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Alive and Kicking

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A Guide to FX as an Asset Class

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With trillions in currencies exchanging hands every day, foreign exchange is indisputably the world's largest and most liquid financial market. Yet in spite of its size, this report argues that it is also likely to be the least "efficient" compared to other asset classes.

We review the latest data from a wide range of sources and conclude that only 45%-60% of forex (FX) market participants are likely to be profit-seeking. The presence of a large portion of non-profit maximizing participants explains why the efficient market hypothesis fails to hold in currencies and why FX moves can be both predictable and profitable. The rising share of passive investors as well as the increasing importance of regulation suggests that the FX market may be becoming less, rather than more efficient over time.

We review the returns provided by investing in the currency markets since the 1980s and find no evidence of deterioration over time. A simple rules-based approach using the Deutsche Bank Currency Returns index (dbCR) involving carry, valuation and momentum strategies has provided stable risk-adjusted returns that have been resilient even after the shocks of the 2008 financial crisis.

We also find consistent evidence of positive FX manager returns and introduce a number of new trading strategies.

We compare FX market returns to bonds and equities and show that currencies have offered comparable risk-adjusted returns compared to a global fixed income or equity portfolio since the 1980s.

We show that the addition of FX to a bond and equity portfolio has material diversification benefits by reducing volatility and the drawdown of returns.

We explore the drivers of FX hedging and evaluate the merits of dynamic currency overlay.

We argue that hedging always involves an opportunity cost and even profit-constrained or transactional participants need to carefully consider their approach to FX.

We conclude that currencies as an asset class are "alive and kicking" and that the FX market is likely to continue to offer excess returns to investors for the foreseeable future.

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