Looking for alpha

Hedge funds are increasingly looking at foreign exchange as an opportunity to augment returns, as Elise Coroneos finds out

Over the past few years, foreign exchange investing has come of age, emerging as a bona fide asset class in its own right.

FX markets, the largest and most liquid market in the world, have slowly but surely developed to become venues where investors can go to find alpha, an investment characteristic with which it has not historically been associated.

Buy-side investors such as hedge funds have traditionally used FX as a defensive strategy to reduce the risk and cost of hedging. However, more are now looking to FX as an opportunity to augment returns, according to David Poole of ClientKnowledge.

London-based ClientKnowledge advises intermediaries and sell-side institutions of the needs and requirements of buy-side managers such as hedge funds, on subjects as diverse as FX, fixed income and cash management services.

"We are seeing more equity and fixed income hedge funds actively look at foreign exchange to generate returns," says Poole.

Reasons often cited for the increased interest in FX as an investment class, include the general malaise in equity markets having forced investors to find new markets and the downturn of the US dollar, which has provided currency market novices with a significant and decipherable trend upon which to capitalise.

Another important reason for the interest in FX has been the emergence of specialist multi-bank portals, such as FXall, HotSpot FX and Currenex, which have caught the eye of technology savvy alternative investment managers such as hedge funds.

Trading efficiencies

Traditionally, investors in FX needed to make a phone call to individual banks or service desks to execute an order. About four years ago, research indicated that more than 90% of the institutional FX market still traded via the phone, a number that has now dropped to about 40%.

According to Mark Warms, FXall's global head of sales and marketing, there are five main institutional FX segments. Firstly, major banks who typically are providers of liquidity to other market participants; secondly, smaller, regional banks and broker/dealers; thirdly, asset managers and other the non-levered institutional investors; fourthly, multinational corporates; and fifthly, hedge funds and commodity trading advisors.

It is this last segment, hedge funds and commodity trading advisers, that has gained a lot of attention in FX markets, not only because of their increased interest in using the asset class as a source to generate alpha, but also for the volume of trades they execute.

London-based FXall serves more than 700 institutions. Hedge funds account for about 20% of the firm's customer base, but make up decidedly more than 20% of its volume.

"Hedge funds have become the fastest growing segment in our marketplace," says Warms. "Because they are usually leveraged, hedge funds typically do more volume per customer account."

Platform choice

Which platform a hedge fund chooses to implement, can be influenced by a variety of factors, among the most important of which is the work background of the individual trader.

"A lot of hedge funds are set up by people who used to trade as proprietary traders at banks, so they look for similar systems to that which the banks use," says Poole of ClientKnowledge.

One such trader is Scott Greene of London-based SRG Capital, a $54 million currency only hedge fund. Prior to forming SRG, Greene traded FX at AIG for ten years. It is because of his sell-side background, that Greene says he uses HotSpot FX. It is the only platform that uses an exchange model like that used by banks, thus enabling hedge funds to make actual bids and offers on currencies – an activity that is usually the domain of broker dealers.

Hedge funds' attraction to an actual live marketplace, such as that provided by New Jersey-based HotSpot FX, is evident. Hedge funds make up over 75% of the firm's client base.

"It is a huge benefit for hedge fund traders to be able to use a system they are familiar with using in other asset classes. So if a hedge fund has a strategy that works effectively in the equity markets, where exchange/ECN marketplace platforms prevail, the strategy can be executed in the currency markets on our platform," says John Eley, the president and CEO of HotSpot FX.

Although this type of live market structure has been available to equity traders for a number of years, FX traders had been limited to using the traditional Request For Quote system where investors call up individual banks, either via phone or computer, and ask for a price.

According to Greene of SRG Capital: "With HotSpot FX you see running dealable prices, as well as the volumes being traded, so it is not unlike being on the bank side where you actually feel like you're involved in the market. Also, you have the ability to bid or offer at the price you determine, whereas with all the other platforms, if you want to trade on a euro/dollar price, you have to call them for a price and they give you a two-way price," he says.

"In the competitive investment world, where asset managers are fighting for the next percentage or two of performance, the ability to make a bid can make a significant difference to returns over the course of a year," says Greene, who describes his fund as short to medium term and opportunistic in nature.

Using electronic platforms is an integral part of Greene's operation, without which it would be difficult to execute his trading strategy, which involves moving in and out of positions quickly as the market scene changes.

