CURRENCY'S NEW CLOUT

After spending years in relative obscurity, currency managers have been thrust onto centre stage. With international equity markets promising single digit-returns at best, suddenly everyone cares about currency risk and return. For the FX banks, it means business from asset managers is booming. And they're battling hard to stay on top. By **James Rutter**. Research by **Katy Macbeath** and **Anne Totten**.

CURRENCY COUNTS. The extra 100 or 200 basis points that active currency management can add to portfolio performance is no longer something to be sniffed at. Equally, in a world of 7% equity market returns, losing a percentage point or two due to currency fluctuations is not something many international equity investors will like to contemplate.

It has prompted a wave of interest in currency overlay from both asset managers and institutional investors. And where the buy-side goes, the banks quickly follow. More active management of currency means more turnover, which for FX banks means more commission. With cross-border investment only set to keep growing, banks are falling over each other to meet investors' every need in the FX market.

The new clout being enjoyed by currency managers is perfectly illustrated at Deutsche Asset Management. Every time it puts in a pitch for a new global equities mandate, a few pages are included to explain its stand alone currency overlay approach. As Michael Collins, product manager of DeAM's new-look currency team points out: "No one ever thought that currency would be having a big enough impact for investors to be asking what they're doing in international equity."

But this is exactly the question numerous US investors have been asking themselves in recent years. The Eafe unhedged index is down 7.9% in the three years to January 2002, with 8.1% of that due to the negative currency impact of a strong dollar.

Of course, on the opposite side of the fence, European and Japanese investors with unhedged US dollar portfolios have enjoyed the ride. For them, the concern now is that at some point in the not-too-distant future, the tables are likely to be turned. Regardless of where they may be domiciled, for investors contemplating the outlook for returns in the sober light of the early 21st century, the importance of currency cannot be missed.

The long wait

For the faithful, the acceptance of currency management in Europe has been a long time coming. Daniel Szor, Paris-based head of marketing for currency overlay specialist, FX Concepts, arrived in Europe to preach the gospel of currency management in 1993. His initial high hopes were quickly deflated. But now he sees the work of the past nine years finally paying off. "We see a lot of growth coming out of Europe and the Far East," he says. "In the past 12 months I've seen interest really picking up."

In February FX Concepts launched two euro-denominated overlay funds, which Szor says are the first of their kind. The funds are being marketed to managers who want to hedge their exposure to the dollar or yen. "We wanted to create something liquid, that has an NAV, that can be used with a degree of leverage – and so needs minimal cash – and that can be looked at as a strategic or a tactical tool," explains Szor. While he says they are really just "a footnote" to FX Concepts main business (segrated overlay and absolute return products), he has still identified up to 100 managers which he says are a perfect fit for the funds, notably fund-of-funds managers using predominantly US-based asset managers.

But just as the specialist overlay boutiques are seeing an upturn in interest, so larger asset managers with in-house currency expertise are looking to promote their own capabilities. Nigel Jenkins, head of fixed income and currency at WestAM, the asset management arm of German bank, WestLB, says that although his team isn't managing any overlay mandates at present, "we're certainly in a position to feel confident that we could add value doing it."

BEST PROVIDER OF FX SERVICES

OVERALL RANKING ONE

Bank	percentage
1 (1) Citibank	12.59
2 (2) Deutsche Bank	11.78
3 (6) Goldman Sachs	10.34
4 (3) JP Morgan	9.31
5 (5) UBS Warburg	9.31
6 (7) Morgan Stanley	8.16
7 (4) State Street	7.07
8 (–) Bank of New York	4.89
9 (–) CSFB	4.25
10 (–) HSBC	4.02

RANKING TWO

Bank	percentage
1 (–) Bank of New York	5.83
2 (2) BBH	5.62
3 (–) Northern Trust	5.51
4 (1) State Street	5.41
5 (–) Goldman Sachs	5.32
6 (3) Citibank	5.06
7 (4) UBS Warburg	4.91
8 (6) Deutsche Bank	4.83
9 (–) Morgan Stanley	4.80
10 (8) Bank of America	4.67

