the emergence of a new asset class

an introduction

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Summary

The foreign exchange (currency, forex or FX) market exists wherever one currency is traded for another. It is by far the largest market in the world, in terms of cash value traded, and includes trading between large banks, central banks, currency speculators, multinational corporations, governments, and other financial markets and institutions. Trade happening in the forex markets across the globe is exceeding $3 trillion/day (on average).

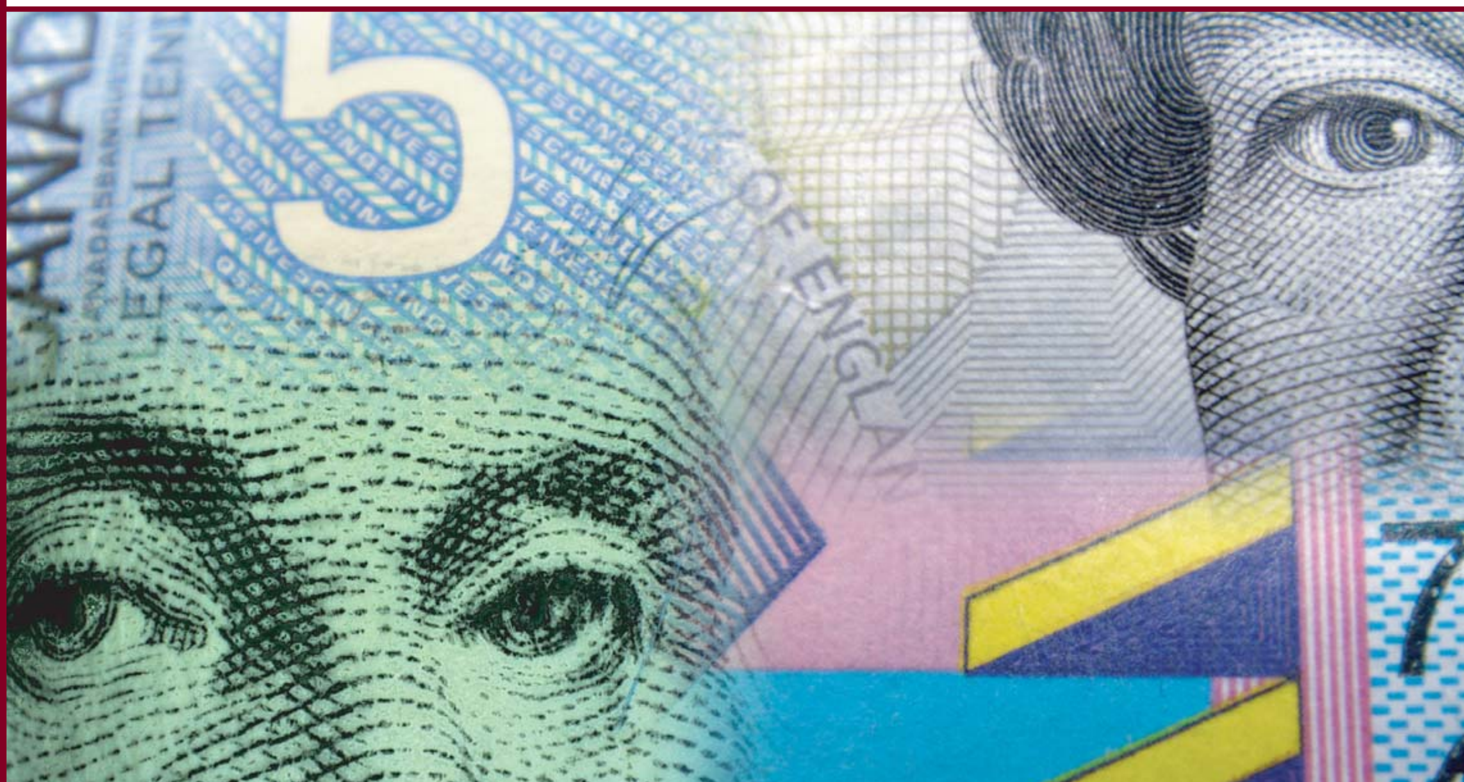
TowerGroup, a financial services research consultancy, said it expected total global average daily volumes on the FX market to exceed $3,500 bn in 2009. FX volumes, which rose from $1,770bn in 2004 to $2,500bn last year, were set to rise to $3,000bn this year and $3,500bn next year, as foreign exchange became accepted as an asset class in its own right according to TowerGroup.

