Currency Investing – Increasing Net Worth While Protecting Net Wealth

Everyone's invested in currencies, some don't know it:

As I travel the world to conferences, client meetings and vacations, I am constantly running into people who are interested in investing in one form or another. It doesn't matter whether the individual has a lot of money or a little, is in Europe or the States, is investing for a corporation or for himself. If they find out that I'm a money manager, the topic of conversation shifts to investments.

Invariably, I mention somewhere along the way that I trade a fair amount of currencies. The usual reaction: "Wow! That's pretty risky, isn't it?" My answer: "It depends on how you decide to invest, how much leverage you put into the portfolio, and by the way, you're already invested in currencies."

Every investor everywhere is investing in currencies, whether he likes it or not. His portfolio could be in stocks, bonds, futures or real estate, but whatever he owns, it's denominated in some currency, and like it or not, that currency is fluctuating over time. One might say that every investment has at least two components: the actual investment itself and the currency the investment is denominated in. Most investor concentrate on the former and ignore (or are ignorant of) the latter.

Net Worth versus Net Wealth:

I like to think of it as a Net Worth versus Net Wealth challenge. An investor's Net Worth is simply his assets minus his liabilities. It's usually denominated in some home currency. That investor's Net Wealth is the amount of goods and services he can buy across the world with his Net Worth. If a stock portfolio increases, while the investor's home currency falls by a similar amount, Net Worth increases, while Net Wealth remains unchanged. That does little to advance the investor's financial condition.

My biggest concern, as a US investor, is the possibility of the stock and bond markets of the world and the US Dollar would all fall at the same time. Most US investors would have few places to hide and they would surely watch both their Net Worth and their Net Wealth plummet. They would find themselves in a seriously, declining standard of living. Protecting stock and bond portfolios is not the focus here, but protecting the value of the portfolio's currency value is something currency traders routinely attempt to achieve.

The industry has around 60 speculative currency trading programs of any size and there are all sorts of currency overlay programs to hedge the currency exposure of investor portfolios. Investing a portion of a diversified portfolio into a speculative currency portfolio would be one way to gain some protection against major currency swings. Presumably, a major move down in your home country's currency would produce potential profitable trading opportunities for the currency trading program to offset some of the loss of purchasing power in the portfolio.

Another way to attack the risk would be the use of a currency overlay program on the portfolio. Here, a portion of the portfolio is used as margin to cover positions in the currency markets that should reduce the risk of currency fluctuations. This can be done on a passive, active or speculative basis. The first two are traditional and usually cost the portfolio some return to put in place. They both involve taking positions against the negative move of the investor's home currency. The speculative approach is my favorite and attempts to hedge the portfolio, while providing a slightly positive return over time. Here, a speculative trend-following program is structured to a size roughly approximating the risk of the portfolio to be hedged. This yields a speculative program, attempting to produce a profit, but inversely correlated to the underlying portfolio's currency risk when it needs to be inversely correlated to it.

Reasonable goals here should be to tie up perhaps 5 percent or less of a portfolio, produce 0-6% increase in the portfolio's returns per year over time, and cost the portfolio no more than about 2-4 percent in potential drawdowns. We find it difficult to use the inter-bank markets for anything less than about a $25 million portfolio, due to the sizes of trades in that venue. Under that level, you probably should consider a currency program based in the futures arena.

Currency Values – The score of the game we're all playing:
When it comes right down to it, the value of a country's currency doesn't have a true inherent value. It's just the score of the game each country is playing to be the best country out there. Fundamental traders would cite GDP growth rates, interest rates and economic conditions as determinants of currency value. Opportunistic traders might say political events and announcements drive the values of one currency against another. Technical traders might simply buy the breakouts or measure the momentum of the markets.

In the end, it's all of these things. It's the score of the one of the most complicated games in the world. How one country fares in the getting the value of it's currency to go higher is dependent on political, economic, interest rate factors and the perception, by the currency trading community, of how well one country appears as a place to park one's assets versus another country. Perhaps we should pay our countries' leaders like we pay most currency traders: part management fee, part incentive fee based on how well the leader's home currency fares against a basket of other currencies. That would truly link our leaders' economic incentive to the citizens' macro-economic well being.

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