MOST IMPROVED BANK OVER THE PAST 12 MONTHS

Bank	percentage
1 Goldman Sachs	10.04
2 UBS Warburg	9.96
3 State Street	8.96
4 Deutsche Bank	8.80
5 Citibank	8.55
6 JP Morgan	7.97
7 Morgan Stanley	6.72
8 HSBC	6.22
9 CSFB	5.64
10 Bank of New York	4.98

GENERAL INFORMATION

We received questionnaires from 514 institutions of which 384 qualified. (Figures in brackets denote 2001 rankings.) **Ranking methodology on page 50.**

GEOGRAPHICAL BREAKDOWN

Europe	**47 % (55%)**
Americas	**36 % (30%)**
Asia/ROW	**17% (15%)**

RESPONDENT TYPE BREAKDOWN

Type of firm	percentage
Investment management	63 (52)
Hedge fund	13 (3)
Insurance company	8 (7)
Pension fund	7 (6)
Currency overlay manager	4 (5)
CTA	4 (2)
Other	1

EUROPEAN RESPONDENTS BEST OVERALL FX PROVIDER RANKING ONE	
Bank	percentage
1 (2) Deutsche Bank	15.60
2 (9) Goldman Sachs	12.96
3 (1) Citibank	12.08
4 (4) UBS Warburg	10.06
5 (6) Morgan Stanley	7.17
6 (3) JP Morgan	6.92
7 (–) CSFB	5.66
8 (5) State Street	4.40
9 (10) HSBC	3.77
10 (–) Bank of New York	3.65
RANKING TWO	
Bank	percentage
1 (1) State Street	6.03
2 (10) Goldman Sachs	5.92
3 (–) Bank of New York	5.83
4 (–) Dresdner Bank	5.63
5 (3) ABN Amro	5.31
6 (–) BBH	5.31
7 (–)RBC	5.31
8 (4) UBS Warburg	5.22
9 (–) Morgan Stanley	5.09
10 (6) Citibank	5.03
MOST IMPROVED OVER PAST 12 MONTHS RANKING ONE	
Bank	percentage
1 Goldman Sachs	14.91
2 Deutsche Bank	11.93
3 UBS Warburg	8.95
4 CSFB	6.96
5 Citibank	6.76

AMERICAN RESPONDENTS BEST OVERALL FX PROVIDER RANKING ONE	
Bank	percentage
1 (–) Morgan Stanley	11.81
2 (1) Citibank	10.68
3 (3) Deutsche Bank	10.36
4 (–) UBS Warburg	9.87
5 (4) JP Morgan	9.71
6 (2) State Street	9.39
7 (–) Bank of New York	8.58
8 (5) BBH	6.15
9 (–) Goldman Sachs	6.15
10 (–) Mellon	5.50
RANKING TWO	
Bank	percentage
1 (2) BBH	7.67
2 (–) Bank of New York	7.64
3 (1) State Street	7.02
4 (3) Citibank	6.89
5 (–) Goldman Sachs	6.77
6 (5) UBS Warburg	6.6
7 (–) Deutsche Bank	6.46
8 (–) Morgan Stanley	6.31
9 (–) Bank of America	6.06
10 (–) HSBC	6.06
MOST IMPROVED OVER PAST 12 MONTHS RANKING ONE	
Bank	percentage
1 UBS Warburg	13.25
2 State Street	7.51
3 JP Morgan	7.28
4 Bank of New York	6.84
5 Deutsche Bank	6.84

INVESTMENT MANAGERS BEST OVERALL FX PROVIDER RANKING ONE	
Bank	percentage
1 (2) Citibank	11.84
2 (1) State Street	11.53
3 (4) Deutsche Bank	11.12
4 (3) JP Morgan	10.61
5 (5) UBS Warburg	9.29
6 (–) Bank of New York	6.84
7 (7) Goldman Sachs	6.53
8 (8) Morgan Stanley	5.00
9 (6) BBH	4.08
10 (–) CSFB	3.67
RANKING TWO	
Bank	percentage
1(9) Bank of New York	5.88
2 (1) State Street	5.58
3 (2) BBH	5.58
4 (–) Northern Trust	5.53
5 (5) UBS Warburg	5.39
6 (–) Merrill Lynch	5.14
7 (6) Citibank	5.09
8 (–) RBS	4.96
9 (7) Deutsche Bank	4.87
10 (–) Standard Chartered	4.74
MOST IMPROVED OVER PAST 12 MONTHS RANKING ONE	
Bank	percentage
1 State Street	14.58
2 Citibank	10.06
3 UBS Warburg	9.62
4 JP Morgan	9.18
5 Deutsche Bank	8.31

New model army

Collins at DeAM has already cleared that particular hurdle, not only in terms of offering overlay as a stand-alone product, but also running overlay on internal international equity portfolios. "We've convinced the internal market of the validity of the approach," he says.