History of the Currency Market

The forex market is a cash inter-bank or inter-dealer market, which was established in 1971 when floating exchange rates began to appear. The foreign exchange market is huge in comparison to other markets. For example, the average daily trading volume of US Treasury Bonds is $300 billion and the US stock market has an average daily volume of less than $10 billion. Ten years ago the Wall Street Journal estimated the daily trading volume in the forex market to be in excess of $1 trillion. Today that figure has grown to approximately $3 trillion per day.

Prior to 1971 an agreement called the Bretton Woods Act prevented speculation in the currency markets. The Bretton Woods Agreement was set up in 1945 with the aim of stabilising international currencies and preventing money fleeing across nations. This agreement fixed all national currencies against the dollar and set the dollar at a rate of $35 per ounce of gold. Prior to this agreement the gold exchange standard had been used since 1876. The gold standard used gold to back each currency and thus prevented kings and rulers from arbitrarily debasing money and triggering inflation. Institutions like the Federal Reserve System of the United States and foreign Central Banks now have this kind of power.

The agreement was finally abandoned in 1971, and the US dollar was no longer convertible to gold. By 1973, currencies of the major industrialized nations became more freely floating, controlled mainly by the forces of supply and demand. Prices were set, with volumes, speed and price volatility all increasing during the 1970's. This led to new financial instruments, market deregulation and open trade. It also led to a rise in the power of speculators. In the 1980's the movement of money across borders accelerated with the advent of computers and the market became a continuum, trading through the Asian, European and American time zones. The market has changed dramatically with most international financial transactions being carried out not to buy and sell goods but to speculate, with the aim of most deals to ***make money out of the flow of money***.



The Currency Market in General

The competitive pricing in the Interbank forex market is now readily accessible on a 24-hour basis to a broader base of investors which used to be exclusive to the world's large corporations and financial institutions. Individual investors and professional speculators are no longer limited to the currency futures market which cannot offer the advantages that interbank foreign exchange transactions provide.

Some banks make 40-60% of all their profits trading currencies. In the August 1995 issue of International Financial Magazine, Charles Sanford, Chairman of the Bankers Trust, expressed his opinion that by the year 2020 banks will cease their loan transactional business. This would allow banks to focus on currency trading as their primary revenue source. So why is the American public largely oblivious to the forex market? The answer is simple; until recently the interbank currency market was financially inaccessible for the general population of investors and traders, minimum account requirements were beyond the resources of the average individual investor. The situation has changed dramatically. The retail side of foreign exchange began to expand considerably with the emergence of new players; secondary banks and financial institutions that opened the market to smaller investors, while retaining the advantages of the institutional players. Suddenly, instead of a minimum investment of $50 million, accounts could be opened for $25 - 250K. The forex market, like futures, utilizes the account deposit as collateral, a performance band that can be ***liquidated at any time***.

The FX market is unique because of:

- its extremely large trading volume
- the high liquidity of the market
- the large number and variety of participants
- its geographical dispersion
- its 24 hr trading day *(except on weekends)*
- the variety of factors affecting currencies

Source: BIS Study 2007

This market does not have a single physical location such as a trading exchange. Rather, it is a global network of commercial banks, investment banks and brokerage houses that comprise an electronically linked infrastructure servicing currency trading. Millions of dollars are moved from one currency into another every second of the day, by virtue of an electronic trading platform of a simple telephone conversation.

