Currency Strategy Section 4 Ops Notes

To follow is the **final** section of our *Ops Notes* on Callum Henderson's *Currency Strategy*. In case you missed our previous *Notes*, here is section 1, section 2, & section 3.

Keep in mind, these *Ops Notes* serve as a great reference for those who already have a foundation in currency theory and application. This is pretty advanced stuff. In the future, we'll take each of these sections and dive deeper via separate *Vault* pieces.

Table Of Contents

Chapter 9: Managing Currency Risk III — The Speculator: Myths, Realities, And How To Be A Better Currency Speculator

9.4 The Speculators — Who They Are

Broadly speaking, currency speculators can be divided into the following main groups.

1. **Interbank Dealers**
    a. This group makes up the vast majority of currency speculation and therefore of the currency market as a whole. The primary task of an interbank dealer is to provide liquidity and make markets in currencies for the bank's clients. The principle is that all client positions have to be offset in the market (i.e. if a client sells you Euros against dollars, you the dealer are buying the Euros and therefore have to sell those Euros back to the market to keep a flat exposure).

2. **Proprietary Dealers**
    a. The second group of currency speculators is that of the “proprietary dealer”. This individual is usually among the most experienced currency dealers in the dealing room. He or she plays no part in providing liquidity for client orders, but instead uses a designated amount of the bank’s balance sheet for the specific purpose of position taking in the currency markets. A “prop” dealer may take these positions based on any combination of fundamental, technical, flow or quantitative considerations.

3. **Hedge Funds**
    a. The umbrella term of “hedge funds”, even those that focus on the same asset or currency or have the same trading style, can reflect a variety of different types of organization.

4. **Corporate Treasurers**
    a. Most corporate Treasuries see their main goal as management and reduction of risk, a (not small) minority see the Treasury as a profit centre in addition to the underlying business. These deliberately take asset and currency market positions for the specific purpose of adding to the company’s bottom line.

5. **Currency Overlay**
    a. The job of a currency overlay manager may be either to ensure the total return of the portfolio by reducing risk as much as possible, or alternatively it may be to add alpha.

9.7 Currency Speculation — A Guide

Having watched the currency markets for over a decade and in the process benefited from the knowledge and experience of the hundreds of currency market contacts that I have made or come into contact with, as an emerging market currency strategist I advise a bank’s traders, sales and clients on what are the best trading and hedging strategies within emerging market currencies. The recommendations that I have made are compiled in an EMFX leveraged model portfolio1 which produced annual cumulative simple returns of 46.3%, 25.9% and 47.1% in 1999, 2000 and 2001, respectively. As a result, I feel reasonably qualified to make some suggestions, which though they may undoubtedly not prove definitive at the very least add to the debate.

- **An integrated approach** — The most powerful, consistent form of currency analysis and therefore of currency speculation is that which brings together all the main analytical disciplines to create a combined trading signal.

    - Fundamentals may or may not be enough on their own. However, currency speculators who want to create consistent outperformance and high excess returns do not deal with "maybes".
    - Fundamental, technical, flow and valuation analysis need to be coordinated and integrated to provide the clearest picture of what is going on in the market and how one can profit from it. This is the heart of currency economics that I have tried to impart. A very simple and effective discipline is to create a signal grid for these four types of analysis and stick to it rigorously (see Table 9.1).
        - Only when at least 3 of 4 readings are showing "green" or "red" should one put on a major new position. The advantage of this is that it should greatly reduce the bias created by relying only on one analytical type.

Table 9.1 A currency strategy signal grid

	Currency economics	Flow analysis	Technical analysis	Long-term valuation
Exchange rate	Buy/sell	Buy/sell	Buy/sell	Buy/sell

- **Risk appetite** — Use a risk appetite indicator as a gauge of overall market sentiment and as a benchmark against which to measure your positions. The one I mentioned in Chapter 2 is an excellent one, the Instability Index, but there are others.
    - When your signal grid is showing no clear signal, but the risk appetite indicator is in risk-neutral or risk-seeking mode, go long a basket of higher carry currencies, albeit selectively chosen, in order to boost the total return.
    - When the risk appetite indicator moves from risk-seeking to risk-neutral, take half your profit. When it moves from risk-neutral to risk-averse, cut your position entirely and go short the carry basket of currencies you have used.
        - This strategy, used in a disciplined way, can add significantly and consistently to your total return, particularly during periods when the signal grid is showing mixed signals (which will be most of the time).

