Conscious Currency®

A transparent, rules–based currency risk premia strategy

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EXECUTIVE SUMMARY:

In the current environment of low expected returns, investors continue to seek ways to improve their multi–asset portfolios returns through more dynamic allocations, diversity and opportunities to add value in non–traditional areas.

Currency management is an often–overlooked aspect of multi–asset portfolio management. Some investors simply believe that it is a zero–sum game and can be ignored. Others view it as difficult to get a cost–effective strategy that adds value. However, what is most often unappreciated is that currency can present very attractive return characteristics, with little to no correlation to traditional asset classes. Therefore, you can potentially add value by incorporating a return–seeking currency strategy into your portfolio.

There is widespread academic support showing that currency factors can offer valuable, persistent and relatively uncorrelated return sources. As such we believe there is an advantage to investors in accessing a combination of the three currency factors shown to drive currency markets: Carry, Value & Trend. Moreover, a rules–based approach offers a cost–effective way to access these risk premia.

The Russell Conscious Currency® Index (Conscious Currency) has been designed as a robust and transparent rules–based strategy which gives a diversified exposure to Carry, Value and Trend. Over the last 16 years, the strategy has achieved an annualised return of 3.6%, with a return–to–volatility ratio of 0.8. Conscious Currency has a low correlation to traditional assets and thus can enhance multi–asset portfolio returns with modest or no additional risk.

Background

Why is now the right time to consider currency factor investing as a return source?

More than seven years have passed since the depths of the global financial crisis. Despite a relatively lackluster economic recovery, these seven years have been surprisingly kind to multi–asset investors. Bond yields have fallen to unprecedented levels and risky asset prices were boosted by unconventional central bank policies. Between January 2009 and the end of 2015, a 60–40 global equity–bond portfolio achieved a compound return of 8.5% in euro on a fully currency–hedged basis.

We believe it is unlikely for this performance to be repeated in the seven years that lie ahead of us. Alas, there are no signs that the forces that brought us into this low–return environment are fading. Real bond yields are being kept artificially and deliberately low. Global economic growth appears to be on a slow structural decline exerting long–term drag on corporate profits.

With historically low interest rates and expensive equities, there is no clear way to get reasonable returns from traditional investments. Also, the standard practice of diversifying portfolios across asset classes fails when correlation between assets goes up.

Ways to improve your multi-asset portfolios returns include more dynamic allocations, diversity and opportunities to add value in non–traditional areas. Another way is to be more discerning buyers of skill, leading to the increased consideration of transparent, rules–based “smart beta” strategies in areas where you can gain exposures to systematic and replicable factor returns more cost–effectively.

There are multiple avenues to capture factors or risk premia in various asset classes. At Russell Investments, we have established a currency risk premia strategy, Conscious Currency, which aims to capture three of the most important risk premia—Carry, Value and trend—with a systematic, rules-based approach. Not only have these risk premia been shown to be effective components, using currency as the source of such provides significant diversification to traditional and alternative asset classes.

Our internal analysis shows that Carry, Value and Trend explain a substantial part (and as much as half) of successful active currency manager returns over the last decade. We also find that only about 1/6 of active currency managers generate alpha that goes over and above exposure to these three currency factors.

Given that the currency markets are also liquid, with low trading costs, this creates a powerful basis for a transparent rules–based strategy. Such strategies should offer simple, fundamental capture of the currency factors than is not over–engineered (and thus susceptible to hindsight bias). Such a systematic, rules based approach would be amenable to low cost management and thus provides a more efficient capture of these factors than the majority of active managers.

Though there are avenues within equity, bonds and commodities markets for capturing Carry Value and Momentum factors, the currency risk premia strategy has been shown to be very highly effective for capturing these factors.

Russell Investments Conscious Currency

Carry, Value and Trend are three currency strategies that have demonstrated significant positive average returns at moderate volatility over long periods. Whilst each of the currency factors in isolation has experienced periods of significant negative returns, these falls do not often occur at the same time. As such, we believe there is an advantage to investors in accessing a combination of the three currency factors.

Conscious Currency was designed as a robust and transparent rules–based strategy giving efficient exposure to Carry, Value and Trend factors. The strategy is constructed by equally weighting Carry, Value and Trend, using the major developed market currencies.

The rules-based construction methodology we employ for each underlying factor is explained in Exhibit 1 below.

