CAN CURRENCY COPE WITH NEW DEMANDS?

HAVING EXISTED for two decades on the margins of the asset management industry, currency management is moving into the mainstream. The search for new sources of alpha is focusing investors' attention on the potential of currency management not only for risk reduction, but for enhancing portfolio returns. It is placing new demands on managers, forcing them to re-evaluate their investment processes and be more creative in finding alpha. At the same time, investors of all types are becoming more demanding of the services they receive from sell-side institutions. Pension funds want to know they're getting best execution for FX, while asset managers want much more than just a commodity service from their FX banks. *Global Investor*'s annual poll, the biggest survey of the buyside anywhere, reveals which FX banks are succeeding in keeping investors happy. *Plus* the currency management roundtable.

CURRENCY MANAGEMENT GROWS UP

Currency is no longer a forgotten asset class. Everyone suddenly wants a bit extra from currency, be they pension funds looking for alpha or equity managers wanting to rescue a few basis points. It's putting new demands on currency managers and their service providers. By **James Rutter**.

FOR ALL THE MISERY suffered by asset managers and investors over the past three years, there are pockets of the investing community that have welcomed the equity bear market with open arms. Currency managers are quick to emphasize that they've taken no pleasure in the calamitous decline of equity markets (afterall, it's their pensions and portfolios too), but from a professional point of view the past three years have been a godsend. "We've really benefited from the doom and gloom being experienced elsewhere," says Paul Duncombe, managing director and head of currency management at State Street Global Advisors (SSgA). As investors have started searching for alternative sources of alpha to replace their traditional reliance on equities, so currency has been receiving a lot more attention.

If the search for alternative alpha sources wasn't good news enough, currency managers have been further buoyed by the decline of the US dollar. Inevitably, big currency trends prompt more consideration of currency risk– especially when investors get hurt. A European investor buying US equities without a currency hedge would have had an unpleasant 2002 on two counts: a stock market down 20% and the dollar weaker by a similar margin.

Currency advice in demand

Thanos Papasavvas, vice president at Credit Suisse Asset Management in London, says that last summer was the first time he had ever been asked to attend his equity colleagues' morning meeting, in order to explain his outlook for euro/dollar. "They're taking a much more active view on currencies than they used to," he suggests.

Papasavvas says he is also in demand from other business areas within CSAM, as they become increasingly aware that currency can play a key role in their performance. "There's demand from cash managers to add a little more alpha; from equity managers who want to stop haemorrhaging basis points; and from global core bond managers who want to diversify their alpha sources. Suddenly, since summer, everyone wants a bit extra from currencies."

But increasingly, investors are wanting more than just a little bit extra from currencies. The trend reported by virtually all currency managers is away from traditional overlay strategies, where the reduction of currency risk in an underlying portfolio is the goal, and towards straightforward alpha generation.

The long-term performance of currency managers hardly sounds impressive enough to warrant much excitement on the part of beleaguered investors. Frank Russell has tracked a universe of 494 currency overlay accounts since 1988, finding that on average managers have added 87 basis points of return a year. It's hardly a sum likely to solve the funding problems of the average pension fund.

But in the past, currency managers have been severely restrained in their ability to add alpha. Most overlay strategies have been focused on risk reduction through hedging rather than generating excess returns.

But according to Arun Muralidhar, managing director at FX Concepts in New York, it is time pension funds moved beyond the risk versus return argument where currency is concerned. "Uncorrelated returns – that is the true risk management currency provides."

Muralidhar has tracked the performance of currency strategies compared to other asset classes over six years and found that the correlation with the S&P 500, EAFE and Salomon World Government Bond Index respectively to be less than 0.2.

BEST FX SERVICE OVERALL (ALLRESPONDENTS) RANKING 1

Bank	Score	%
1. (3) Goldman Sachs	344.0	19.0
2. (6) Morgan Stanley	219.0	12.1
3. (4) JPMorgan	190.0	10.5
4. (2) Deutsche Bank	155.0	8.6
5. (1) Citibank	141.0	7.8
6. (8) Bank of New York	119.0	6.6
7. (5) UBS Warburg	108.0	6.0
8. (7) State Street	102.0	5.6
9. (–) BBH	49.0	2.7
10. (9) CSFB	49.0	2.7

RANKING 2

Bank	Score	%
1. (1) Bank of New York	270.5	6.2
2. (5) Goldman Sachs	247.5	5.7
3. (2) BBH	245.0	5.6
4. (9) Morgan Stanley	228.1	5.2
5. (–) JPMorgan	226.2	5.2
6. (–) Mellon	215.0	4.9
7. (6) Citibank	213.6	4.9
8. (–) Dresdner Bank	208.3	4.8
9. (4) State Street	208.2	4.8
10. (8) Deutsche Bank	201.3	4.6

MOST IMPROVED SERVICE OVER THE PAST 12 MONTHS (ALL RESPONDENTS)

