Interview
with John Dean, CIO, Absolute Return Strategies, London

Diversified Currency Strategies for Institutional Investors

Frankfurt am Main, October 14th 2015

Absolute Return Strategies Ltd. (“ARS”) was founded in 2006 by a team of currency experts to provide investors with easy access to the world’s top performing currency Alpha strategies. The company created the Alpha Blend™ suite of Investible FX Indices in cooperation with Citibank to deliver attractive risk-adjusted returns with daily liquidity and complete transparency. ARS developed a proprietary strategy selection model which is predictive and able to identify those strategies with a high probability of superior future performance. Citi selected ARS as its consultant to undertake due diligence on all strategies on the Citi Access platform. John Dean, CIO and founder of ARS had an interview with altii.

**altii: What are the benefits of an investment in FX Alpha Strategies that are often described as an alternative asset class?**

**John Dean:** The inter-bank FX market is the largest market in the world with unparalleled liquidity. The pattern of returns from FX investment programmes is typically different from traditional assets. This negative correlation means that FX strategies are a robust portfolio diversifier. Transaction costs are very low, enabling a wide variety of investment styles including high frequency trading. Another key benefit from FX Alpha is that, subject to credit, these strategies can be delivered unfunded.

The inter-bank cash foreign exchange market is a global decentralised market for the trading of currencies. This includes all aspects of buying and selling currencies. The foreign exchange market determines the relative values of different currencies.

The foreign exchange market makes international trade and investments in global asset markets possible. The modern foreign exchange market was formed in the early 1970s after three decades of government restrictions on foreign exchange transactions (the Bretton Woods system of monetary management established the rules for commercial and financial relations among the world’s major industrial states after World War II). Countries gradually switched to floating exchange rates from the previous exchange rate regime which had been based on largely fixed exchange rates linked to the price of gold.

The foreign exchange market is unique because of the following characteristics:

- its huge trading volume means that is the most liquid market globally
- volumes currently exceed $5 trillion per day.
- its geographical diversity;
- its continuous operation: 24 hours a day except weekends, i.e. trading from 22:00 GMT on Sunday (Sydney) until 22:00 GMT Friday (New York);

Most institutions recognise currencies as an asset class. In every currency pair, whether in developed or emerging markets, the currency asset (long position) is funded using another currency (short position).
altii: What kind of models are currently used for FX investments?

Dean: FX Alpha strategies can be broken down into two main categories, systematic and discretionary. In the current FX Alpha space there are approximately four systematic strategies to every one discretionary strategy. Holding periods vary from seconds to months. In both categories there are directional, mean-reverting and volatility strategies.

altii: How important are allocation models to generate alpha and how stable are they over time?

Dean: A study of all the professional strategies in the FX Alpha space (there are approximately 100) shows that there is tremendous inconsistency of returns. All strategies either have had or will have at least one or two losing years in each ten-year period. Picking the best of last years’ strategies for the coming year typically leads to disaster as the FX markets are constantly changing. A robust and predictive allocation model is needed to create a portfolio which will generate consistently positive returns. Active rebalancing of the portfolio is also vital. The Alpha Blend Investible FX Indices use this new generation of allocation models.

altii: What characterises the theory behind the “new generation” of models?

Dean: In the last five years the new generation of FX Alpha platforms has facilitated much more detailed analysis of individual strategies. Daily performance data combined with comprehensive information on leverage, pairs traded, holding periods etc. has enabled the building of a new generation of models which makes traditional analysis by most pension consultants obsolete. The size of the company and the team is no longer the only thing that matters. For example on the Citi platform that hosts individual FX strategies, clients credit risk is Citi, there is no exposure to an individual manager so that a client can comfortably allocate $100m to a manager with $200m AUM. The old mistake of looking for FX Alpha from the FX Overlay industry is also gone. The Alpha Blend Global Currency Index can be delivered to the client (subject to credit) unfunded. This means that the underlying portfolio remains undisturbed.