Exhibit 1: FTSE Russell Conscious Currency Index Methodology

	CARRY	VALUE	TREND
Objective	Tendency of higher interest rate currencies to appreciate relative to lower interest rate currencies.	Compare currency to some equilibrium or fair value. Sell if currency is over-valued and buy if undervalued	Buying (selling) currencies which have recently shown positive (negative) performance.
Metric	10-day average of (1-month forward rate / spot rate) based on foreign currency/USD.	(20-day average of spot rate) / PPP based on foreign currency/USD as an expectation of gradual convergence to PPP.	[(50-day average of spot rate) – (200-day average of spot rate)] / (200-day average of spot rate) based on USD/foreign currency. Representing currency trend.
Ranking	The highest carry currency is assigned to the top rank and the lowest carry currency is assigned to the bottom rank.	The most undervalued currency is assigned to the top rank and the most overvalued currency is assigned to the bottom rank.	The currency with the highest trend metric is assigned to the top rank and the currency with the lowest trend metric is assigned to the bottom rank.
Weighting	Allocate 1/3 long position to each of the 3 top-ranked currencies and 1/3 short position to each of the 3 bottom-ranked currencies.	Allocate 1/3 long position to each of the 3 top-ranked currencies and 1/3 short position to each of the 3 bottom-ranked currencies.	Allocate 1/3 long position to each of the 3 top-ranked currencies and 1/3 short position to each of the 3 bottom-ranked currencies.

The strategy consists of 4 basic characteristics

1. Equal weighting of the 3 factors—Carry, Value & Trend
2. Universe of 10 currencies: AUD, CAD, CHF, EUR, GBP, JPY, NOK, NZD, SEK, USD
3. Three long and three short positions within each factor—equally weighted
4. Rebalanced monthly

Conscious Currency return characteristics

The Conscious Currency strategy has earned an average return of 3.6% per annum between December, 1999 and September, 2016. Given annualised volatility of 4.4%, the reward–to–risk ratio is an attractive 0.8.[1]

In Exhibit 2, we demonstrate the stability of the Conscious Currency strategy, relative to the individual components of Carry, Value and Trend. Each of the individual currency factors has experienced significant negative returns, however typically at different times. As a result, Conscious Currency achieves a better balance of return to risk with much shallower falls, with the largest fall being 6.1%.

Exhibit 2: Conscious Currency Performance Characteristics

	CARRY	TREND	VALUE	CONSCIOUS CURRENCY
Annualised Return (%)	4.7%	1.3%	3.9%	**3.6%**
Annualised Std. Deviation (%)	8.6%	8.5%	7.6%	**4.4%**
Cumulative Return (%)	115.8%	24.6%	92.5%	**81.6%**
Worst 12 months	-24.6%	-11.8%	-14.2%	**-3.4%**
Max fall	-29.7%	-17.2%	-17.1%	**-6.1%**

Source: FTSE Russell, Russell Investments. Data between 30/11/1999 and 30/09/2016

Low correlation to traditional asset classes

The benefit of Conscious Currency is not limited to its stand-alone return and risk properties. As supported by academic research[2], Carry, Value and Trend provide economically large and significant diversification benefits within broader multi-asset portfolios.

Our view is that Conscious Currency can play an important role in both multi-asset and single–asset portfolios. For multi-asset investors, a potential diversification benefit derives from currency's low correlations with multi-asset portfolios. For investors in single assets—particularly, fixed income portfolios—currency may serve as both a diversifier and a potential source of returns.

In Exhibit 3, we show the correlations of Conscious Currency with asset classes typically represented in multi–asset portfolios:

Exhibit 3: Correlations between currency factor strategies and standard asset classes

	Concscious Currency®	US Equity	Non US Equities	US Aggregate	Global High Yield	Global Agg ex US	Property	Hedge Funds	Balanced ortfolio*
Conscious Currency®	1.00								
US Equities	0.22	1.00							
Non US Equity	0.19	0.88	1.00						
US Aggregate	-0.10	-0.09	0.02	1.00					
Global High Yield	0.14	0.69	0.75	0.22	1.00				
Global Agg ex US	-0.02	-0.19	-0.13	0.77	0.03	1.00			
Property	0.05	0.65	0.62	0.18	0.63	0.10	1.00		
Hedge Funds	0.15	0.59	0.69	0.11	0.65	-0.13	0.44	1.00	
Balanced portfolio*	0.18	0.93	0.95	0.17	0.81	0.01	0.76	0.69	1.00

Source: FTSE Russell, Russell Investments, Bloomberg and Barclays Capital between Dec 2004 and Dec 2016

Note: For calculation purposes, we assume a global balanced portfolio consisting of: 33% Global Equity, 42% Fixed Income (13% Global Agg, 12% Euro govies,10% Global Credit and 7% High Yield), 17% Hedge Funds, 2% Infrastructure, 2% Commodities and 4% Cash. Equities and Fixed Income hedged, everything else unhedged.