Market Characteristics

There is no single unified foreign exchange market. Due to the over-the-counter (OTC) nature of currency markets, there are rather a number of interconnected marketplaces, where different currency instruments are traded. This implies that there is no such thing as a single dollar rate - instead a number of different rates (prices), depending on what bank or market maker is trading.

The main trading centers are in Zurich, London, New York, and Tokyo, however banks throughout the world participate. As the Asian trading session ends, the European session begins, followed by the US session, and returning to the Asian market. Traders can react to news when it breaks, rather than waiting for the market to open. There is essentially no "inside information" in the foreign exchange markets. Exchange rate fluctuations are caused by actual monetary flows as well as by expectations of changes in monetary flows as a result of changes in GDP growth, inflation, interest rates, budget and trade deficits or surpluses and other macroeconomic conditions. Major news is released publicly, often on scheduled dates, so that everyone has access to the same news at the same time. However, the large commercial banks have an important advantage; they observe their customers' order flows.

London and Zurich have grown to become the world's leading international financial center and is the world's largest forex market. This arose not only due to its location, operating during the Asian and American markets, but also due to the creation of the Eurodollar market. The Eurodollar market was created during the 1950's when Russia's oil revenue, all in US dollars, was deposited outside the US in fear of being frozen by US authorities. This created a large pool of US dollars that were outside the control of the US. These vast cash reserves were very attractive to foreign investors as they had far less regulations and offered higher yields.

Traded Products on the Spot Market

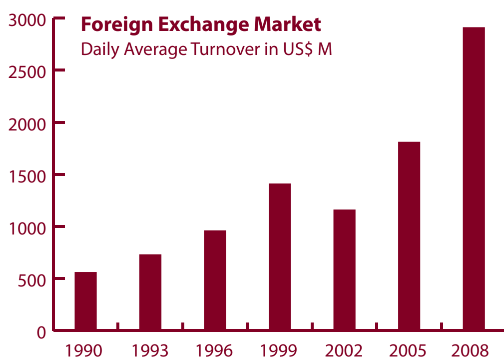
- EUR / USD - 28% of total Trading
- USD / JPY - 18% of total Trading
- GBP / USD - 14% of total Trading

Source: BIS Study 2007

Currencies Traded on the Spot Market

- USD - 89% of total transactions
- EUR - 37% of total transactions
- YEN - 20% of total transactions
- GBP - 17% of total transactions

Note: Total sum of market transactions = 200%
Source: BIS Study 2007



Source: BIS Study 2008

According to the BIS study Triennial Central Bank Survey 2008, average daily turnover in traditional foreign exchange markets was estimated at $2,550 billion. Daily averages in April for different years, in millions of US dollars, are presented on the chart.

The Market Participants

Unlike a stock market, where all participants have access to the same prices, the Forex market is divided into levels of access. At the top is the inter-bank market, which is made up of the largest investment banking firms. Within the Inter-bank market, spreads, which are the difference between the bid and ask prices, are razor sharp and usually unavailable, and not known, to players outside the inner circle. As you descend the levels of access, the difference between the bid and ask prices widens. This is due to volume. If a trader can guarantee large numbers of transactions for large amounts, they can demand a smaller difference between the bid and ask price, which is referred to as a better spread. The levels of access that make up the Forex market are determined by the size of the "line" (the amount of money with which they are trading). The top-tier inter-bank market accounts for 53% of all transactions. After that there are usually smaller investment banks, followed by large multi-national corporations (which need to hedge risk and pay employees in different countries), large hedge funds, and even some of the retail Forex market makers. According to Galati and Melvin , "Pension funds, insurance companies, mutual funds, and other institutional investors have played an increasingly important role in financial markets in general, and in FX markets in particular, since the early 2000s" (2007).

