

# Currencies Where is your money safer?

In these days of day-to-day volatility, currency trading is not for the faint hearted. Money can be made or lost on the up and down swings of a single day. If you're looking for a cast iron safe investment, currency trading may not be for you. Nonetheless, if you have an amount of risk capital on which you're prepared to take a hit or lose altogether then there are possibilities to make some money. Currency trading is all about knowing when to get in and when to get out which means a lot of research and second-guessing events and trends.

On Wednesday, June 24 the US Federal Reserve, as expected, kept its benchmark rate unchanged at 0.25 per cent. The statement accompanying the announcement was more bullish than the market expected so the following day the US dollar rallied. In the short-term however, the dollar is expected to be under some pressure, with the long-term trend still bullish. The Federal Reserve said, "Although economic

activity is likely to remain weak for a time, the Committee continues to anticipate that policy actions to stabilise financial markets and institutions, fiscal and monetary stimulus and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability."

The UK pound hit a 12 day high on June 24 almost hitting US\$1.66. However, current market expectation is that that bubble will burst especially when the Bank of England governor, Mervyn King, said, "I feel more uncertain now than ever. This is a pattern of recession that we've not seen since the 1930s." He followed on by saying that economic recovery could still be a, "long, hard slog." Early trading on June 25 at the US\$1.63 mark would seem to confirm this sentiment. However, smart buying before the 12 day high would have netted a profit.

The Euro has been described recently as choppy and the Japanese Yen is expected to be under some



WHICH COUNTRY HAS THE BEST POLICIES, LIMITING INFLATION AND PROMOTING GROWTH? THAT'S THE MILLION DOLLAR QUESTION...

bearish pressure. Other notable currency movers to look out for, given recent movement, are the Australian dollar, the Canadian dollar, the New Zealand dollar and the Swedish Krona. Will investing in any of these currencies be absolutely safe? Absolutely not. Could your investment net a profit? Absolutely possibly.

dence got a severe hammering when the World Bank revealed that it thought that the world economy would decline by 2.9 per cent in 2009 instead of 1.7 per cent as previously forecast. The Bank said that 2010 may see some growth but that it was uncertain and that those who could least bare the pain, developing countries, would see more to come. The International Monetary Fund (IMF) is upbeat however, predicting modest growth mainly for 2010. "Financial conditions have improved, confidence is recovering gradually and indicators of future production and demand have firmed," said IMF first deputy managing director, John Lipsky, at a conference in Turkey.

The Organization for

Economic Cooperation and Development (OECD) recently released its twice yearly report, in which it estimated that the US recession will bottom out in 2009 with a 2.8 per cent contraction but should grow 0.9 per cent in 2010. The OECD did note however, that the decline in the US housing market appeared to be coming to an end, citing a reduction in the supply of unsold homes relative to demand. The news isn't that good from Canada, as reported bank lending for May shrank 3.5 per cent, the third consecutive monthly drop in the commodity rich nation, suggesting that for the short term the recession will continue.

In Asia, speaking at an executive meeting of the State Council

in China, Chinese premier Wen Jiabao said that the economy was at a crucial point as a steady recovery has begun. He tempered his words saying that there were still uncertainties for a stable economic recovery such as weak exports, the fiscal deficit and trade protectionism. In Japan, there are encouraging signs as the nation logged a fourth straight monthly trade surplus for May of US\$3.2bn beating expectations by around 37 per cent.

Reading between the lines, it's pretty clear that we are not out of the woods yet but, hopefully, the recession won't get any worse. Getting back to where world economies were before this all started however, is likely to be a long, slow haul.

## The current economy; on the up, going down or bumping along the bottom?

Lately, there have been signs and portents that the global economy may have reached a point where the situation is not going to get much worse but, conversely, is not expected to climb off the bottom anytime soon. The recent rise in confi-



PHOTO OF MIKKEL THORUP, FOREX STRATEGIST AND FOUNDER OF CAPRICORN ASSET MANAGEMENT

# Mikkel Thorup Making Money in Forex

**Q** Please give us a brief background about yourself and Capricorn Asset Management.

**A** I was a proprietary trader for Smith Barney working from the Geneva office when I decided to go on my own and form Capricorn. I know I was not the first 'ex-prop trader' with a well performing strategy wanting to start his own hedge fund, but I knew that I needed to find someone to 'seed' the fund. As it happened, the prop desk also serviced a number of the banks' HNW clients, which I had developed quite a close relationship with. It was two of these clients that offered to back me if I did go on my own, so I suppose you can say that they prompted me to form Capricorn.

