Currency as king

Tindaro Siragusano explains to Francesca Fabrizi how the Berenberg Currency Alpha Sterling fund can offer a solution to pension funds looking to generate alpha returns without taking on too much risk

The benefits that currency can bring to a pension fund portfolio are manifold – its low correlation to standard asset classes (like equities or bonds) even in times of extreme stress, is a key factor, particularly in today's uncertain environment. This, coupled with its potential to generate high returns, makes it one of the most popular investment choices of the moment.

But alpha generation alone is no longer enough to satisfy a pen-sion fund's needs. The pressure is on to not only produce returns but to do so while protecting the scheme's assets in the long run. That is why an investment fund which promises stable returns without un-due risk should be exactly what pension funds are looking for, hence the timeliness and relevance of Berenberg's Currency Alpha Sterling fund.

The strategy, which was launched in 2002, aims to use currency pairs to generate 'stable alpha returns with foreseeable moderate risk'. How it does this is based on the philosophy that (a) currency markets are inefficient; (b) these inefficiencies are exploitable when using a statistical (systematic) trading approach; and (c) various models can help to diversify risk.

The fund focuses on the most liquid currency pairs – these include the Swiss Franc, the British Pound, the Euro, the US Dollar, the Japanese Yen and even Gold. These currencies offer daily liquidity as well as low transaction costs.

Tindaro Siragusano, managing director and head of asset management at Berenberg Bank, explains: "The sources of our returns are directional currency movements, so we do not use options or even more exotic instruments. Instead we use very simple and transparent forwards to benefit from sustainable exchange rate fluctuations."

The philosophy behind this is that currency markets show some degree of inefficiency, continues Siragusano, "due to the special and unique structure of the foreign exchange markets, where we see a considerable measure of non-price sensitive behaviour of particular market participants causing biased prices and price trends. Hedgers, commercial companies as well as tourists and central banks make up this not entirely price-sensitive part of the market. With our quantitative approach we seek to exploit these market inefficiencies, especially trend behaviour."

The trading approach Siragusano refers to is a purely systematic one, without any discretionary element at all i.e. there is no input from a portfolio manager. Instead the whole decision of whether to be long or short a currency pair is completely systematic and model driven. This is a key factor in reducing risk.

Siragusano explains: "We believe – especially in times of high volatility – that it is a key strength to manage market price risks without emotion and without fear following a transparent and highly reliable investment process. Our clients also appreciate our focus on risk management, which is an integral element of the investment process."

Internal and external models add extra layers of risk management. "For each currency pair we have three models – short, medium and long term, and these are, in general, trend following models. Each has its own stop loss strategy and risk budget which is mainly volatility driven."

The models do not predict where a certain exchange rate is going to be in, say, one month but, he adds, certainly all the models react to exchange rate fluctuations and will sooner or later indicate a new trend which is establishing itself in the markets. "When this is the case we will adjust our market positions to cash in on the trend, whether a currency appreciates or depreciates."

On top of this, Berenberg uses an overall risk management system looking at the fund itself which looks at drawdown, market behaviour etc, and a "traffic light" system flags up potential problems. "For example, if the currency markets show high bid/offer spreads which result in high transaction costs, then a red-light will alert us. This happened, for example, in October 2008 when the Euro/Yen spread became very broad, and no cost effective trading was possible. So we had to close down our short-term-model for nearly two weeks."

But it isn't purely the models behind the fund which make it efficient and low risk. Berenberg's decision to include only the most liquid currencies is also key. This in turn, however, means potentially missing out on the upside that could be generated from the less liquid currencies such as those in the emerging markets area.

Siragusano justifies this decision: "Risk management is a key factor of our strategies, and as a result our currency approach is perhaps more conservative than others. That is why we do not use emerging market currency pairs because they are not that liquid, and there can be some political events or some external shocks which can make them higher risk. We do not think we can manage these risks as effectively as we can manage the risks within highly liquid currencies, so we choose to exclude them."

Doubters need only look at the fund returns for evidence that the Berenberg strategy – which can be described as an absolute return strategy with a long volatility characteristic – does work. Performance to date has been impressive. In 2009, a difficult year, the fund returned 6,06%, with some of its best years hitting highs of 17% (2006) and 14,44% (2003). Coupled with this, volatility has remained low.

So what's on the cards for 2010? "It is still too early to tell exactly what is going to happen" says Siragusano, "but to us it is not about whether or not the Dollar or the Euro will go up or down, but about movement, and I believe that we will still see high volatility going forward. We will see big moves in the currency pairs because the global economy is still shifting from the US to Asia – the impact of the economy is rotating and this will affect the currency markets as well. And when the currency pairs move, we will take advantage of that and hopefully see a very nice performance."

The Berenberg Currency Alpha strategy applies in two funds – one denominated in Sterling for British investors and the other in Euro for European investors. Demand has been significant in recent months, the strategy seeing in-flows of nearly €200 million. This is no surprise, argues Siragusano, given the challenges facing investors today. "Because of the current low level of interest rates coupled with the high volatility in equity markets, investors are searching for new sources of alpha with reduced risk, so they are asking: where can such performance come from?

> "Risk management is a key factor of our strategies"

"History has shown that the correlation between currency investments and other asset classes is very low, even in times of above average volatility or stress. This makes currencies very interesting and to be seriously considered as a source of alpha in a broader portfolio context." In addition investors, especially pension funds, like the transparency the Berenberg process and the fund itself can offer. "There are no exotic instruments or strategies that investors need to get to grips with. While the models we use to derive a specific management decision are of some complexity, the instruments used to get exposure to the market are not at all. Essentially there are a bunch of FX-Forwards which easily can be valued on a spread sheet. Investors like this kind of transparency and they like our systematic approach as well. Finally, if an investor wants to get out of a strategy they can do so within minutes as there is no other market offering more liquidity than this one."

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