Bank	Score	%
1. (1) Goldman Sachs	228.0	18.7
2. (7) Morgan Stanley	170.0	13.9
3. (6) JPMorgan	118.0	9.7
4. (10) Bank of New York	103.0	8.4
5. (5) Citibank	102.0	8.4
6. (4) Deutsche Bank	66.0	5.4
7. (3) State Street	59.0	4.8
8. (2) UBS Warburg	55.0	4.5
9. (–) ABN Amro	39.0	3.2
10. (–) RBS	39.0	3.2

GI 100 RESPONDENTS BEST FX SERVICE OVERALL

Bank	Score	%
1. JPMorgan	65.0	18.3
2. State Street	42.0	11.8
3. Goldman Sachs	40.0	11.3
4. Citibank	30.0	8.5
5. Deutsche Bank	30.0	8.5
6. Morgan Stanley	25.0	7.0
7. UBS Warburg	25.0	7.0
8. Bank of New York	21.0	5.9
9. Barclays	16.0	4.5
10. BBH	13.0	3.7

WEIGHTED BY ASSET SIZE BEST FX SERVICE OVERALL

Bank	Score	%
1. (5) Goldman Sachs	753.0	14.5
2. (3) JPMorgan	623.0	12.0
3. (6) Morgan Stanley	601.0	11.6
4. (1) Deutsche Bank	509.0	9.8
5. (2) Citibank	460.0	8.9
6. (4) UBS Warburg	406.0	7.8
7. (7) State Street	311.0	6.0
8. (10) Bank of New York	231.0	4.4
9. (8) CSFB	168.0	3.2
10. (–) BBH	126.0	2.4

FOREIGN EXCHANGE SURVEY 2003

There's no doubt that this year's FX survey belongs to Goldman Sachs. Having shown rapid improvement in the past two surveys, this year Goldman virtually sweeps the board in the overall service rankings. The increasing crossover of leveraged and traditional currency accounts has no doubt played to the bank's strengths. It utterly dominates the hedge fund segment, which was a significant factor in this year's survey, but has clearly made large inroads into the real money world as well.

If the plaudits must go to Goldman Sachs, then the Bank of New York is not far behind. BNY shows significant improvement across the board, and while it performed strongly in terms of client satisfaction last year (ranking two), it has clearly added weight to its service offering over the past 12 months. It will be particularly happy to have captured top spot in the main ranking for US respondents.

Two other houses on an upward trajectory are Morgan Stanley and JPMorgan. The former vaults up many of the rankings, although will be disappointed at falling from first to fourth position overall for servicing US clients. JPMorgan seems to be highly regarded by larger investors – being the top service provider for the world's 100 largest asset managers, and finishing second in the asset-weighted category.

If these are the winners, then the two obvious losers are Citibank and Deutsche Bank. Having traditionally dominated the overall rankings, the two powerhouses of the FX market appear to have taken their eye off the ball over the past year.

They may have underestimated the determination of rivals to build their FX businesses, particularly for the buy-side. It will be interesting to see if they can bounce back in 2004.

Both State Street and UBS Warburg have also slipped down many of the rankings – although the former retains its pre-eminence in technology and e-forex.

Of the smaller houses, Mellon and Dresdner Bank break into the top 10 for the first time in a number of key categories, while Brown Brothers Harriman puts in another solid showing on the back of its focus on the investment community.

With Merrill Lynch not being shy in proclaiming its ambitions in the FX arena, there seems little likelihood of competition getting any less fierce on the sellside. Which should be good news for investors.

REAL MONEY ACCOUNTS
BEST FX SERVICE OVERALL RANKING 1

Bank	Score	%
1. Goldman Sachs	173.0	13.0
2. JPMorgan	167.0	12.6
3. Morgan Stanley	133.0	10.0
4. Citibank	120.0	9.0
5. Bank of New York	119.0	8.9
6. Deutsche Bank	105.0	7.9
7. State Street	103.0	7.7
8. UBS Warburg	84.0	6.3
9. BBH	49.0	3.7
10. Mellon	43.0	3.2

RANKING 2

Bank	Score	%
1. Bank of New York	270.5	7.2
2. Brown Brothers Harriman	245.0	6.5
3. Goldman Sachs	230.7	6.1
4. JPMorgan	228.8	6.1
5. Morgan Stanley	221.7	5.9
6. Mellon	215.0	5.7
7. Citibank	214.3	5.7
8. State Street	210.2	5.6
9. CSFB	205.0	5.4
10. Dresdner Bank	200.0	5.3

MOST IMPROVED THEIR SERVICE OVER THE LAST 12 MONTHS

Bank	Score	%
1. Goldman Sachs	109.0	11.8
2. Bank of New York	106.0	11.5
3. JPMorgan	104.0	11.3
4. Morgan Stanley	99.0	10.8
5. Citibank	79.0	8.6
6. State Street	57.0	6.2
7. UBS Warburg	47.0	5.1
8. Deutsche Bank	46.0	5.0
9. RBS	38.0	4.1
10. ABN Amro	33.0	3.6