He has also participated in the re-structuring of currency management within DeAM. In December 2000, CIO Dean Barr convened a meeting of all the people with responsibility for managing currencies within the legacy asset management businesses of Deutsche Bank, Bankers Trust and Morgan Grenfell. "It was the first time that everyone had unbundled themselves from their roles within equities or fixed income and identified themselves and others as being currency specialists," says Collins.

The idea was not to create a single centre of currency management, to "smash it all together" as Collins puts it, but rather to build an integrated currency product that retained the diverse approaches and styles of each of the legacy groups. "In essence we realized that what we had was four pure alpha, hedge funds," he says. "So we have a multi-style, multi-manager concept, which has a five year track record with a correlation between managers of 0.1."

The four separate teams retain their pre-existing roles within equity and fixed income product teams, but also deal model portfolios online with a central portfolio engineering team using DeAM's intranet. "Every client portfolio gets customized once a day," explains Collins. "There is a single framework to run the whole business, and this model, which was built for currency, is now being run more broadly across the firm."

The new stand-alone currency overlay product is still building a track record, but has already won $500 million in new business, with a similar sum due to be funded in the first quarter of this year. Collins' group is also running segregated overlay on $5 billion of DeAM's existing international equity and balanced business, and there is the potential to deliver overlay on all the firm's cross-border business.

Of course, existing clients still have to be convinced of the merits of the appraoch. Collins, who prior to joining DeAM spent two years as an investment consultant at William M Mercer, says that clients often still don't understand how to get the best out of active currency management. "Currency overlay on equity mandates usually means being relatively constrained. My job is to help clients understand the nature of those constraints and the positive impact from loosening them."

Bank battle

All this should be music to the ears of FX banks, for whom asset managers have rapidly taken on the mantle of being their most important client segment.

In the triennial survey of foreign exchange markets published by the Bank for International Settlements last April, the daily volume of trading between banks and financial customers was, at $329 billion, more than double that of the business conducted with non-financial customers. According to the BIS, this "reflected the increasing role of asset managers."

Foreign exchange may traditionally have been seen by many money managers as a task best entrusted to a custodian bank, but that cosy relationship is one that non-custodians have been targeting aggressively for some time. Traditional custody banks continue to fare well in

FOREIGN EXCHANGE SURVEY

ASIAN RESPONSES
BEST OVERALL FX PROVIDER

RANKING ONE	
Bank	percentage
1 (3) Citibank	19.06
2 (2) JP Morgan	15.72
3 (4) Goldman Sachs	13.04
4 (1) State Street	10.03
5 (–) HSBC	9.36
RANKING TWO	
Bank	percentage
1 (–) Credit Agricole Indosuez	10.54
2 (–) JP Morgan	9.07
3 (–) CSFB	8.92
4 (1) Citibank	8.89
5 (4) State Street	8.69

MOST IMPROVED IN PAST 12 MONTHS

RANKING ONE	
Bank	percentage
1 Citibank	16.88
2 State Street	14.72
3 JP Morgan	13.85
4 HSBC	12.99
5 Goldman Sachs	11.26

HEDGE FUNDS
BEST FX SERVICE OVERALL

RANKING ONE	
Bank	percentage
1 Goldman Sachs	22.55
2 Morgan Stanley	20.59
3 Deutsche Bank	14.71
4 UBS Warburg	12.75
5 CSFB	9.80
RANKING TWO	
Bank	percentage
1 Citibank	20.95
2 CSFB	19.01
3 Deutsche Bank	16.85
4 Goldman Sachs	13.82
5 HSBC	9.94