The price action in many FX pairs after the Credit crunch (2009 – 2014) was very difficult to navigate due to the lack of clear structural moves. This caused problems for many systematic strategies. The strategies that survived this period have re-emerged stronger than ever together with some new innovative approaches.

The new generation allocation process consists of two parts. The first part of the process analyses all the FX strategies available and constructs a universe of consistent strategies. The second part consists of individual statistical forecasting models which have been built for each strategy from a library of factors which influence performance. This produces a forecast of the group to be included in the relevant index.

altii: In a globalised investment world how should institutional investors manage their FX exposure?

Dean: The hedging of non-balance sheet FX exposure has come a long way in 30 years. The old strategies of option replication or passive directional hedging became unpopular due to the costs incurred when non-domestic portfolio assets produced strong currency gains which were reduced by the cost of hedging. Clients were typically obliged to liquidate part of the portfolio to pay the costs. Active overlay as part of a hedging strategy came about as a way to mitigate these costs. However many overlay managers did not have the correct technology to generate the necessary gains.

There are two modern solutions for asset managers and institutions.

1. Agree a passive hedge ratio for the foreign portfolio with the FX Overlay manager and then agree a risk budget for an allocation to a diversified FX Alpha Index to generate positive returns in periods when the natural FX exposure produces gains or losses.

2. Agree a risk budget for a larger allocation to a diversified FX Alpha Index to generate higher positive returns in all periods.

This is particularly important for fixed income investments. A high yield EM bond portfolio is essentially a carry trade for clients in developed markets. The coupon is often dwarfed by the underlying FX moves. Both the Ruble and the Brazilian Real have halved in value over the last three years! In this period the majority of EM bond funds have been negative as they have not taken advantage of investible FX Indices as a hedging tool.

Using a total return swap or an index tracker account from Citi the Alpha returns from the Alpha Blend Global Currency Index can be delivered to the client (subject to credit) unfunded. This means that the underlying portfolio remains undisturbed.

The swap is in fact just a simple settlement agreement and is a “cash flow transformer”. Although the phrase has often been misused, modern investible FX indices provide the perfect diversifying “Portable Alpha”

altii: Can investors without natural FX exposure benefit from FX investments?

Dean: Euro fixed income investors who are not producing enough yield to fulfil their liability contracts could and should use investible FX indices to access a second return stream. This will have low or negative correlation
to the existing fixed income assets and increase the absolute return. These investors are missing an opportunity to diversify their portfolio if they do not incorporate the index returns into their portfolio.

**altii**: Institutional Investors under regulated regimes have a tendency to enter into the UCITS format. What else is possible?

**Dean**: We recognise that the strong regulatory environment of UCITS is important and this is why we have structured the Alpha Blend Global Income fund together with LGT and Portfolio Concepts. This is a very safe and easy way to invest in a well-managed unconstrained bond portfolio with a good track record and also to access the returns from the flagship Investible FX Alpha Index. For larger institutions who want to run their own fixed income books the total return swap from Citi works extremely efficient.

**altii**: What is your next project?

**Dean**: To construct investible indices in the Global Macro and CTA space.

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**About John Dean**

Mr Dean has been selecting currency managers since the 70’s. In the Eighties he ran the European FX and Futures business for Donaldson Lufkin and Jenrette where he built a substantial FX Alpha business. He is the Managing Director and CIO of Absolute Return Strategies. +44 20 3287 6768, jdean@ars-alpha.com

**About Absolute Return Strategies Ltd.**

Absolute Return Strategies Ltd. (“ARS”) is an SEC Registered Investment Advisor and CFTC Commodities Trading Advisor specialising in multi-strategy currency alpha programs. The firm has staff in London and Cincinnati. ARS management has been researching and selecting FX strategies for over 30 years in order to identify investment teams capable of delivering superior performance. www.ars-alpha.com

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