EUROPEAN RESPONSES (REAL MONEY)
BEST FX SERVICE OVERALL
RANKING 1

Bank	Score	%
1. (2) Goldman Sachs	104.0	13.3
2. (6) JPMorgan	82.0	10.5
3. (5) Morgan Stanley	70.0	8.9
4. (1) Deutsche Bank	68.0	8.7
5. (3) Citibank	65.0	8.3
6. (4) UBS Warburg	57.0	7.3
7. (8) State Street	49.0	6.3
8. (10) Bank of New York	46.0	5.9
9. (7) CSFB	30.0	3.8
10. (–) Dresdner Bank	22.0	2.8

RANKING 2

Bank	Score	%
1. (3) Bank of New York	255.6	5.8
2. (–) CSFB	250.0	5.6
3. (–) BNP Paribas	242.9	5.5
4. (2) Goldman Sachs	241.9	5.5
5. (–) JPMorgan	234.3	5.3
6. (6) BBH	228.6	5.2
7. (9) Morgan Stanley	225.8	5.1
8. (–) State Street	222.7	5.0
9. (–) Mellon	220.0	5.0
10. (7) RBC	220.0	5.0

(He also found very low correlation with the main alternative asset classes, prompting him to conclude that currency should be getting more attention from funds of hedge funds.)

Few asset classes match currency for sheer consistency of returns. And if performance remains solid regardless of what is going on in equity or bond markets, then from a portfolio perspective, it's a valuable risk management tool.

But in most peoples' minds, risk management is one thing, alpha another. According to Duncombe at SSgA, if managers have proved themselves to be successful at hedging currency risk, then they should have no problem adding currency alpha. "The core issue is: can you predict currency movements? If the answer is yes, then you can make money out of it."

The fact that the vast majority of currency managers and forecasters accurately called the slide in the dollar versus the euro in 2002, has given the idea of active currency management more clout. As Paul Blain, managing director at Morgan Stanley, observes: "If people are seeing macro forecasts becoming more reliable, then as managers are going through their risk budgeting process, perhaps they'll put a bit more in the currency bucket."

Disinformation ratio

The question then is just how much risk to allocate a currency manager? Despite claims to the contrary, many managers have yet to prove that they can consistently provide the sort of performance that would warrant the inclusion of currency as a true absolute return product.

One could argue that the conservative mandates awarded to overlay managers have successfully disguised whether or not the managers actually possessed much skill. And managers that boast of impressive information ratios – the most widely accepted measure of manager skill – may be misleading investors. "To measure overlay managers using information ratios is pretty much useless," claims Ulf Lindahl, chief investment officer at AG Bisset, one of the longest-established currency management specialists. He points out that benchmarks play such a large role in determining decisions and performance that an information ratio – the ratio of expected return to risk as measured by tracking error – is an empty figure.

Duncombe at SSgA says that from the point of view of evaluating traditional overlay managers that may be right, given the influence of the benchmarks. But as currency mandates become increasingly return-focused, and unconstrained, that problem disappears.

Bill Muysken, head of manager research at Mercer Consulting in London, agrees that measuring the performance of currency managers has its problems, and that one can quibble over whether or not tracking error is a fair measure of risk, but: "For all practical purposes we haven't found another measure that is as good a yardstick [as information ratio]."

Nevertheless, he says that in evaluating currency managers prospective clients should examine track records according to a range of different benchmarks. "Sometimes constraints can hold back performance, other times they might boost it." He adds: "It's very important to monitor performance in two parts. The first is the passive, partial hedging implied by the benchmark. The second is the active decisions the manager takes."

Different flavours

There is increasing evidence that those active decisions pay off more often than not. AG Bisset signed up the first client for its alpha strategy last September, with the aim of achieving a 5.2% annual return. The fund returned 4.5% in the first quarter, and Bisset says the client, a European pension fund, is now looking to add two more currency alpha managers to its roster.

Phillip Moffitt, managing director at Goldman Sachs Asset Management (GSAM) says the firm's currency business now comes in three flavours. There is overlay as a component part of a GSAM equity or bond product; traditional third-party overlay mandates; and the alpha strategies. The first may still be the biggest part of the business, but it's the third part that is growing most rapidly. In that area, says Moffitt: "We are now entirely crossed over with the hedge fund world: the pricing is the same and the manufacturing has intersected."

It is a trend being recognized by the sell-side. In the past year, State Street has moved into servicing hedge funds and CTAs for the first time, while banks such as Goldman Sachs and Morgan Stanley, which already have strong reputations for servicing hedge funds, have seen their FX businesses benefit immensely as a result. At Goldman Sachs, global head of FX, Geoff Grant, echoes Moffitt in observing that there is an increasing convergence in the services being used by traditional asset managers and leveraged accounts.