Banks

The interbank market caters for both the majority of commercial turnover and large amounts of speculative trading every day. A large bank may trade billions of dollars daily. Some of this trading is undertaken on behalf of customers, but much is conducted by proprietary desks, trading for the bank's own account. Until recently, foreign exchange brokers did large amounts of business, facilitating interbank trading and matching anonymous counterparts for small fees. Today, however, much of this business has moved on to more efficient electronic systems, such as JDFX Technologies, EBS, Reuters Dealing 3000 Matching (D2), the Chicago Mercantile Exchange, Bloomberg and TradeBook(R). The broker squawk box lets traders listen in on ongoing interbank trading and is heard in most trading rooms, but turnover is noticeably smaller than just a few years ago.

Highlights of the FX Market and Trading

- Most participants do not seek profits
- Hedge Funds exploit the opportunities
- Such opportunities are expected to continue
- Excellent source for seeking returns
- Returns have a low correlation to other assets

Source: Deutsch Bank AG 2007

Commercial companies

An important part of this market comes from the financial activities of companies seeking foreign exchange to pay for goods or services. Commercial companies often trade fairly small amounts compared to those of banks or speculators, and their trades often have little short term impact on market rates. Nevertheless, trade flows are an important factor in the long-term direction of a currency's exchange rate. Some multinational companies can have an unpredictable impact when very large positions are covered due to exposures that are not widely known by other market participants.

Central banks

National central banks play an important role in the foreign exchange markets. They try to control the money supply, inflation, and/or interest rates and often have official or unofficial target rates for their currencies. They can use their often substantial foreign exchange reserves to stabilize the market. Milton Friedman argued that the best stabilization strategy would be for central banks to buy when the exchange rate is too low, and to sell when the rate is too high. Nevertheless, the effectiveness of central bank "stabilizing speculation" is doubtful because central banks do not go bankrupt if they make large losses, and there is no convincing evidence that they do make a profit trading.

Investment management firms

Investment management firms use the foreign exchange market to facilitate transactions in foreign securities. For example, an investment manager with an international equity portfolio will need to buy and sell foreign currencies in the spot market in order to pay for purchases of foreign equities. Since the forex transactions are secondary to the actual investment decision, they are not seen as speculative or aimed at profit-maximization. Some investment management firms also have more speculative specialist currency overlay operations, which manage clients' currency exposures with the aim of generating profits as well as limiting risk.

Hedge funds

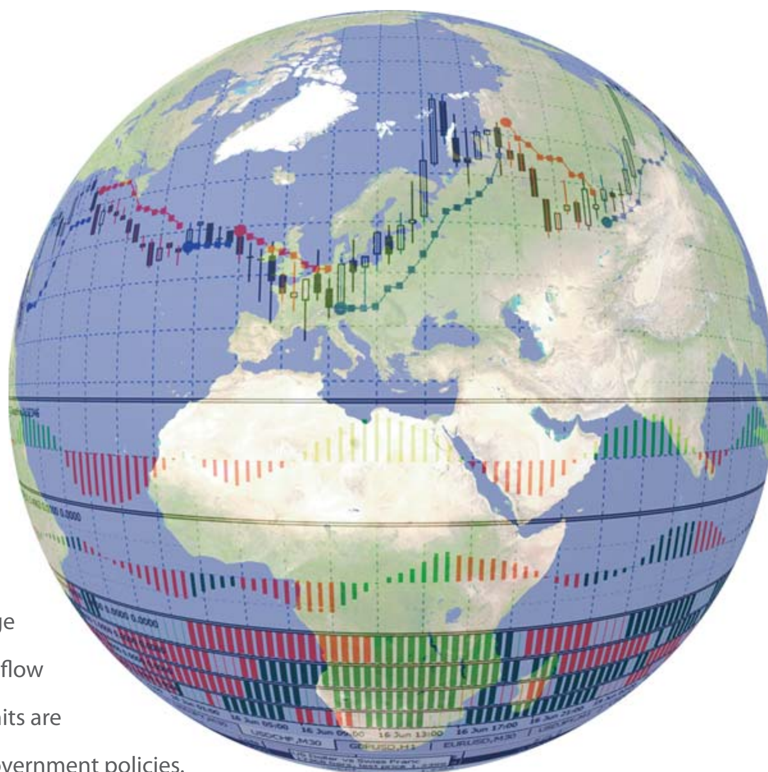
Hedge funds, such as George Soros's Quantam fund, (investors have enjoyed over 30%+ annualized returns since inception) have gained a reputation for aggressive currency speculation since 1990. They control billions of dollars of equity and borrow billions more, and thus may overwhelm intervention by central banks to support almost any currency. In September of 1992, Stanley Druckenmiller and George Soros made 1 Billion dollars positioning against the British Pound Sterling in less than 24 hours. By the end of the month the financiers made a cool 2 Billion dollars on the transaction.

