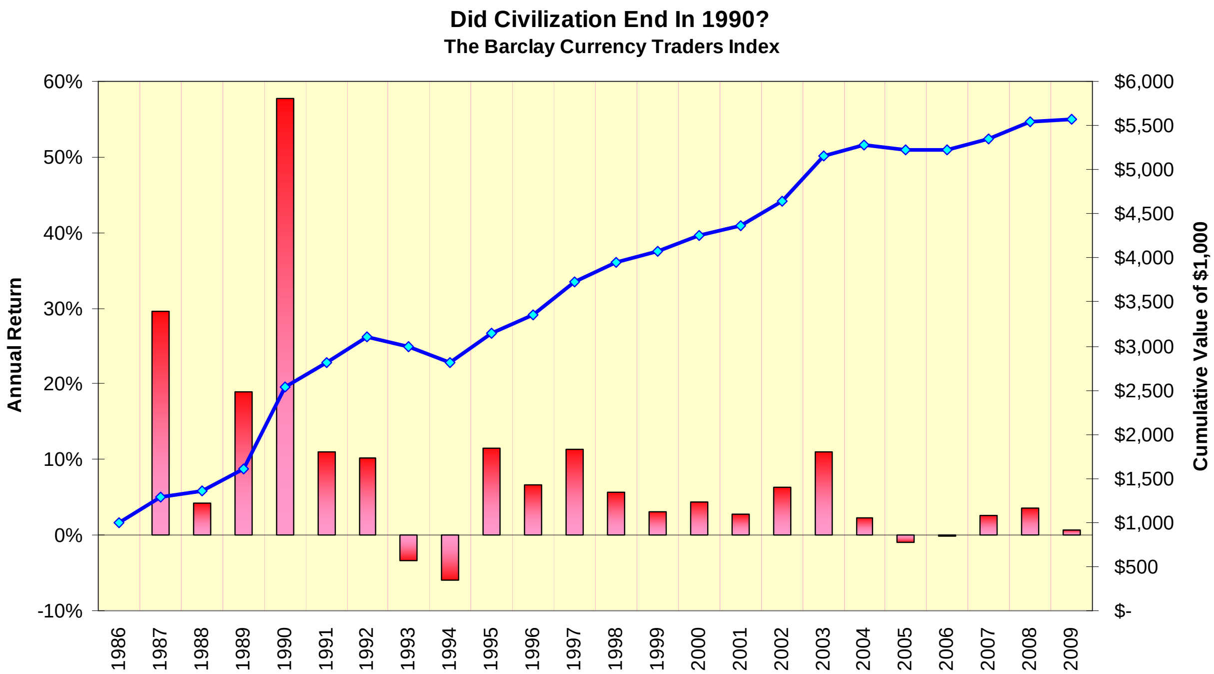
Failure Is An Option In Currency Trading

The admonition, "do not try this at home; these are professionals" should not apply in the world of currency trading. As a long-ago acquaintance lamented to me, the econometrician-in-residence, "if econometrics were ever to succeed on Wall Street, it would be in currencies." Fat chance: The central equation in currency valuation has three unknowns, the two short-term interest rates involved along with the spot rate. Even the bad algebra students, most of whom had to go on to law school, know one equation with three variables has an infinite number of solutions.

As we will see below, no other approaches have knocked the doors down, either. If we track the Barclay Group's Currency Traders index, which like all such indices has an enormous survivor bias, from the end of 1986 onwards, we find a $1,000 initial investment would be worth $5, 575 at the end of 2009. Nearly all of the large annual gains occurred during the first four years tracked, which makes us wonder if civilization ended when Saddam Hussein invaded Kuwait.