Getting rid of the lumps

Yet for all the optimism expressed by currency managers, mandates are hardly flooding the market. In 2002 Mercer completed just eight currency overlay searches, up from four in 2001, although according to one currency manager "a lot of the business is coming without consultants being involved."

One problem that still dogs currency managers is the fact that positive returns tend to be concentrated in a few good months. Frank Russell's performance data shows that for managers with a 50% hedged benchmark (which institutions have traditionally preferred), there have been only six quarters of positive returns since the start of 1999 with 10 negative periods, even though as a universe managers returned an annualized 0.37%. The big issue for pension funds is that they will have to write a cheque to cover the losses in negative quarters.

According to Duncombe: "You have to make sure the pattern of returns is something the client is happy to accept, especially on the downside. Because as sure as eggs is eggs, they will have to write cheques at some point."

But if managers could reduce the so-called lumpiness of returns, it would undoubtedly make currency a more attractive institutional product. As Duncombe sees it, the onus lies largely with the clients. "Lumpiness to a certain extent can get smoothed out by clients giving managers much more flexibility," he claims.

It's sometimes easy to forget just how limited the horizons of a currency manager can be. Modern portfolio theory may proclaim the benefits of diversification, but in currencies a three stock portfolio isn't unusual – US dollar, euro, sterling and yen with one currency being the base.

While risk reduction was all clients had in mind, such mandates seemed to make sense. If these were the only currencies in which underlying asset managers were taking risk, these were the only currencies an overlay manager should be worrying about.

Nor is everyone sold on the idea that adding more currencies necessarily improves performance. "There's really no true diversification," suggests Lindahl at AG Bisset, pointing out that marginal currencies tend to shadow movements in the majors. "It's like buying several different auto companies and claiming you've diversified your industry exposure." So AG Bisset sticks to the four majors, and its performance would suggest it doesn't suffer unduly for doing so.

Most other managers, however, extol the virtues of diversifying exposure as much as possible. The trend is certainly towards a total lack of constraints, with emerging markets currencies the latest fad for many.

Duncombe at SSgA says the firm is doing research on a standalone emerging markets product, which will "probably be more subjective" than the more quant-driven developed market products. Nevertheless, he emphasizes that while liquidity in emerging markets has definitely improved – particularly with the growth in non-deliverable forwards (NDFs), which don't require delivery of the emerging market currency – running positions of any size remains problematic.

"We're big believers in diversity," says GSAM's Moffitt. "It's easier to take punchy risk when there are lots of ways of doing it."

MOST IMPROVED SERVICE OVER LAST 12 MONTHS

Bank	Score	%
1. (1) Goldman Sachs	61.0	11.5
2. (–) Morgan Stanley	58.0	10.9
3. (5) Citibank	49.0	9.2
4. (–) JPMorgan	43.0	8.1
5. (–) Bank of New York	40.0	7.5

NORTH AMERICAN RESPONSES (REAL MONEY)

BEST FX SERVICE OVERALL: RANKING 1

Bank	Score	%
1. (7) Bank of New York	64.0	16.0
2. (9) Goldman Sachs	50.0	12.5
3. (6) State Street	48.0	12.0
4. (1) Morgan Stanley	39.0	9.7
5. (5) JPMorgan	34.0	8.5
6. (2) Citibank	32.0	8.0
7. (8) BBH	31.0	7.7
8. (3) Deutsche Bank	23.0	5.7
9. (4) UBS Warburg	23.0	5.7
10. (10) Mellon	21.0	5.2

RANKING 2

Bank	Score	%
1. (2) Bank of New York	278.3	9.9
2. (1) BBH	258.3	9.2
3. (5) Goldman Sachs	227.3	8.1
4. (9) Bank of America	220.0	7.8
5. (8) Morgan Stanley	216.7	7.7

MOST IMPROVED SERVICE OVER THE LAST 12 MONTHS

Bank	Score	%
1. (4) Bank of New York	58.0	22.4
2. (–) Goldman Sachs	33.0	12.7
3. (3) JPMorgan	32.0	12.4
4. (2) State Street	23.0	8.9
5. (–) Morgan Stanley	21.0	8.1

ASIAN RESPONSES (REAL MONEY)

BEST FX SERVICE OVERALL

RANKING 1

Bank	Score	%
1. (2) JPMorgan	49.0	37.7
2. (1) Citibank	23.0	17.7
3. (–) Morgan Stanley	17.0	13.1
4. (–)Bank Tokyo Mitsubishi	15.0	11.5
5. (3) Goldman Sachs	14.0	10.8

RANKING 2

Bank	Score	%
1. (2) JPMorgan	245.0	19.5
2. (–) BTM	214.3	17.1
3. (–) Morgan Stanley	212.5	16.9
4. (4) Citibank	209.1	16.6
5. (–) Deutsche Bank	200.0	15.9

