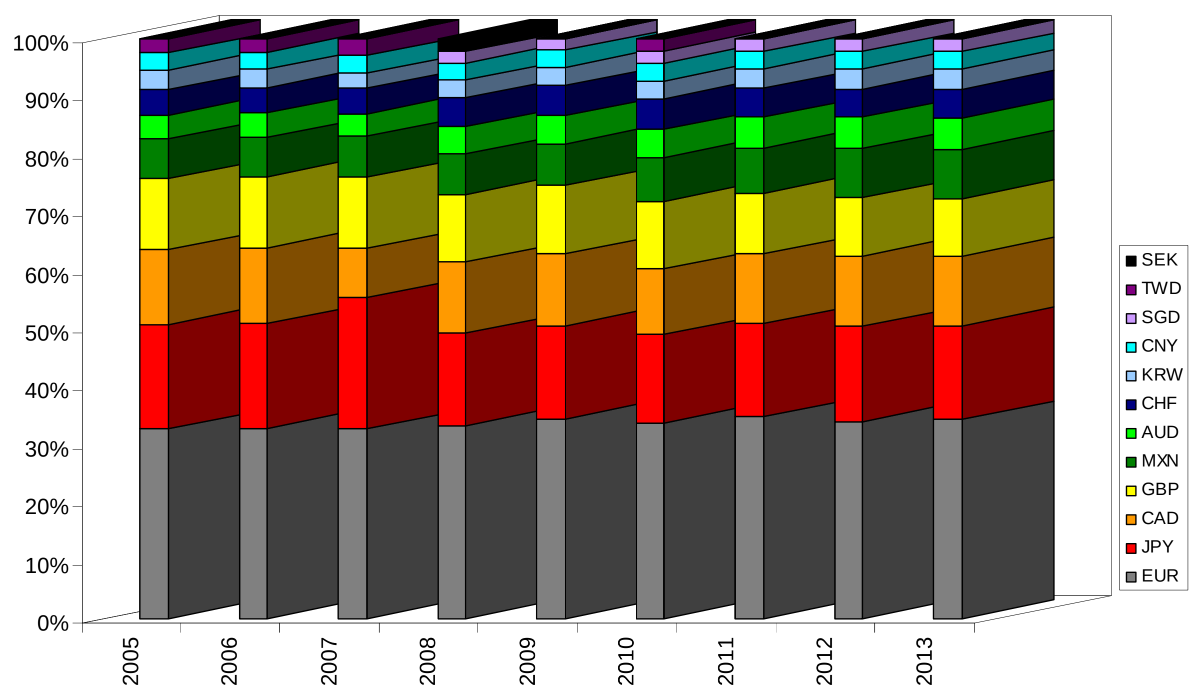
This parable is replete with meaning for indexation of all stripes. When the solution to a problem is unknown, answers proliferate. This is why we have equal-, price-, fundamental- and capitalization-weighted indices for equities and numerous approaches to commodities such as the S&P-Goldman Sachs and Dow Jones-UBS indices.

Currencies present an even worse problem. Consenting trading partners transact in a given currency; you buy Chinese goods to put on the shelves at Wal-Mart (WMT) or for whoever has your Target (TGT) credit card at the moment and you must sell dollars to buy yuan. You do not sell a dollar index; nor does a importer of American goods sell, say, euros to buy a dollar index. On the financial side of the transaction, you can borrow euro deposits and lend dollar deposits without ever transacting in actual goods, but why would you trouble yourself to borrow a weighted basket of currency deposits to lend into the dollar?