- **Trading discipline is at least as important as having the right view** — A currency speculator can have the right view but bad trading discipline can reduce or even reverse trading profits.
    - The view should be the unequivocal result of the combined trading signal from the four analytical disciplines, or as a result of the risk appetite indicator.
    - There is nothing else to consider. "Gut feel" can earn excess returns for a period of time if you are a good and experienced currency speculator, but it is not enough on its own. Eventually it will result in you getting burned.

    - The more overconfident you are, the more badly you are likely to get burned.
        - As regards positions, the entry, exit and stop levels should be decided by flow and technical considerations. Run profits, depending on technical and flow developments. Always cut losses.

- **Emotion comes before a fall** — Currency speculation is about making money pure and simple. There should be no emotional aspect to it. It is neither moral nor immoral.
    - Furthermore, try to remain detached from your P&L to the extent that it does not affect your trading approach.
    - Great danger lies in the making of both profit and loss. The more profit you make, the more your view of financial markets appears to be confirmed and the more overconfident you become. Many have produced incredible results speculating against market inconsistencies to the point where they appeared to believe they were the market.

- **Less is more** — Take fewer trading positions rather than more for two reasons. Firstly, a small number of trading positions is more easily managed than a larger number of positions, and that takes us back to point 3.
    - Secondly, currency speculation is the pursuit of inconsistency in currency market pricing. There are rarely a very large number of inconsistencies at any one time, not least because if it were that easy we would all be doing it.
    - The aim of creating the signal grid and using the discipline of the risk appetite indicator is to trade on sure-fire winners and nothing else. A portfolio that has a very large number of positions suggests a portfolio that is trading on more than sure-fire winners, a portfolio that is increasingly relying on such vague concepts as luck, hope, belief and emotion.
        - Currency speculation is not a game, it is not betting and there should be no luck involved. If there is, you have the wrong position. Cut it.

- **Speculators make predictable mistakes** — Everyone makes mistakes and currency market practitioners are no different. However some mistakes are more predictable than others.
    - In this regard, there are three key themes of behavioural finance that should be considered as a guide to the usual mistakes made, and therefore how to avoid making them in the future. Readers who have well understood the points above will of course note that the mistakes below reflect straying from the signal grid and the risk appetite indicator:

- **Heuristic-driven mistakes** — Currency speculators frequently rely on “heuristics” or rules of thumb in relation to their approach to trading. For instance, one such heuristic or rule of thumb can be that previous trends will continue. If something has gone up for six weeks it will go up for a seventh and an eighth. Heuristic-driven trading is biased in that the very act of establishing a rule of thumb approach to one's trading reflects one's past experience. Because of their reliance on heuristics, or rules of thumb, currency speculators can hold biased beliefs that make them vulnerable to committing errors, errors which result in painful losses.

- **Frame dependence** — This idea deals with the distinction between form and substance. Framing is about form. Frame dependence means that the results of one's currency view are dependent on the frame or framework within which one focuses one's view and thoughts. Frame dependence can deal not only with one's fundamental view but also one's approach to trading generally. One can be loss averse, meaning that one is far more reluctant to make a certain-sized loss rather than put on the risk necessary to make that level of profit. Losses result in emotion, which results in regret, which in turn alters the frame one uses to look at markets.

- **Markets are inherently inefficient** — The idea of financial markets being perfectly efficient is an elegant nonsense, which clearly deals with a perfect rather than a human being. Market mispricing happens all the time. Heuristic and frame dependence create consistent errors and therefore consistent losses. Learning how to distinguish such behavioural patterns means one can reduce such losses.