BEST RESEARCH IN DEVELOPED MARKET CURRENCIES		
Bank	Score	%
1. (5) Goldman Sachs	73.0	15.1
2. (–) Morgan Stanley	72.0	14.8
3. (3) Citibank	64.0	13.2
4. (2) JPMorgan	63.0	13.0
5. (–) Bank of New York	39.0	8.0

BEST RESEARCH IN EMERGING MARKET CURRENCIES		
Bank	Score	%
1. (1) Citibank	50.0	17.7
2. (2) JPMorgan	42.0	14.9
3. (–) Bank of New York	37.0	13.1
4. (–) Morgan Stanley	30.0	10.6
5. (5) Goldman Sachs	29.0	10.3

BEST TRADING IN DEVELOPED MARKET CURRENCIES		
Bank	Score	%
1. (5) Goldman Sachs	68.0	13.3
2. (3) JPMorgan	68.0	13.3
3. (–) Morgan Stanley	55.0	10.8
4. (–) Bank of New York	50.0	9.8
5. (1) Citibank	45.0	8.8

BEST TRADING IN EMERGING MARKET CURRENCIES		
Bank	Score	%
1. (1) Citibank	50.0	17.2
2. (2) JPMorgan	43.0	14.8
3. (–) Bank of New York	39.0	13.4
4. (–) Morgan Stanley	30.0	10.3
5. (4) Goldman Sachs	27.0	9.3

BEST ADVICE ON SPOT TRADING		
Bank	Score	%
1. (4) Goldman Sachs	63.0	15.5
2. (–) Morgan Stanley	51.0	12.5
3. (1) Citibank	44.0	10.8
4. (5) JPMorgan	42.0	10.3
5. (–) Bank of New York	38.0	9.3

BEST ADVICE ON OPTIONS TRADING		
Bank	Score	%
1. (1) Goldman Sachs	54.0	29.0
2. (–) Bank of New York	26.0	14.0
3. (5) Morgan Stanley	26.0	14.0
4. (4) JPMorgan	22.0	11.8
5. (3) Citibank	18.0	9.7

BEST DAILY RESEARCH		
Bank	Score	%
1. (3) Goldman Sachs	69.0	14.1
2. (2) JPMorgan	64.0	13.1
3. (–) Bank of New York	43.0	8.8
4. (–) Morgan Stanley	43.0	8.8
5. (5) Citibank	35.0	7.1

BEST ECONOMIC RESEARCH		
Bank	Score	%
1. (3) Goldman Sachs	77.0	18.1
2. (2) Deutsche Bank	63.0	14.8
3. (1) JPMorgan	60.0	14.1
4. (4) Morgan Stanley	58.0	13.6
5. (5) Citibank	53.0	12.5

BEST TECHNICAL ANALYSIS RESEARCH		
Bank	Score	%
1. (3) Citibank	62.0	16.1
2. (1) JPMorgan	56.0	14.5
3. (4) Morgan Stanley	56.0	14.5
4. (–) Goldman Sachs	35.0	9.1
5. (2) UBS Warburg	25.0	6.5

BEST CAPITAL FLOW RESEARCH		
Bank	Score	%
1. (4) JPMorgan	41.0	18.4
2. (1) Citibank	38.0	17.0
3. (3) State Street	37.0	16.6
4. (5) Goldman Sachs	29.0	13.0
5. (2) Deutsche Bank	21.0	9.4

MOST COMPREHENSIVE SALES COVERAGE		
Bank	Score	%
1. (2) Goldman Sachs	74.0	16.1
2. (–) Morgan Stanley	57.0	12.4
3. (5) JPMorgan	50.0	10.9
4. (–) Bank of New York	47.0	10.2
5. (1) Citibank	38.0	8.3

BEST RISK MANAGEMENT SERVICES		
Bank	Score	%
1. (2) Goldman Sachs	38.0	21.0
2. (1) Citibank	37.0	20.4
3. (–) Bank of New York	28.0	15.5
4. (4) JPMorgan	17.0	9.4
5. (–) Morgan Stanley	17.0	9.4

BEST TRADING OR PORTFOLIO MANAGEMENT TECHNOLOGY INTEGRATION		
Bank	Score	%
1. (1) State Street	35.0	22.3
2. (3) Bank of New York	32.0	20.4
3. (5) Goldman Sachs	32.0	20.4
4. (–) Morgan Stanley	21.0	13.4
5. (2) Citibank	12.0	7.6

BEST ON-LINE RESEARCH WEBSITE FOR FX		
Bank	Score	%
1. (1) UBS Warburg	55.0	19.6
2. (–) JPMorgan	46.0	16.4
3. (2) Citibank	41.0	14.6
4. (4) Goldman Sachs	35.0	12.5
5. (5) Morgan Stanley	31.0	11.0