Speculators

Controversy about currency speculators and their effect on currency devaluations and national economies recurs regularly. Nevertheless, many economists (e.g. Milton Friedman) argue that speculators perform the important function of providing a market for hedgers and transferring risk from those people who don't wish to bear it, to those who do. In addition, according to the standardized Series 3 exam, speculation adds liquidity to a market.

At the age of 73, Warren Buffett made his first investment in Foreign Exchange - approximately 20 billion dollars. Buffett "couldn't see a better return". He couldn't go out and buy 20 billion worth of a stock because he would not be able to get out of the position. A stock purchase of this size would constitute over 130% of the daily activity on the New York Stock Exchange. If a position like this were to ever be liquidated - there would be an immediate stock market crash. On the contrary, the currency markets trade between $2 to 3 trillion daily. A 20 billion dollar transaction is routine and has no impact whatsoever on the price of currency.

Market Moving Factors



There exist as many methods of forecasting moves in currencies as there are forces moving these markets. There are many factors, some significant and some minor, but they all have something in common. The forex markets move when some force makes one currency either more or less valuable than another.

Floating Exchange Rates

In a floating exchange rate environment, the exchange rate responds to the flow of imports and exports, the flow of capital, relative inflation rates and more. Often, limits are placed on exchange rate fluctuations according to government policies.

The Merchandise Trade Balance

This is the net difference between the value of merchandise being exported and imported into a particular country. For example, the net difference between the Canadian demand for US dollars to buy American merchandise, and the supply of Canadian dollars affected by the Americans' purchase of Canadian merchandise, is the merchandise trade balance between the two countries.

Flow of funds

The flow of funds between countries to pay for stocks and bonds also affects the currency exchange rate between countries. However, in the near term, capital flows are greatly influenced by yield differentials.

> ***Forces Moving the FX Markets***
>
> *"The forex markets move when some force makes one currency either more or less valuable than another."*

Yield differentials

This is the difference between interest rates in various countries and how it affects currency values. For example, a higher yield on European securities (compared to American securities) would make European securities more attractive. An increase in European yields would raise the flow of U.S. dollars into European securities, and decrease the outflow of Euro's to American securities. This increased flow of funds into Europe would lower the value of the U.S. dollar and increase the value of the Euro.

Rate of inflation

Consumers try to avoid the eroding effect inflation has on their purchasing power. Consequently, goods from countries with a low inflation rate become more attractive than the goods from countries with higher inflation. In turn, the currency from the lower inflation country rises in value, while the currency from the higher inflation country falls in value. Both the inflation factor and the purchasing power of the currencies directly impact currency exchange rates.

The Trading Sessions

A true 24-hour market, Forex trading begins each day in Sydney, and moves around the globe as the business day begins in each financial center, first to Tokyo, then London, and New York. Unlike any other financial market, investors can respond to currency fluctuations caused by economic, social and political events at the time they occur - day or night. The interbank market has three sessions of trading. The first begins on Sunday at 7:00 pm EST (Eastern Standard Time), which is the Asia session. The second in the European (London) session, which begins at approximately 3:00 am (EST), and the third and final session in the New York, which begins at approximately 8:00 am and ends at 5:00 pm. The majority of all trading occurs during the London session and the first half of the New York session, between 3:00 am and 1:00 pm (EST).

