

Investing in Currency

By Richard Olsen

Investing in a portfolio of currencies is different from *currency trading*. The success of currency trading comes, obviously, from being on the right side—either long or short—of one transaction. In a certain sense this is like successful stock-picking: you commit to one position; you hope that the equity you choose will, sooner or later, be valued at a higher rate when you decide to sell it; you expect that if you time your sale correctly other investors will be willing to buy the security, even at its appreciated price.

Currency investing is different. Compared to investing in stocks or bonds, its time horizons are greatly compressed (meaning that the effects of trading volume *plus* liquidity *plus* the perceived value of a currency can present greater opportunities for gain and loss *in one day* that you might expect on conventional equity and fixed income markets *in one year*).

The equality of gains and losses: conventional investing is based on the notion of one-sided ownership: you buy (go long)...you hold...you sell. Currency markets, in contrast, place equal value on selling (going short); this is reflected in the very nature of every currency transaction because you must buy and sell *a pair*: you cannot take a one-sided position. As a practical matter, this means that opportunities exist regardless of whether “the market” is rising, falling, or moving sideways.

Liquidity is the key: when you are trading one currency pair you depend on the presence of buyers and sellers to move the price of that one pair; but this is a risky proposition. Despite its massive volume, liquidity in forex waxes and wanes. For a hundred different reasons. A more sensible strategy is to diversify positions for two reasons: 1) so that winning positions outnumber losing ones, but more important: 2) to be in a position to provide the liquidity the market requires.

Unlike conventional markets, pricing momentum in forex derives not from institutional consensus (or manipulation!) but from a much more immediate condition of supply and demand. Therefore, successful currency investing depends on the portfolio manager’s ability not only to anticipate pricing direction but *to effect that direction by anticipating the need for liquidity*.

Don't take liquidity for granted.

In the bid-and-ask world of over-the-counter currency trading, prices routinely jump around “fair value.” Extreme price points (“overshoots”) are the norm; they may be momentary or last for days or months—or even longer. Smart currency managers are flexible enough to time their trades so as to make incremental profits by providing liquidity when and where it’s needed. [See the section below, [*The Importance of Liquidity.*](#)]

Currency *trading* is a zero-sum game: there is a corresponding loser for every winner. Currency *investing* rejects that simple assumption. This market is unique because much of its volume comes from participants who are not out to make a profit but to stabilize value. The experts call this a “structural inefficiency.”

Exploiting this inefficiency is the challenge and the reward of the currency portfolio manager.

**General Characteristics
of
the Investment**

What Makes This A Viable
Investment?

By “viable investment” we mean an asset class that small as well as large investors can understand and why they might consider using it. How does this understanding happen? What are the criteria for at least considering currency as an investment?

- *There must be a public marketplace for trading instruments that invites broad participation.*

Forex is the largest, most active over-the-counter market in the world. Anyone in the world can invest.

- *There must be sufficient liquidity to create and sustain trading momentum. (Don't confuse *liquidity* with *volume*.)*

Forex has the greatest volume of any market in the world (on a daily basis, more than 50 times the trading volume of the New York Stock Exchange), but volume is after-the-fact. Liquidity refers to the presence in the market of traders and investors who are prepared to buy and sell at prices that enable orderly (more or less) trading. A “liquid market” means you can get deals done: buyers find sellers, and vice-

versa; and prices evolve in patterns that—while they may be volatile—reflect ongoing supply and demand. Liquidity is a prerequisite for market stability; without liquidity prices spike and free-fall in patterns that disconnect from value and disenfranchise investors.

In general, forex is a highly liquid market. But forex transactions happen at such a high rate of speed, and are subject to peaks and troughs of trading activity around the world, *there are thin markets*. These may last for a day or so (for example, starting Friday afternoon GMT when Asian, Australian and European markets have closed for the weekend), or only for a matter of seconds.

- *Investors must have confidence in a risk/return relationship.*

Opportunity alone is not enough; the cost of the opportunity—or risk—has to be defined. Speculative currency trading is a high-risk/high-return game. Currency investing diversifies this risk by taking many different positions in many different exchange rates. The risk/return characteristics of currencies are different from other asset classes and among individual exchange rates.

The volatility of major currency pairs, such as EUR/USD, is typically less over the course of a year than the volatility of the S&P 500 Index. The problem is that investors look at short-term volatility and use that as a general measure of risk. That won't work for currencies as an asset class.

If all forex participants were speculative traders, the story would be different. But they're not. The majority of forex trades are made not to bid up prices but to cover outstanding positions and otherwise maintain stability.

Positions are taken based on many different perceptions of the market—using strategies that include technical analysis, economic indicators, interest-rate differentials (the “carry trade”), and derivative plays based on emerging as well as major currencies. This multiplicity of “currency views” enhances the natural diversification effect of currency investing.