BEST ON-LINE ELECTRONIC TRADING TOOL		
Bank	Score	%
1. (1) State Street	55.0	27.2
2. (4) Bank of New York	50.0	24.8
3. (2) Goldman Sachs	40.0	19.8
4. (3) UBS Warburg	19.0	9.4
5. (–) FX All	11.0	5.4

BEST STP SOLUTIONS IN FX		
Bank	Score	%
1. (1) State Street	40.0	37.4
2. (2) Bank of New York	37.0	34.6
3. (4) Goldman Sachs	13.0	12.1
4. (–) JPMorgan	10.0	9.3
5. (–) Morgan Stanley	7.0	6.5

INVESTMENT MANAGERS ONLY BEST FX SERVICE OVERALL		
Bank	Score	%
1. (7) Goldman Sachs	127.0	12.5
2. (4) JPMorgan	117.0	11.6
3. (6) Bank of New York	94.0	9.3
4. (8) Morgan Stanley	88.0	8.7
5. (2) State Street	87.0	8.6
6. (1) Citibank	83.0	8.2
7. (3) Deutsche Bank	75.0	7.4
8. (5) UBS Warburg	56.0	5.5
9. (9) BBH	44.0	4.3
10. (–) Mellon	38.0	3.8

MOST IMPROVED SERVICE OVER THE LAST 12 MONTHS		
Bank	Score	%
1. (4) JPMorgan	84.0	12.2
2. (–) Goldman Sachs	83.0	12.1
3. (–) Bank of New York	82.0	12.0
4. (–) Morgan Stanley	79.0	11.5
5. (2) Citibank	53.0	7.7

HEDGE FUNDS ONLY BEST FX SERVICE OVERALL		
Bank	Score	%
1. (1) Goldman Sachs	188.0	42.8
2. (2) Morgan Stanley	91.0	20.7
3. (3) Deutsche Bank	54.0	12.3
4. (–) JPMorgan	31.0	7.1
5. (4) UBS Warburg	22.0	5.0

MOST IMPROVED SERVICE OVER THE LAST 12 MONTHS		
Bank	Score	%
1. Goldman Sachs	122.0	49.4
2. Morgan Stanley	75.0	30.4
3. Deutsche Bank	18.0	7.3
4. Citibank	16.0	6.5
5. JPMorgan	16.0	6.5

GSAM is active in 35 currencies, and according to Moffitt: "The broader the playing field the better we do." In the past two years, during which GSAM has been taking more diversified bets, the information ratio has been close to two, compared to it being nearer one over the life of the product.

Muralidhar at FX Concepts also believes in diversification, and not only in terms of currencies. He has written a paper titled *Don't be grumpy because returns are lumpy*, and says the focus should be firmly on currency managers to produce a product that is more appropriate for pension funds' needs.

He claims that using options in a currency portfolio has enabled FX Concepts to "dramatically improve performance and reduce risk." Yet when he surveyed clients to ask what other managers' approach to options is, he discovered that three out of four managers advise clients to exclude options from their mandate guidelines. It leaves him non-plussed: "By diversifying across different instruments you diversify your risk," he says. "The advent of the euro took 11 currencies off the table, so you have to look for ways to diversify. It is a question of being creative in the way you structure the programme."

Muralidhar has analyzed the impact of options on performance over a two year period and found that programmes without options post a negative performance in 50% of months, while including options reduces the frequency of negative months to 30%.

Unsurprisingly, the sell-side is keen to promote the virtues of options. Blain at Morgan Stanley says that January was one of the busiest months the bank had ever had as far as options trading was concerned. "Options are one of the products managers should be using in terms of alpha generation," he suggests.

State Street is among the banks building their currency options business. According to managing director Mark Snyder: "The mystery surrounding options has receded somewhat. As a financial tool, they better allow investors to express views by changing the shape or duration of their risk." He suggests that it's another area of the FX market where obvious inefficiencies exist, given the fact that the biggest users of options in the past have been corporates hedging exposure on their balance sheets.

Duncombe, however, points out that it would be misleading to suggest that its easy to simply extend a traditional currency strategy into options. "It's not just a move in spot that's impacting price, you have to take into account time value and implied volatility, and look at funding too."

Best execution

If clients are becoming more demanding of currency managers, then managers are in turn putting increasing pressure on the sell-side. It may be the most liquid and actively traded market around, but foreign exchange hasn't escaped the scrutiny of investors seeking proof of best execution. Pension plans in particular now have the means to check that they're not getting a raw deal in FX.

Late last year, Record Currency Management and Mercer Consulting teamed up to market a Currency Audit service that gives pension plans a transparent record of what they're paying for FX services. Having completed 20 such audits in the UK, Record is in the process of negotiating its first contracts in the US and continental Europe.

According to Peter Wakefield, director at Record CM:"If you go into a competitive market with your eyes shut, you're going to get taken advantage of." And until recently, pension funds were completely in the dark as far as foreign exchange trading costs were concerned. The implication is obvious.