BEST OVERALL WEIGHTED BY ASSET SIZE

RANKING ONE	
Bank	percentage
1 (2) Deutsche Bank	13.00
2 (1) Citibank	12.79
3 (3) JP Morgan	10.45
4 (4) UBS Warburg	10.43
5 (6) Goldman Sachs	9.76
6 (8) Morgan Stanley	8.41
7 (5) State Street	5.88
8 (–) CSFB	4.87
9 (–) HSBC	3.97
10 (–) Bank of New York	3.26

MARKET TRENDS
AVERAGE MONTHLY TRADING VOLUME IN FX MARKETS

Band	percentage
Less than US$50 million	26.11
US$ 50 - 100 million	14.17
US$100 - 500 million	25.00
US$500 million - 1 billion	11.11
US$1 billion -10 billion	20.00
More than US$10 billion	3.61

NUMBER OF FX BANKS

Band	percentage
4 or fewer	48 (32)
5 - 7	30 (37)
8 - 10	11 (17)
11 or above	11 (14)

IS THIS NUMBER INCREASING, DECREASING OR STAYING THE SAME

	percentage
Increasing	18 (24)
Decreasing	15 (20)
Staying the same	67 (57)

PERCENTAGE OF FX LOCKED TO CUSTODY, PRIME BROKERAGE OR OTHER RELATIONS

Band	percentage
0 - 20%	49
20 - 40%	11
40 - 60%	8
60 - 80 %	10
80 - 100%	22

REASONS FOR CHOOSING FX BANKS (1 MOST IMPORTANT)

Price	1.55 (1.52)
Liquidity	2.11 (2.25)
Sales coverage/relationships	2.27 (–)
Quote speed	2.29 (2.36)
Credit standing	2.45 (2.54)
Back office qualities	2.63 (2.76)
Breadth of global coverage	2.70 (2.85)
Research	3.03 (2.92)
Strategy advice	3.15 (3.04)
STP facilities	3.28 (–)
Trading recommendations	3.47 (3.33)
Electronic trading	3.52 (3.73)

METHODOLOGY

THE TWO RANKINGS

Ranking one is simply the sum of all votes, where banks are awarded three points for first place, two points for second and one for third. The score is a percentage of the whole. Those banks with a larger customer base will inevitably stand a better chance of topping this poll.

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. For each bank with at least 10 responses, the percentage of first, second and third place votes is calculated, and these figures then multiplied by three, two and one respectively (eg Bank X has 10 responses. 20% rank it first place, 30% second and 50% third. It therefore scores 170). The score is a percentage of the whole.

Global Investor's annual survey, especially in ranking two, where the quality rather the quantity of relationships is better reflected. One obvious explanation is that one-in-five respondents remain tied to a custodian or prime broker for at least 80% of their FX business. At the top of the rankings, however, it seems that the prominance of custodians is being eroded. The two largest custody banks in the FX market, JP Morgan and State Street, have both dropped down the rankings this year.

Going on last year's survey, the merger of JP Morgan and Chase, in 2001 ranked seventh and third respectively, should have been enough to loosen Citibank's grip on the number one spot. Instead, the merged bank finds itself displaced by Goldman Sachs – the most improved bank this year – in third place overall. Not only has the merged whole proved less than the sum of its parts, it appears to be less than Chase alone. Paul Standing, managing director and head of rates at JP Morgan, expresses surprise that the bank's performance has apparently dipped. He says that considering 2001 was a merger year, the FX business made "steady progress."

But as competitors target FX with renewed vigour, such momentum may fail to match the market. Mark Snyder, head of foreign exchange at State Street, agrees that the competition is getting tougher. "It's fair to say that some other banks have reorganized as they've recognized that other elements of the market are not growing while the investment management segment is growing a lot."

At the top of the overall ranking, Citibank and Deutsche Bank continue to fight it out. Citibank again comes out on top, although it is only Deutsche Bank's weakness in the Asian market that separates the two. Richard Moore, Citibank's global head of foreign exchange, says the key to the bank's success is simple: "Staying very close to the changing needs of the customer – that's the key challenge. I'd like to think that we're very nimble in responding to their requirements."