High volume trading is typical of hedge funds in the FX markets. "In these current market conditions, you always feel you are on the precipice of something interesting," says Greene, who looks to capture moves in the range of 1% to 3%.

"There are a lot of smaller moves to exploit in FX so it is just a matter of trying to be flexible in order to capture them and then move on to the next one," says Greene.

Liquidity

Other factors swaying hedge funds' choice of electronic trading platform are tight pricing and deep liquidity. "A key component is the depth and the breadth of the banks that are creating the liquidity pool," says Kelly Adams, chief technology officer at FX Concepts.

BIS notes growth

According to the *Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2004* by Bank for International Settlements (BIS), the level of trading between banks and other financial institutions rose by an impressive 78% between 2001 and 2004, and its share of total turnover went up from 28% to 33%. BIS says market commentary suggests that the higher trading activity between reporting banks and other financial institutions reflected trading by a large range of investors, including institutional investors (such as pension funds and insurance companies), hedge funds, commodity trading advisers (CTAs), proprietary trading desks of large commercial banks and currency overlay managers. "This is in contrast with the period between 1998 and 2001, when activity in this market segment had been driven many by institutional investors, while the role of hedge funds had reportedly declined," said BIS.

"The surge of activity between banks and financial customers was arguably a manifestation of the broad search for yield that has characterised financial markets in recent years," the report continued. "In this environment, financial customers followed two key strategies – carry trades and momentum trading – that targeted the same currencies. Extended period of exchange rate appreciation by higher-yielding currencies in the 2001-2004 period attracted investors playing both types of strategies." ❑

New York-based FX Concepts is a currency specialist with about $12 billion in assets. It currently uses a combination of platforms, including FXall, HotSpot FX and Currenex.

"If each vendor has their own liquidity pool they have created, you have to figure out whether that pool is going to satisfy your needs and includes the currency pairs that you want to trade," says Adams.

One US-based hedge fund that declined to be named chose FXall because of its deep liquidity. FXall is integrated to 57 FX banks, creating one of the deepest sources of liquidity in the market across more than 180 currency pairs.

"At the time we were looking at the platform alternatives, it seemed that FXall had the depth of liquidity we needed compared to the other competing execution platforms we looked at," said the manager, whose funds' assets total some $700m.

This manager moved to electronic trading only within the last year, after nine years in operation. This development was prompted by the manager's adoption of a FX prime broker, a move that allowed it to consider alternative avenues of execution.

"Trading electronically gives us greater transparency in the marketplace because it allows for competition amongst different banks so you get to see the bid and ask they are posting at any given time," said the manager.

Beyond spot

While HotSpot FX can claim to be the only electronic platform with a live market structure, FXall promotes itself as the only service that goes beyond the deal by automating the entire deal life cycle.

FXall provides full STP, which allows for functionalities such as the ability to do trade splits on either a pre- or post-trade basis. "So that means they can either upload all those splits, add them together automatically and do a trade, or they can just do one trade and split them back out," says Warms.

HotSpot FX provides STP, but uses a different method of delivery. Instead of having its own stand-alone settlement system, as is the case with FXall, HotSpot FX has intergrated its plarform with 14 prime brokers' back office systems.

"Hedge funds need only select a prime broker and everything from start to finish is taken care of in an automated fashion," says Eley.

This method of STP, Eley argues, is actually very convenient because trades executed through HotSpot FX are directed to the same prime broker back office a hedge fund already uses for its direct trades with banks and trades on other electronic platforms with integrated prime brokers. This enables hedge funds to trade on HotSpot FX through its existing middle and back office systems, saving time, IT resources, expense and the operational risks of intergrating new post-trade systems.

"We want to make sure that the pre- and post-trade operational issues are simple, so that the individual trader or portfolio manager can concentrate on the investment and trading decision and not on things like allocations and averaging," says Eley.

As hedge funds become more comfortable with FX and the various avenues via which it can be traded, electronic platform providers will not rest on their laurels.

One of the next levels of innovation will be APIs, or application program interfaces, which will enable hedge funds to deal effectively and directly from their own order management system rather than going to an external site. Both HotSpot FX and FXall have on APIs, according to Poole of ClientKnowledge.

"We have gone past the stage of early adopters where people were just enthusiastic to do it electronically," says Poole. "Now people are more in terms of cost benefit." ❑