Things have evolved a lot since 1999, both in terms of Capricorn as a business as well as the fx market as a whole. I started out as a one man operation and ran the business like that for 2 years. I however realized that doing the trading, marketing, administration and many other things was too much and focus was not there to do every job 100%, therefore the organization gradually has grown since then. Today we are a team of 4, myself as CIO, Mike Rasmussen, Partner and COO, Martin Zoller, Compliance & Klaus Oesterballe, Global head of sales.

We run 3 trading strategies covering different time frames, as well as an external multi manager strategy which was launched in cooperation with a US fund which is already a

client of ours. Our combined asset under management are currently just under 300 million USD across the strategies in managed account and fund formats, and our clients include corporate treasuries, fund of funds, family offices and HNW individuals.

**Q** Do you see increasing investment opportunities in the currency markets despite the current turmoil in other markets and why do you believe currency management should be part of an investment portfolio?

**A** I believe there will always be investment opportunities in trading currencies, mainly because of the inherent inefficiencies of the marketplace. As long as these inefficiencies continue, in my opinion a skilled trader should be able to generate risk-adjusted returns over time regardless of the situation in other markets. For this reason I believe that every investment portfolio should have an 'active currency' component seeking additional returns. Empirical evidence has suggested a low correlation between currency strategies and other asset classes, and this simply strengthens the argument for currency management for me. However in my judgment, increasing investment opportunities in the currency market will only prevail by introducing unique strategies and ideas. The marketplace is vast and deep enough for skilled managers to develop alpha seeking strategies that truly add value,

while the 'copycat' funds are unlikely to gain any traction.

Currency investments are gaining momentum and popularity with investors as a source of uncorrelated returns. With markets in a general slide and funds losing billions in capital, new ways to achieve better portfolio diversification is at the top of the agenda for institutional investors. Currency as an asset class provides low correlation to traditional investments and even to alternative investments (making them almost the alternative to alternatives). The last two years have also strengthened the need of investors for highly liquid investments and the right risk tools in place in times of distress. Only a few managers were able to still deliver their performance, with all three of the above-mentioned needs in mind.

**Q** What are the benefits of currency as an asset class?

**A** Liquid market: High liquidity is one of the primary advantages, an area in which currencies are unrivalled. This market is extremely liquid. Turnover is over three trillion a day, according to the triennial BIS survey 2007, and recent surveys by central banks indicate higher totals for the 2010 survey. Transaction costs are, I would say, on average 20 times more advantageous than equity, maybe even more. It's the most cost-efficient capital market in the world. This high liquidity allows for much shorter redemption periods, and also means that Capricorn does not

impose any lock-ups on clients.

**Free leverage:** The instruments used for our investment strategies gives our fund access to free leverage. However, this doesn't mean that the team is overly aggressive when it comes to gearing. "You can get leverage of up to about 20 times for free, "but in our case we use only a maximum of two. We are very conservative on leverage. Our performance has been better than most hedge funds and at the same time our leverage has been well below the other hedge funds.

**Low correlation:** A good currency strategy can prove to be extremely useful in generating alpha, as correlation is very low to the traditional asset classes used by institutional investors. That's why we see more and more pension funds actually looking at currency as an asset class. We have provided asset-liability studies to several of our investors, adding our portfolio to their existing portfolio, and you see very positive portfolio effects. And the interesting point in our case is that the correlation with other alternatives is also low. So even within your hedge fund portfolio, you can create diversification by adding currencies as an asset class.

**Q** Can you elaborate on the currency programs Capricorn currently offers and how have you tailored your investment vehicles to assist investors to participate in your strategies?