In the short term, there may be no easily defined relationship between risk and return in forex. Over longer periods, however, valuation trends are slow to change, and it is possible to take advantage of established flows.

Think of an exchange rate as the market price of a currency.

- *Investors must see a purpose for including currency in their portfolios.*

Currency returns have a low correlation with returns from traditional asset classes. Currency is a good diversifier.

As account-opening minimums for currency investments have fallen, smaller investors have entered the market, demanding a wider array of products and more precise ways to control their investment risk. The reality of control has permanently changed the forex landscape since the days when uncontrolled risk was a fact of life.

Actively managed currency portfolios are a proven source of excess return over time.

Currency portfolios can be finely tuned to offset the exchange-rate risk of existing positions in other asset classes in other parts of an investor's portfolio.

- *There have to be multiple investment providers with different strategies and methodologies; most important: these providers must be willing to explain their "take" on forex and justify their expenses.*

In the old days (a mere five years ago), big currency investors didn't ask too many questions. Their tolerance for loss allowed them to gloss over the fine print.

No longer. Three forces have made forex more transparent, more competitive, and a more realistic investment:

- >> A general decline in return levels from conventional asset classes (a greater demand for alternative sources of investment return);
- >> The increasing retail focus on forex, which drives down costs and leads to the development of more diverse products designed to serve a broader range of needs.
- >> Technological improvements that put the investor closer to his investment and offer greater control over it—in real time...

...and...

(from the provider's side) enable more precise trading and investment strategies with less margin for error

(lower risk) and increase the ability to capture incremental returns.

Qualities/Sources
Of
Return

A survey of Web sites and promotional material from currency-investment providers reveals a strange but telling fact: while many tout their products' potential to generate return, few talk about where that return comes from.

This is because the statistically expected return from currencies is zero.

That doesn't mean you can't make money, but it does caution that profitability is far from certain. (Unlike the popular perception of long-term equity investing: *stocks always go up!*)

Against such a pessimistic backdrop of short-term volatility and erratic, unpredictable pricing patterns, *why should we expect return from currencies, and, where does it come from?*

In the Introduction we noted that forex moves at a much higher rate of speed than conventional markets, and with much greater trading volume. Add to this the never-ending need for cash and the diversity of players in forex, and it should be obvious that the basic *quality* of currency returns is fleeting: now you see it, now you don't. But there's more to it.

The underlying driver of returns from currency is *change*: the discrepancy not only between the quote on a pair now versus a quote on the same pair in 10 seconds, but the discrepancy between a perceived "fair value" for a currency and the market's transient valuation. Speculative currency trading concerns itself primarily with the momentary price points; currency investing involves a much more complex set of factors:

Fundamental Drivers of Value

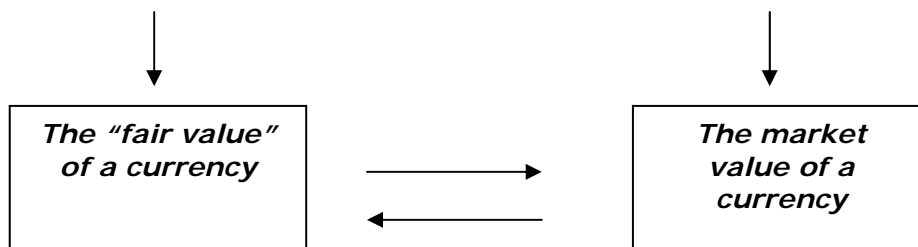
(event-/news-related)

- central banks announce major shifts in monetary policy, changes in interest rates, etc.
- natural or man-made disasters that will impair a national economy's ability to continue to produce or compete
- devaluation of a currency, or re-pegging the value of that currency to an arbitrary benchmark
- economic or political developments that enhance or jeopardize the potential of a national economy to produce, compete, and succeed at international trade
- the effect of inflation on a regional or national economy

Market Drivers of Value*

(systemic/strategic/intrinsic to the market)

- an individual currency's relative interest rate (the "yield" on the currency)
- liquidity or illiquidity to support trading momentum
- the ability to go long or to short a currency at any time
- investors' use (or mis-use) of leverage so that even relatively small trades upset the orderly evolution of pricing and trading strategies
- diverse investment strategies—used singly or in combination:
 - systematic (quantitative) trading that instantly recognizes or anticipates pricing and liquidity discrepancies and executes ahead of other market participants
 - technical trading strategies that correctly identify a trend or micro-trend and its duration
 - "fundamental" strategies (based on macro- and micro-economic analysis) that correctly anticipate a major trend and its duration



(Note that this discrepancy is itself a source of return, as currencies migrate away from and then "correct" to something approximating "fair value.")

(Note also that the drivers of potential return are also sources of risk!)*

Confidence in currency return from any manager should be a function of the manager's skill at including fundamental realities in a methodology that also takes into account trading behaviors that are *irrational*. Because they are not profit-driven, because they are too short-lived to represent a trend, or because they contradict macro- or micro-economic fundamentals.