Different Approaches

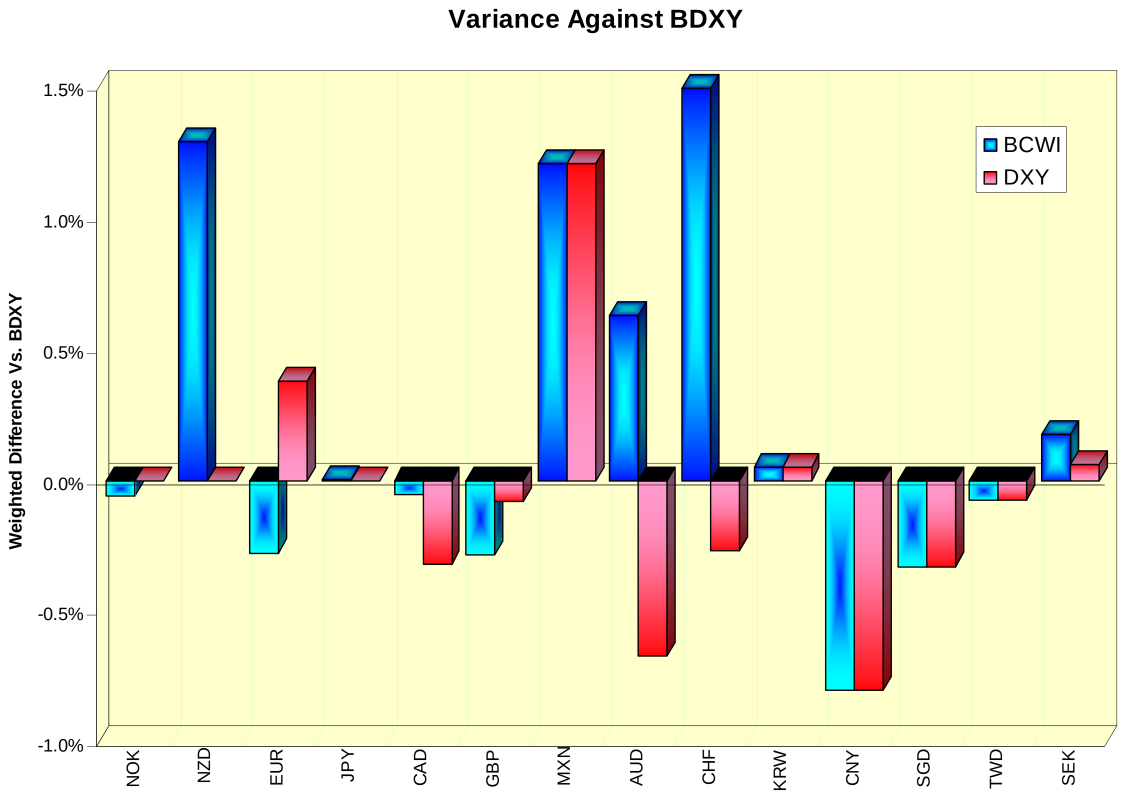
The term "dollar index" generally defaults to the ICE dollar index (DXY) whose weights, as noted here recently in another context, have remained unchanged since 1973 even though the world has changed here and there. *Bloomberg* has constructed a ten-member family of currency indices whose weights are based on their correlations against one other (BCWI). They recently added a spot dollar index (BDXY) whose weights are based on trade flows and financial liquidity. These weights are recalculated annually and are presented below for the index' history since the end of 2004.

Annual Weights For Bloomberg Dollar Index



A total of 20 currencies are considered for inclusion, of which ten make the cut every year. This is why smaller currencies such as the Singapore and Taiwan dollars (SGD and TWD) or Swedish krona (SEK) make cameo appearances. You also may notice if you have good eyesight and a high-resolution screen the yuan's weight is a constant 3%. This managed weight is done in response to the managed CNY; touché!

Performance Variance
These different weights and compositions naturally produce different results. While the BDXY advanced 2.08% between December 2004 and November 2013, the BCWI and DXY declined 4.00% and 0.21%, respectively. A map of the weighted variances for each currency using 2013 weights shows some very prominent differences between each currency's weighted returns in either the BCWI or DXY and the BDXY.



These different approaches will continue to produce different results. In addition, they will stimulate the creation of new and different indices. What should you do? To go back to my answer for commodity indexation, if you want to trade gold or crude oil, trade gold or crude oil; why add corn or cocoa into the mix? Here if you want to trade the euro or yen, trade the euro or yen. Real answers to real problems are simple when we allow them to be.