Goldman Sachs is one FX bank making a concerted attack on the asset management market. Having hired an aggressive sales team from Deutsche Bank under managing director and head of FX sales and e-commerce, Zar Amrolia, it has not wasted any time in boosting its profile in the market. Not one given to cautious statements of intent, Amrolia says: "Our strategic objective is to be number one for the investor client base." He refers to "project X" which, he says, will make headline news during the second quarter. While he declines to reveal any details, it seems likely that the initiative will be targeted squarely at the custody banks. "The custodial banks still represent a barrier to entry in the short

BEST RESEARCH IN DEVELOPED MARKET CURRENCIES

RANKING ONE

Bank	percentage
Deutsche Bank	16.30
JP Morgan	13.37
Citibank	12.26
UBS Warburg	11.70
Goldman Sachs	9.75

RANKING TWO

Bank	percentage
Bank of New York	6.90
Brown Brothers Harriman	6.65
UBS Warburg	6.16
Citibank	6.09
Dresdner Bank	6.08

BEST RESEARCH IN EMERGING MARKET CURRENCIES

RANKING ONE

Bank	percentage
Citibank	17.56
JP Morgan	13.92
Deutsche Bank	10.71
HSBC	8.35
Goldman Sachs	7.71

RANKING TWO

Bank	percentage
Merrill Lynch	7.90
Bank of New York	7.50
HSBC	7.00
UBS Warburg	6.51
CSFB	6.46

BEST TRADING IN DEVELOPED MARKET CURRENCIES

RANKING ONE

Bank	percentage
Citibank	13.69
UBS Warburg	13.54
JP Morgan	12.97
Deutsche Bank	11.38
Goldman Sachs	8.65

RANKING TWO

Bank	percentage
BNP Paribas	6.26
Merill Lynch	6.26
Bank of New York	6.21
UBS Warburg	6.05
State Street	5.83

term," he says. "But increasingly fund managers will be looking to link best and value-added research and services."

Needless to say, the custody banks aren't about to give up without a fight. Jorge Rodriguez, head of FX at the Bank of New York, the world's largest custodian, suggests that for all the emphasis being placed on active currency management, the vast majority of asset managers retain a traditional approach to FX: "Foreign exchange for many is nothing but a by-product of another investment decision. While some might trade FX as an asset class, many do not." He says that over 90% of the bank's

BEST TRADING IN EMERGING MARKET CURRENCIES

RANKING ONE

Bank	percentage
Citibank	16.28
JP Morgan	14.19
Deutsche Bank	11.86
Goldman Sachs	8.60
UBS Warburg	6.74

RANKING TWO

Bank	percentage
BNP Paribas	7.15
Standard Chartered	7.06
Brown Brothers Harriman	6.95
Citibank	6.78
Bank of New York	6.62

BEST ADVICE ON SPOT TRADING STRATEGIES

Bank	percentage
Citibank	14.88
UBS Warburg	12.04
Deutsche Bank	10.37
Goldman Sachs	9.87
JP Morgan	8.53

BEST ADVICE ON OPTIONS TRADING STRATEGIES

Bank	percentage
Goldman Sachs	21.20
UBS Warburg	15.51
Citibank	11.71
JP Morgan	10.44
Morgan Stanley	10.44

BEST DAILY RESEARCH

Bank	percentage
Deutsche Bank	13.29
JP Morgan	11.61
Goldman Sachs	10.21
UBS Warburg	10.07
Citibank	9.79

BEST ECONOMIC RESEARCH

Bank	percentage
JP Morgan	14.67
Deutsche Bank	13.77
Goldman Sachs	13.16
Morgan Stanley	10.89
Citibank	10.29

custody clients use its FX services: "And if you make your clients' jobs easier on the business that you custodize then you have the ability to capture non-custody business." A somewhat dated view, maybe, but one that seems to be working.

Best execution

According to Henry Wilkes, European head of FX at Brown Brothers Harriman, the view that only the biggest will survive in the FX market is "the big boys doing their own PR, which they have been doing for years." He suggests that while competitors are right to point out that custody banks can no longer take FX business as a divine right, the more forward-thinking

BEST TECHNICAL ANALYSIS RESEARCH

Bank	percentage
JP Morgan	15.28
UBS Warburg	13.35
Citibank	12.77
Morgan Stanley	10.25
Deutsche Bank	6.38

BEST CAPITAL FLOW RESEARCH

Bank	percentage
Citibank	23.19
Deutsche Bank	18.18
State Street	15.58
JP Morgan	10.20
Goldman Sachs	8.53