**A** The first program that I developed was the Short-term strategy that was launched in January 1999. This is our flagship program in terms of the long track record and annualized returns. The program is currently available only as a managed account as it is the preferred investment vehicle of our clients. Institutional investors such as Fund-of-Funds, Banks and Corporate Treasuries approve the transparency and the ability to notionally fund the investment. The strategy has a very low margin-to-equity ratio and therefore the managed account format is extremely cash efficient. The Medium-term strategy was launched in February 2007, utilizing a long-options strategy to capitalize on the broader intra-month market moves.



CAPRICORN MANAGEMENT AT WORK; SIX SCREENS, CHARTS AND A HEAD FULL OF IDEAS TO GET RETURNS FOR INVESTORS.

This program is available to investors as a managed account only. Our most recent strategy is our Long-term program, Capricorn fxG10 that was first introduced April 2008, developed as a 'carry trade' strategy with a specialized arbitrage component to reduce risk. This strategy is only available as a fund as we target clients seeking an investment opportunity they can passively managed because it is administered and audited professionally.

**Q** Achieving risk-adjusted returns consistently is never easy. What key attributes do you think successful currency managers need to have?

**A** I am definitely an advocate of the 'Turtle' philosophy to successful trading; having confidence, consistency and

discipline. So even though I technically analyze market opportunities daily, our trade frequency is comparatively low due to our discretionary view and methodology. A clearly defined methodology with a robust risk control policy is crucial for a currency manager to be successful in the long term. Creating a unique strategy that is able to achieve risk-adjusted returns is half the battle, being able to maintain your discipline during all market conditions and follow your rules to trading is the other half. My personal view is that the ability to be selective over the identified 'alpha' seeking opportunities is more important than following what the charts indicate. I have seen too many occasions when even professional managers have given back their profits and more by over-trading.

**Q** You have been nominated as "best newcomer" for the European Performance Award. What's your secret? Tell us about the strategy.

**A** The Capricorn FX G10 fund's strategy is categorized by Capricorn as long-term, fundamental seeking alpha opportunities in most market conditions by benefiting from currency arbitrage and exchange rate discrepancies. The program seeks risk-adjusted returns that are uncorrelated to other investment strategies by trading the most liquid assets available to investors, the major currencies. The strategy uses currency forwards and has a directional bias in the carry trade, borrowing low-yielding and lending high-yielding currencies. Risk is controlled through a dynamic hedging

strategy aimed at reducing exchange rate risk. Performance tends to be strong in all market conditions, providing ample liquidity is available. When we launched the Capricorn FXG10 fund, we had already established ourselves as a foreign exchange manager over the past 10 years so I did not want to stray into another asset class. In early 2008 I thought it wise to launch the strategy because of the diverse changes and inefficiencies in the currency markets at the time. The differentiating factor behind this program is the fundamental approach of the strategy; where as the other programs that we run are technically orientated in analysis. The Capricorn FXG10 fund uses a systematic approach to trading with a longer-term view. We also checked that our clients would like the offering and it turned out that a small Swiss family office wanted to

**"You definitely need discipline in trading and in decision-making and we have ten years of experience."**

seed the fund, as they believed in the approach.

In order to provide a source of uncorrelated alpha to professional investors, Capricorn believes our niche, as a currency manager is the discipline inherent within its trading methodology. The routine for the strategy is initiated with the analysis of interest rate discrepancies, as well as the global macro fundamentals of the major currencies.

After the fundamental view is determined on the G10 crosses, leverage is re-balanced on a portfolio level depending upon the monthly cash adjustments within the fund. The individual currency crosses are then entered into the in-house carry model, used to optimize the allocations of the components within the portfolio. This builds a portfolio that is balanced in currency weighting, in order to reduce the exchange rate risk of the components and to isolate the carry benefits of the strategy. Execution is automated across multiple liquidity providers to access the arbitrage opportunities created by the risk control measures.

The recent foreign exchange environment has not been the best type of environment for this strategy because it has seen interest rates coming down. When this happens, carry trades do not get very exciting and there is not much interest rate arbitrage around. Nevertheless, I attribute the recent success of the fund to hedging off much of the fund's exposure in long carry trades, and being able to time entries and exits efficiently.

Through this we have been able to maintain constant performance. If we look at the first year track record, we have only have three down months. The main reason for our success I think is discipline. You definitely need discipline in trading and in decision-making and we have 10 years of experience in discretionary and technical traders. Discipline and risk management are the key drivers of our achievement.