Most traders on the sell-side will claim that the free lunch that used to be provided by trading FX for pension funds or international equity managers has long since been gobbled up by competition in the market place. Yet the experience of some of Record's FX audit clients suggests otherwise. In fact, they may well be footing the bill for gourmet dinners.

In 2001, as part of a risk and corporate governance review, the London Regional Transport (LRT) pension fund wanted evidence its managers were achieving best execution. Foreign exchange was one area where there was no obvious report that fund secretary Chris Angell could take to trustees. "It became obvious that managers and our custodian weren't able to tell us exactly when they were trading," he says. "A lot of the response was: trust us, we're gentlemen."

Angell, however, wanted hard evidence, and asked Record to provide it. The £3 billion fund has around £500 million invested overseas, which Angell says doesn't turn over very regularly. "I must admit I was surprised at the sheer scale of FX going on," he says.

According to Record's figures, the execution LRT was getting through its custodian, JPMorgan, was far from best. Angell declines to provide an exact figure, but says poor FX execution was costing the fund "hundreds of thousands of pounds" a year.

After what he calls "a friendly discussion" with JPMorgan, LRT agreed a new service for FX wherein it is provided with time-stamped data and a guarantee that execution will be within what Angell says is "a minimal deviation – single digits in percentage terms" of the best rate.

Wakefield says one shouldn't infer the custodians invariably offer a poorer service than non-custodian banks: "Custodians are nice big targets for investors to go for, but there's no strong evidence that as a group their execution is poorer [than non-custodian banks]," he says. And Angell says that from his perspective, using the custodian for FX remains the preferred option. For its part, JPMorgan says that LRT's currency audit was "a very positive exercise."

Electronic access

The growth of electronic trading tools has made it much easier for investors to make sure they are getting best execution. Brown Brothers Harriman is one among many banks to offer an online execution service guaranteeing a best market price (in BBH's case, the day's closing price according to WM Company rates).

E-FOREX (ALL RESPONDENTS)
DO YOU USE ELECTRONIC TRADING PLATFORMS?

	%
Yes	40.2 (29.2)
Average % of trades?	43.4 (40.8)
No, but plan to in the next 12 months	24.8 (30.8)
No, no plans to	35.0 (39.9)

IF YOU TRADE ON-LINE, DO YOU USE…

	%
One single bank electronic platform	41.2
Two or more single bank electronic platforms	18.7
One multi-bank electronic platform	30.8
Two or more multi-bank electronic platforms	9.3

WHICH PLATFORM DO YOU USE, OR ARE YOU PLANNING TO USE
MULTI-BANK PLATFORMS

Platform	%
1. (1) FXall	49.5 (41.1)
2. (2) Global Link	36.8 (30.8)
3. (4) Currenex	5.1 (2.4)
4. (–) Hotspot	3.5 (–)
5. (–) Bloomberg	3.2 (–)

SINGLE BANK PLATFORMS

Platform	%
1. (1) Goldman Sachs	41.4 (30.7)
2. (2) Bank of New York	14.5 (18.7)
3. (–) Morgan Stanley	10.4 (–)
4. (7) Deutsche Bank	9.2 (6.2)
5. (4) UBS Warburg	8.0 (10.8)
6. (3) State Street	3.6 (12.0)
7. (5) JPMorgan	3.6 (8.3)
8. (8) Dresdner Bank	3.0 (5.8)
9. (–) Barclays	2.7 (–)
10. (6) Northern Trust	2.7 (7.5)

GENERAL INFORMATION
HOW MANY BANKS DO YOU USE FOR FX SERVICES?

	%
4 or fewer	58 (48)
5 - 7	25 (30)
8 - 10	9 (11)
11 or above	8 (11)

WHAT % OF YOUR BUSINESS IS LOCKED TO BANKS DUE TO CUSTODY, PRIME BROKERAGE OR OTHER RELATIONS?

	%
0 - 20%	44.1 (49)
20 - 40%	12.7 (11)
40 - 60%	7.1 (8)
60 - 80 %	8.2 (10)
80 - 100%	28.0 (22)

REASONS FOR CHOOSING FX BANKS (1 TO 5, 1 = MOST IMPORTANT)

1. (1) Price	1.7 (1.5)
2. (4) Quote speed	2.3 (2.3)
3. (3) Quality of sales coverage / relationships	2.3 (2.3)
4. (2) Liquidity	2.4 (2.1)
5. (5) Credit standing	2.7 (2.5)
6. (6) Back office qualities	2.7 (2.6)
7. (7) Breadth of global coverage	2.8 (2.7)
8. (8) Research	3.2 (3.0)
9. (12) Electronic trading	3.4 (3.5)
10. (10) STP facilities	3.4 (3.3)
11. (9) Strategy advice	3.5 (3.2)
12. (11) Trading recommendations	3.6 (3.5)

Muralidhar: A fan of prime brokerage.