BEST FX STRATEGY SOLUTIONS

Bank	percentage
Citibank	19.26
Goldman Sachs	14.07
UBS Warburg	13.33
Morgan Stanley	10.37
Deutsche Bank	8.89

BEST DATA FOR QUANTITATIVE ANALYSIS

Bank	percantage
Citibank	18.10
JP Morgan	15.03
UBS Warburg	13.50
Goldman Sachs	13.19
Deutsche Bank	11.04

MOST COMPREHENSIVE SALES COVERAGE

Bank	percentage
Citibank	13.97
Goldman Sachs	11.94
Deutsche Bank	11.79
UBS warburg	9.75
JP Morgan	9.17

BEST RISK MANAGEMENT SERVICES

Bank	percentage
Citibank	18.53
Goldman Sachs	13.99
UBS Warburg	13.29
JP Morgan	10.84
Deutsche Bank	10.14

BEST TRADING OR PORTFOLIO MANAGEMENT TECHNOLOGY INTEGRATION

Bank	percentage
State Street	27.85
Citibank	15.19
Bank of New York	12.24
UBS Warburg	11.81
Goldman Sachs	9.28

custodians are well prepared for the competition. "There are custody banks that have taken FX seriously, and custody banks that have tended to view it as a cash cow. It is the latter that will suffer. We live in the real world."

The assault on the custody banks is being aided by the arrival of electronic trading, and the price transparency that it brings. The increased onus on fund managers to prove to clients and regulators that they are achieving best execution extends to FX trading. Paul Blain, head of FX sales

E-FOREX
DO YOU USE ELECTRONIC TRADING PLATFORMS?

	percentage
Yes	29.20 (29.66)
Average % of trades	40.82 (36.30)
No, but plan to in next 12 months	30.85 (35.36)
No, no plans to	39.94 (34.98)

WHICH PLATFORM DO YOU USE, OR ARE YOU PLANNING TO USE?

Multi-bank platforms

Platform	percentage
FX All	41.08 (16.89)
Global Link	30.81 (27.27)
Atriax	25.67 (27.27)
Currenex	2.44 (–)

SINGLE BANK PLATFORMS

Platform	percentage
Webet (Goldman Sachs)	30.71
iFX Manager (BONY)	18.67
FX Connect (State Street)	12.03
FX Trader (UBS Warburg)	10.79
EFX (JP Morgan)	8.30
FX Passport (Northern Trust)	7.47
Deutsche Bank	6.22
Piranha (Dresdner)	5.81

WHAT HAS MOST INFLUENCED OR WILL INFLUENCE YOUR DECISION?

Multi-asset class link	6.48
Flexible pricing request & trading tool format	3.87
Platform integration with your trading or portfolio management system	3.67
Security	3.50
Overall efficiency gains - STP	3.19
Multi-bank trading platform	3.05
Ease of use	2.82
Improved pricing	2.77

BEST ON-LINE RESEARCH WEBSITE FOR FX RANKING ONE

Bank	percentage
UBS Warburg	18.49
Citibank	17.20
Deutsche Bank	11.83
Goldman Sachs	10.54
Morgan Stanley	10.11

BEST ON-LINE ELECTRONIC TRADING TOOL RANKING ONE

Bank	percentage
State Street	26.80
Goldman Sachs	21.20
UBS Warburg	12.40
Bank of New York	11.60
Citibank	8.40

BEST STP SOLUTIONS IN FX RANKING ONE

Bank	percentage
State Street	31.10
Bank of New York	17.07
Citibank	10.98
Goldman Sachs	8.54
UBS Warburg	8.54

at Morgan Stanley, says: "There will be much more focus from investors on slippage and FX business done with their custody banks." The arrival of platforms that offer real-time multi-bank pricing means that there will be nowhere to hide for banks tying FX to custody business and achieving advantageous pricing as a result.

According to Mark Warms, head of marketing at FXAll: "It has always been a conundrum to prove best execution. A lot of asset management deals have to go through the custodian. But through using our system, a client has been able to go back to their custodian and show slippage."