Currency Blocks

Within the Forex markets there are three major currency blocks; Europe (the Euro), North America (the Dollar) and the Pacific Rim (the Yen and Renimbi). Currencies other than the three major blocks are often considered more satellites.

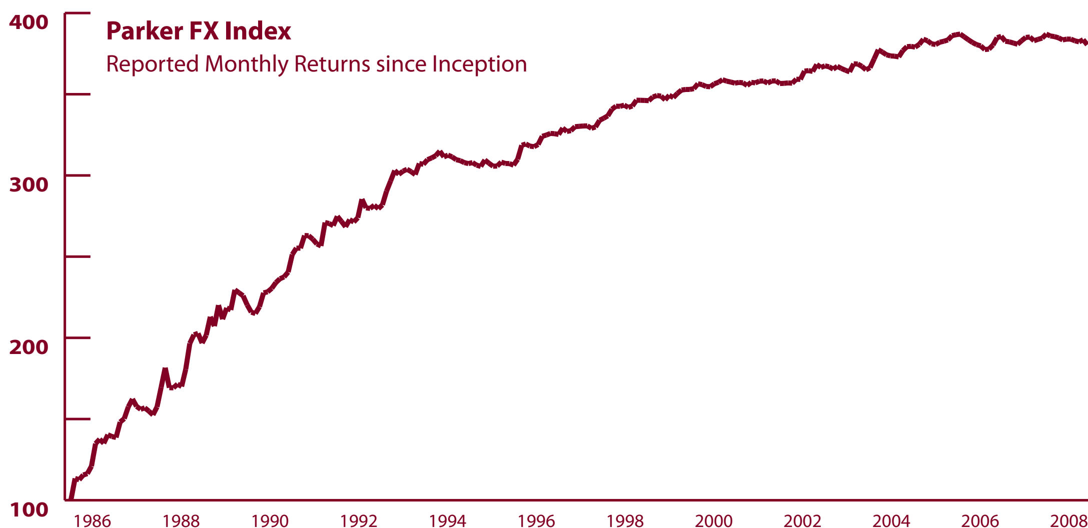
.... **1** EUR = 1.2785 USD ▲ .... **1** USD = 101.54 JPY ▼ .... **1** USD = 1.1672 CHF ▼ .... **1** GBP = 1.7137 USD ▲ ....

Benefits and Opportunities

Currency markets, in many ways, represent an ideal asset class for investors. Not only are they a useful diversifier due to their uncorrelated returns, but are also remarkably efficient due to the market liquidity, size, and 24/6 opening hours. It is unlikely that there are going to be capacity constraints, except in some emerging markets, as the currency market is probably the deepest, highest volume market in the world. A unique aspect of the currency markets is the number of market participants that intervene on a non-profit seeking basis. Professional investment risk-takers, dedicated to profiting from currency markets, only make up around 25% of market participants, as opposed to around 80% or 90% in other capital markets. The other market participants, such as Central Banks (which might intervene to enact government policy) and Corporations (which typically transact to finance a specific deal) do not seek to generate profits as their primary motive for trading currencies. Their mission is hedging and risk management. Thus, the central tenet of the efficient market hypothesis is not applicable, and supernormal profits should accrue to the profit-motivated participants. This was recognized in a recent study, by the Russell Investment Group ("Is there still Alpha to be gained in active currency management?") in September 2007. The study concluded that currency market return opportunities not only exist, but should be persistent due to the number of these non-profit seeking institutions.

This is to a degree backed up by the evidence provided by consultant surveys and databases of currency fund performance, such as the Parker FX Index, seen on the chart. Parker Global Strategies LLC, a U.S. company specializing in alternative asset placements, has been publishing the Parker FX Index for over 20 years. It is based on the submissions of some 64 active managers, and also includes data from managers no longer trading to address survivorship bias. It is seen as an inclusive and generally representative index of currency manager returns. As can be seen, the graph suggests persistent, positive returns from the currency management industry. Another interesting feature is the lack of significant losses in the long history of currency investment.