Conscious Currency exhibits low correlations to all these asset classes, ranging from mildly positive correlation with global equities (0.22) and mildly negative correlation with UK Gilts (-0.11). Among the individual factor strategies, Carry has the highest correlation with equities (0.41), Investment Grade Credit (0.40) & high yield (0.54), whereas the Trend and Value have low or even correlations to the other asset classes. The relatively high correlation of Carry to equities and credit emphasises the benefit of combining it with Value and Trend.

[1] We base all calculations of Russell's Conscious Currency strategy using the Russell Conscious Currency Index

[2] Kröncke, Tim-Alexander, Felix Schindler und Andreas Schrimpf (2014), International Diversification Benefits with Foreign Exchange Investment Styles, Review of Finance 18 (5), 1847-1883.

Comparison with other alternative risk premia strategies

While the strategy provides strong return characteristics and diversification with other asset classes, it also compares quite favourably with other alternative risk premia strategies. In the table below, we took a sample of seven alternative risk premia funds and compared the risk and return characteristics. Clearly RCCI compares favourably over equivalent time periods, generating a higher return-to-risk ratio than four out of seven funds and an roughly equal return-to-risk with one of the seven. In the periods considered, RCCI has consistently positive performance.

Exhibit 4: Conscious Currency compared to multi–asset risk premia funds

	Quoniam Global Risk Premia	LO funds—Commodity Risk Premia	GAM Star Diversified Risk Premia	LO Funds—All Roads Multi–Asset	LO Funds—Alternative Risk Premia	ATCM Alternative Risk Premia	AQR Style Premia
Return	3.3%	-11.1%	3.4%	4.5%	2.7%	-2.2%	3.2%
Risk	6.7%	11.9%	3.7%	4.8%	7.3%	2.3%	7.6%
Return/Risk	0.49	-0.93	0.92	0.93	0.37	-0.93	0.42
Inception	Mar–15	Jul–11	Mar–12	Mar–12	Aug–14	May–15	Jan–15
RCCI over equivalent period							
Return	1.8%	1.9%	2.4%	2.0%	2.1%	3.3%	3.2%
Risk	4.0%	3.5%	3.6%	3.6%	4.5%	4.1%	3.9%
Return/Risk	0.46	0.55	0.67	0.67	0.47	0.80	0.81

Source: FTSE Russell, Bloomberg, as of September 2016.

Further we also compared RCCI to equity risk premia funds with similarly favourable results in Exhibit 5. For all equity risk premia funds considered, RCCI achieves higher returns, lower risk as measured by return volatility, and higher return-to-risk ratios.

Exhibit 5: Conscious Currency compared to equity risk premia funds

	Lyxor JPM Europe Low Beta	GS Structured Investment	Lyxor JPM Europe Low Beta	Lyxor KPM Europe Quality	Lyxor JPM Europe Low Size	Lyxor JPM Europe Value
Return	-3.6%	0.3%	-5.6%	-6.4%	-8.2%	
Risk	13.6%	5.9%	13.0%	16.4%	16.4%	
Return/Risk	-0.27	0.04	-0.43	-0.39	-0.39	
Inception	Jul–15	Nov–14	Jul–15	Jul–15	Jul–15	
RCCI over equivalent period						
Return	4.3%	2.1%	4.3%	4.3%	4.3%	4.3%
Risk	3.8%	4.7%	3.8%	3.8%	3.8%	3.8%
Return/Risk	1.11	0.44	1.11	1.11	1.11	1.11

Source: FTSE Russell, Bloomberg, as of September 2016.

Conclusion

Especially when expected returns from traditional asset classes are low, targeting risk premia with low correlation to traditional asset classes can add value to investment portfolios. Using currency as an alternative risk premia strategy can be a valuable and relatively uncorrelated return source.

There is widespread academic support showing that currency factors can offer valuable, persistent and relatively-uncorrelated return sources. In particular, we believe that Carry, Value and Trend are the strategies that are best placed to generate these positive returns at moderate volatility over long periods.

Our internal analysis shows that Carry, Value and Trend explain a substantial part (and as much as half) of successful active currency manager returns over the last decade. We also find that only about 1/6 of active currency managers generate alpha that goes over and above exposure to these three currency factors. For this reason, we believe a systematic, rules based strategy can offer more efficient access to this return opportunity.

We designed Conscious Currency as a robust and transparent rules-based strategy, giving efficient and diversified exposure to Carry, Value and Trend factors. Over the last 16 years, this strategy has achieved strong returns with low correlation to traditional assets.

IMPORTANT INFORMATION

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