But Rodriguez at BoNY suggests that to focus solely on the pricing aspect of best execution would be misleading. "We're not just talking about understanding the needs of the executor," he says. "We're talking about understanding everyone: operations, compliance, legal."

Morgan Stanley's Blain agrees that asset managers are concerned with good service through the entire life cycle of an FX trade, but suggests custody banks' traditional advantage in that area is diminishing. "One of the biggest concerns for investors thinking of moving away from their custodial banks is operational risk – the danger that errors in trade confirmation, matching or settlement will hit their bottom line. As STP becomes a reality, those concerns will evaporate."

Clients win

The clear winners in this new, ultra-competitive market should be the end users. If as a money manager you're not getting your FX banks to fulfil your every need then you should be looking elsewhere for service, especially given that, as JP Morgan's Standing observes: "Compared to their equity and bond counterparts, currency groups on the buy-side tend to be under resourced."

Banks claim to be only too eager to offer consulting services to help clients integrate electronic trading systems or move towards straight through processing. State Street offers its specialist research group — State Street Associates — as what Snyder calls a "brains trust" to help clients refine their own currency strategies.

Similarly, last June Citibank set up a global risk advisory group which offers investors customized research. According to Laurent Desbois, co-head of the group, most time is being spent working on alpha strategies: "Clients tell us what kind of style they're looking for and we construct a strategy that they're then responsible for executing. It's usually people who are already doing overlay internally or who are looking to develop some internal expertise." Across the market banks have stepped-up their efforts in research as investment managers have become increasingly baffled by currency. Bilal Hafeez, part of JP Morgan's foreign exchange research team, says: "It can feel like there's no real way of making consistent profits in currency markets. But if you take a more holistic approach you can win."

What most people seem to agree on is the fact that the old school of fundamental currency analysis and forecasting is now woefully inadequate.

Research revolution

Jenkins at WestAM agrees that on the buy-side there has been a recognition that managing currencies successfully must now involve much more than just doing medium or long-term fundamental analysis. "That recognition comes from people managing currency on purely fundamental grounds and getting badly burned over the past three years by being long euros and long Australian dollars."

He suggests that the experience has prompted a number of firms to step away from managing currencies altogether, while others have sought to reduce their exposures significantly. At WestAM, however, the reaction has been to reassess how currencies should be analyzed, putting a lot more weight on momentum measures and a particular emphasis on technical analysis. "It would be wrong to completely throw out the view that there is a fair value level or range for a currency over the long term," adds Jenkins. "But unless you can close your eyes and open them in 10-years time, it's not hugely useful."

Avinash Persaud, head of strategy at State Street, suggests that economic research has changed beyond recognition in the past decade. He highlights three trends that have altered the landscape: the collapsing cost of information; the explosion of capital flows; and the equitization of those capital flows.

While the second factor has caused a decline in the usefulness of fundamental valuation methods based on the price of goods, it is the last trend that he suggests has been most influential. "When most economists were growing up in this industry, bond flows were three times equity flows. That was why the FX guys were in the bond department," he says. "But the world's changed. It's not that the fundamentals don't work any more; it's that the traditional bond fundamentals don't work."

He points out that unhedged equity flows were twice bond flows in 2000 – although analysts who thought they'd finally got the new world order figured out were once more left clutching at thin air as bond flows grew in prominence through

E-FOREX: WILL THE PRIME BROKERAGE MODEL CHANGE THE GAME?

The gloves are off in the e-forex arena. After a period of evangelizing by the numerous single and multi-bank trading platforms, the down and dirty battle for customers has begun in earnest. The platforms are live, and asset managers are making their choices.

For many, that choice is still to sit and wait. The exponential increase in e-forex users that many predicted, doesn't appear to be happening. Nevertheless, Paul Blain, head of FX sales at Morgan Stanley, still sees plenty of potential for e-forex. "I've spoken to one fund manager which is looking to get 90% of its FX trades under $1 million done on e-trading platforms within 12 months. In general, managers are looking to free up more time to be thinking about their policy trades."

Among the multi-bank portals FXAll has opened up a clear lead on the competition, while it seems Atriax has fallen off the pace. State Street's decision to open its Global Link platform to third-party FX providers appears to be paying off.