The *Global Investor* survey reveals a growing number of investors now using e-forex, with 40% of respondents now signed up to one or more trading platforms, and on average executing 40% of trades online.

Online portal FXall has also seen volumes on a steady upward path, with asset managers the fastest growing segment of its user-base, according to marketing director, Mark Warms. It is rolling out a new service, Settlement Center, to provide clients with an automated trade confirmation process, and a new batch trading tool that Warms expects to be particularly appealing to buy-side users.

According to one sell-side participant, many asset managers remain concerned that if they move away from their custodian for FX, they are exposed to a significant increase in operational risk. "That's one of the factors that make electronic platforms attractive," he adds. "The issue is then: who will pay for the IT work to link the manager to the platform?"

A number of banks – State Street being one – don't charge clients for connecting them to an electronic platform. Similarly, at BBH in New York, head of global FX sales, Jeff Scott, says the bank is making more effort to help clients cut FX-related costs: "We're going in and trying to understand their operations better." Of course, both State Street and BBH are custodians.

Closer relationships

According to Andrew Bound, executive director at GSAM, e-forex is putting added pressure on the sellside. "As more and more trading gets executed online, where there is a printed record and best execution is virtually guaranteed, the ability to add value on execution disappears," he points out. "In the past we would have had a long list of counterparties. Now we ask: Which counterparties can help us add value with our process? Assuming there are no credit issues, why should we spend time talking to people who are giving us a commodity? We need to form closer relationships with a smaller number of counterparties."

Morgan Stanley's Blain is in complete agreement. "We think of sell-side FX as a three-legged stool," he says. "There's pre-sale, adding alpha through research; sale, which is pricing; and post-sale, which is connectivity. It is impossible to differentiate yourself on the middle leg."

Global Investor's survey suggests that an increasing number of investors are concentrating their FX business in a smaller number of hands, with nearly 60% of respondents using four or fewer banks.

Given that execution has become a commodity, it is only natural to question whether banks will remain committed to FX. But there seems little sign of contraction at the top end of the market, with most banks reporting increased trading volume during 2002, and some – such as Goldman Sachs, Morgan Stanley and the Bank of New York – clearly on an aggressive growth path.

Nor do smaller firms seem dissuaded from expanding. BBH opened an FX desk in London 18 months ago, and has more recently expanded to Tokyo. "We still believe FX is an exciting business to be in. We still believe it's a growth business," says the bank's European head of FX, Henry Wilkes.

Prime brokerage

With the growth of the hedge fund industry, and the crossover between traditional currency overlay managers and leveraged investors, FX prime brokerage is also a growing business.

"We started FX prime brokerage just over a year ago, and business has picked up a lot in the past 12 months," says Mike Burton, managing director at Goldman Sachs. He says real money investors are increasingly interested in prime brokerage, although making the switch is still "a significant step" for any traditional asset manager.

Bound says that although GSAM's experience of prime brokerage has been limited, "it has only been good," while Muralidhar at FX Concepts has become a big fan of using a prime broker. "There was a situation where we were up against a large manager and the client went back to them and asked them to adopt a prime brokerage relationship," he says.

Muralidhar argues that liquidity is actually improved (as the prime broker can access more counterparties than FX Concepts could otherwise), and that both operational and settlement risk can be reduced. GI

METHODOLOGY

We received a total of 512 questionnaires, 398 of which qualified.
We received a total of 76 qualified responses from GI 100 Asset Managers.

Regional breakdown:

Europe	**48%**
Americas	**43%**
Asia	**9%**

Main business of respondent:

Investment management	**49%**
Hedge fund	**27.9%**
Mutual fund manager	**7.4%**
Insurance company	**5.7%**
Pension fund	**4.5%**
Currency overlay manager	**3.3%**
CTA	**2.1%**

Hedge fund and CTA responses are excluded from the "real money" results (all except pages 38 and 45). For best FX service overall (all respondents) banks needed 10 votes to qualify. All other categories required five votes. The main business of a respondent has to be one of the seven categories above.

The two rankings:
Ranking one is simply the sum of all votes, where a bank is awarded three points for being ranked in first place, two points for second, and one point for third. The bank's score is then expressed as a percentage of the total for all qualified banks. Those banks that receive more responses will inevitably fare better in ranking one.
Ranking two attempts to be more qualitative, with banks rewarded for being ranked consistently highly by their clients, regardless of the size of their customer base. The percentage of first, second and third places is calculated and then multiplied by three, two and one respectively (eg. Bank X has 10 responses. 20% rank it first, 30% second, and 50% third. It therefore scores 170.) Again, the score is then expressed as a percentage of the whole.

Weighted by asset size:
Each respondent's vote was given a weighting according to the size of their average monthly trading volume:
1 = Less than US$10 million
2 = US$10-25 million
3 = US$25-50 million
4 = US$50-100 million
5 = US$ 100-500 million
6 = More than US$500 million