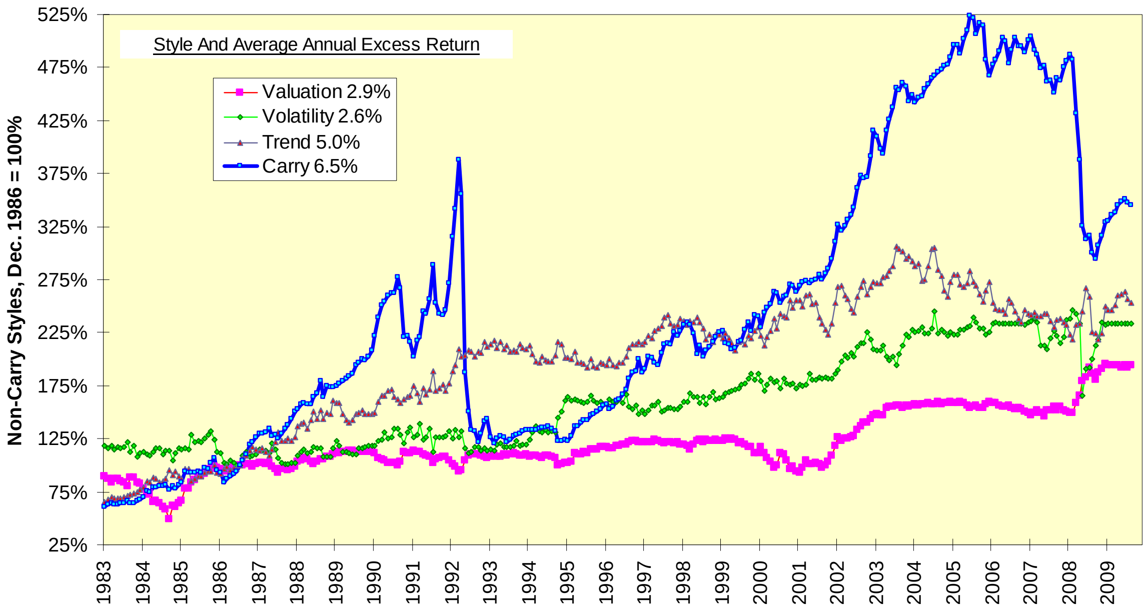
The average monthly return of this index, which like all CTA and hedge fund indices has a massive survivor bias, has been .62% with a standard deviation of 3.33%. The Sharpe ratio is 0.274 over the whole period and a paltry 0.0374 after 1990. Remember, the Sharpe ratio of a Treasury bill is 0.00 by definition. This is not exactly leading the league in value-added, is it?

Styling With The Pros

Now let's look at the indexed excess returns for the currency trading styles defined by Royal Bank of Scotland (Motto: Our bailout was bigger than yours) of Valuation, Trend-following, Volatility and Carry. Average annual excess returns are posted within the legend; for comparison, the average annual return on an index of three-month Treasury bills over this period was 4.56%.

Over the period in question, the excess return for the Volatility and Valuation styles was less than the average annual return of the most commonly accepted definition of risk-free returns. Trend-following and Carry trading produced excess returns greater than Treasury bills, but only at the cost of significant retracements of gain.
The top-performing carry style had a 68.6% retracement of gain between August 1992 and February 1993 and has given back another 34.2% of its gain since its November 2005 peak. The trend-following style has given up 17.5% of its gain since December 2003.

Performance Of RBS Currency Style Indices



For purposes of comparison, the total returns for the MSCI World index in USD terms from December 2003 and November 2005 have been 25.4% and 1.14%, respectively. Similar returns for the Tremont Event-Driven and Global Macro indices from November 2005 were 6.37% and 8.55%, respectively, and from December 2003 were 8.02% and 8.65%, respectively.

Anyone who had relied on either of the two best active currency management styles had excess returns less than those for global equities or related hedge fund styles in a tough period for investors. While individual managers can and do outperform the averages, the simple fact remains currency trading is a zero-sum game. The winners and losers net each other out, the losers disappear eventually and like in a casino, the winners ultimately finance the house. The professionals have not been able to demonstrate in a quarter-century of trying they can, as a class, add value. Failure is an option, and an in-the-money one at that.