Dan Morehead, chief executive of Atriax, concedes that up to now, the company's offering hasn't been as alluring to asset managers as some of the competition. It's initial product, launched last summer had more obvious appeal to corporates or fund managers with straightforward needs. It wasn't until December that it released the first phase of a more complex suite of products aimed squarely at asset managers. The second phase of the roll out will be delivered in March. "That will completely close the functionality gap," promises Morehead. "Frankly, we hadn't really started our efforts with fund managers last year. Now we have a very compelling story."

Virtually everyone agrees that for asset managers the real value-added of e-forex will be in straight through processing. "If you looked back a year, you would have seen a lot of concentration on execution. Now the focus has moved to pre- and post-trade functionality," says Roddy Boulton, marketing director at Currenex.

It is Currenex, an independent online exchange, that has brought the latest evolution in the e-forex arena with its Enhanced Market Access (EMA) concept launced late in 2001.

It effectively brings the prime brokerage model to the online marketplace. "The FX market looks at first sight to be the largest and most liquid market in the world," says Boulton. "But in fact it's very restrictive because it is defined by bilateral credit lines. The prime brokerage model finally breaks the credit lock."

Users separate their credit banks and their trading counterparties, and unlike traditional prime brokerage can use more than one bank to provide credit – of course, for a fee.

Boulton says that attraction is three-fold: first and foremost, enhanced liquidity and better pricing; secondly, outsourcing of settlement; and thirdly, anonymous trading. The latter two positives are fairly uncontroversial; they are the traditional attractions of paying for a prime broker.

It is the first argument that others in the market question, at least in terms prime brokerage being attractive to users beyond the hedge fund and niche asset management sector. "I'm a little sceptical," confesses Mark Snyder, head of FX at State Street. "The cost of executing trades is already much lower than for any other product. If the price of liquidity is low enough and there is added-value being provided, then the dealer model works well."

Nevertheless, many FX banks are considering launching some form of prime brokerage service, especially given the return to prominence of macro hedge funds during 2001 as well as the general bull market in absolute return strategies. Goldman Sachs unveiled its FX prime brokerage offering towards the end of last year, and plenty of others are likely to follow suit in 2002.

2001. As Persaud says with a wry smile: "This will probably be the year of the bond."

James Binney, head of currency at Gartmore Investment Management, agrees that in forecasting FX one now has to look beyond interest rate differentials and take much more account of equity markets and growth. Nevertheless, he remains sceptical that the flow-based research being aggressively promoted by many banks has any real predictive power. "Banks think it's fascinating and useful, but it really just tells you what's happening now, not what's in the future."

Nevertheless, investors remain eager for new explanations of currency trends, if only to give them more confidence that the markets retain a modicum of rationality. The continuing strength of the dollar and the weakness of the euro has certainly dented the confidence of many. "From where we sit, we see fewer of our clients feeling confident about getting the big currency trades right," says Blain at Morgan Stanley. "Increasingly clients are focusing on getting the tactics right. They want to be able to identify the 3% to 5% moves. The approach is like putting a jigsaw together, looking at numerous different inputs."

Desbois at Citibank agrees: "Investors are now more open," he says. "They're looking for models that can make them some money, they realize that they don't need a forecast for the euro to do that, so they're taking more notice of trading models."

But asset managers should consider the banks' motives. As one currency manager points out: "Essentially they're trying to do everything they can to generate turnover and signals in currency land." And bank forecasters have been notoriously wrong. JP Morgan's Hafeez observes that the trend in the G7 currency forecasting error of bank analysts has doubled in the past six years: "Analysts are making a lot more errors in their view."

With the volume and variety of sell-side currency research growing exponentially, Blain at Morgan Stanley suggests that the onus must also be on sales people to know what clients will find most useful. "We hear time and again that market participants are suffering from information overload. The sales person has to act as an editor or a filter." It is revealing that after price and liquidity, investors rank the quality of sales relationships as the most important factor in selecting their FX banks.

From all corners of the industry one hears that the FX market is heading for a period of rapid change and evolution. "FX will not look the same in 18 months time as it does today," promises Standing at JP Morgan. Goldman Sachs' Amrolia agrees. "Somewhere between e-forex, prime brokerage and improvements in operations, in that space is the potential for significant change in the industry."

For many asset managers, the biggest change will be in taking currency seriously for the first time.