This gives the speculator a distinct mathematical advantage in their approach and methodology of extracting profits from this market. Over 75% of the $3 trillion market does not care if they make or lose money!



A Rising Market

The center of Forex trading follows the sun around the globe through the interbank market, a worldwide group of commercial rated prime banks that deal with one another on a continual basis. Geographically starting in Tokyo, market activity moves through London, the last banking center in Europe, before traveling to New York and finally returning to Japan via Sydney. As a result, buyers and sellers are available 24 hours a day. Investors can respond to currency fluctuations caused by economic, social and political events at any time they occur, day or night.

Historically large multinational banks, commercial banks and other major financial institutions have dominated Forex trading. Today there is a major paradigm shift in the nature and type of investing. The individual investor has quadrupled to over 6 million individual accounts in just the past decade. The investor is the clear winner gaining the opportunity to participate directly with other financial institutions in this technologically superior economy. The competition between the brick and mortar institutions and the internet-based companies has dramatically lowered the costs of investing, and empowered the individual investor to take control of their own investment strategy in Forex trading. In the new millennium Forex trading has become accessible for an individual investor right beside the institution and the very wealthiest

Today more investors are preferring the ease of Forex trading over stock trading. There are 4 major markets, 24 hours a day 6 days a week in the Forex market with volume exceeding $3 trillion per day. Unlike stocks and mutual funds, forex transactions typically are commission free. This drastically reduces expenses for traders and managers and ultimately puts more profit in the investor's pocket. The Forex market provides the investor with access to the most efficient global markets that exist today. The Forex market not only dwarfs the equities market in both size and liquidity but also mitigates the complexity of analyzing 4500 NYSE stocks 3500 NASDAQ stocks and over 20,000 listed mutual funds.

Summary

The evidence of excess return generation and skill in exploiting market inefficiencies in currency markets is dramatic. Combined with the low transaction costs, excellent liquidity and thus capacity, currency markets are arguably the ideal market for generating strong returns. The first institutional currency overlay programs only began running in 1987, while currency funds first launched in the early 1980's. Recent growth in institutional and hedge fund investments have raised the profile of currency markets as an emerging investment opportunity. These markets open the way for today's investor to participate in the same markets as commercial banks, institutions, pension funds and the worlds wealthiest investors.

Today's investor can be overwhelmed with a constant bombardment of self-serving investment advice. Vested interest in a product has taken precedence over client interest. Unfortunately, most brokerage firms have evolved to become marketing companies that sell financial concepts as investments. Their mission has to be first and foremost to generate commission for the house. A gain or profit for their investor is merely a bi-product and largely a coincidence. Stock brokers, insurance agents, retail bankers and any and all forms of peddlers that sell from a limited product arsenal, purvey products that are investment in name only. Today's conventional investment advisor cannot have the client interests first and still exist. These industries have created their own sword that they will ultimately fall on!!

Congratulations and Welcome. You have just been exposed to the world's most efficient market place. Global currencies.

The 21st Century Investor Deserves:

- **To have access to all markets.**
- **To receive accurate advice**
- **To have professional service**
- **To have your interests put first**
- **To have full product disclosure regarding fees, commissions, expenses and risk**

HOW IS THE CURRENCY MARKET DIFFERENT?

SIZE. It would take almost ONE YEAR, over 300 trading days, for the equities market to equal one day in volume in the currency markets. The currency market is the world's largest asset class.

LIQUIDITY. The currency markets provide liquidity or access to your funds 24 hours per day 6 days per week on a global basis-no other market provides this liquidity!!

SOLVENCY. The major global currencies are backed by the world's most stable governments, (unlike Enron, Global Crossing, Sun Microsystems, World Com & K-Mart to name a few). Stability provides solvency.

EFFICIENCY. Now, all the elements of a truly global investment opportunity; Safety, Liquidity, & Stability, have become available to the 21st century investor.