A tall order. We now have enough data to know that incremental positive returns from currency are possible, but realizing them is an article of faith in the manager's ability to operate at the specific level where he can create value. So far, no one provider has come up with the fail-safe program.

Qualities/Sources Of Risk

The greatest risk of currencies is when investors expect them to behave like other, more familiar asset classes. They don't, because unlike stocks and bonds currency prices are a function of *two sets of variables*: always traded in pairs, there is a "scissor effect" that amplifies the impact of the underlying variables. (Many of these variables are the same ones that drive returns: see the section above "Sources of Return.")

Macro sources of risk:

--high-speed changes in valuation (not necessarily related to the fundamental value of a currency)

--volatility is the norm, but major currency pairs are typically no more volatile (on an annual basis) than the S&P 500 Index. In fact, the volatility of currencies is actually lower than that of other major asset classes.

--extremes of pricing volatility are not reflected in end-of-day or longer-term reporting: the average annual volatility for EUR/USD is about 12.5% (as measured by OANDA for the six-year period ending December 2006), but the total price movement for that pair during an entire year might be 600%.

--any disaster—man-made or natural—that threatens a country's ability to produce or compete will diminish the value of its currency.

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--political or economic developments that jeopardize national production and/or international trade will diminish the value of a currency.

--inflation by definition devalues a currency and reduces its attractiveness in the forex market.

--announcements by central banks or other government agencies to address any of these threats (including major shifts in monetary policy, changes in interest rates, trade-protection or trade-promotion policies) can have an immediate impact on exchange rates.

Micro sources of risk:

--changes in interest rates associated with a currency (skewing buying interest in higher-yielding currencies regardless of other fundamental considerations).

--unexpected changes in spread (the difference between bid and ask prices for a pair of currencies) which may be the result of:

--widening of spreads that reflect market-maker manipulation (i.e., not the normal widening of spreads to be expected when global markets are inactive on weekends).

--sudden liquidity droughts that cause pricing to gap higher or lower.

--leveraged trading that allows relatively small trades to re-price all positions in the marketplace, triggering unforeseen stop-losses and take-profits.

--the risk that your broker or your broker's trading counterparty may default (credit risk).

The Importance of Liquidity

It is hard to imagine a market that trades \$3 trillion every day *not* pricing currencies efficiently and fairly. So how does irrational pricing happen? Because relatively small transactions move prices for everyone in the marketplace: traders get stopped out of their positions, and small pricing trends are amplified; the cascading effect causes even more market participants to close out losing positions.

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Market makers set the price for every currency pair and the spread. Prices and spreads are driven not by general levels of supply and demand, but by market makers who have to manage their own inventories of currencies. Market makers manipulate spreads to control currency flows—irrespective of price; they create uptrends and downtrends that take on a life of their own, disrupting any normal equilibrium between buyers and sellers.

This accounts for pricing anomalies and explains “overshooting”:

A currency pair with an average annual volatility of 20% may have a total, cumulative annual volatility of 600%. The 580% of extraneous movement is the overshoot. It is inefficient, it clouds valuation, and it disrupts trading strategies based on continuity.

Liquidity works to stabilize markets by limiting overshoots and keeping prices real. Investment managers who are willing to take counter-trend positions accept the tradeoff of lower incremental profits for the sake of perpetuating market activity.

Currency
is a good diversifier

Diversifying investments has two objectives:

defensive: to protect your performance from losses that tend to be concentrated in one stock or bond or one asset class

offensive: to compensate for underperformance in one part of your portfolio through better performance in another part

The forces that drive currency returns are different from those affecting stocks and bonds. The proof is in the performance: currency returns have a low correlation with the returns from other asset classes. (Meaning: the return behavior of currency investments is largely independent of what is happening on the stock and bond markets.)

No bear or
bull markets

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While the performance of the stock and bond markets (as well as real estate and commodity markets) is broadly described in the media as rising or falling—bullish or bearish, such broad-brush characterization does not apply to forex. Even though global trading may be concentrated in a few major currency pairs, the forces driving exchange rates are infinitely complex and changeable.

Because of the wide variety of participants in the currency markets and their different objectives and time horizons, currency pricing cannot be explained by one market “sentiment.”

This means that despite short-term trends there are always buying or selling opportunities in the marketplace—*assuming that sufficient liquidity exists to support trading at rational price levels.*

Determination
of
Value

**The Nature of Forex:
Who’s Trading and Why?**

The World’s Largest
Capital Market

With a daily trading volume of approximately \$3 trillion, forex far exceeds the activity of all other exchanges and markets. (\$3 trillion is about 100 times the daily volume of the New York Stock Exchange.)

Forex is an over-the-counter (OTC) market, meaning that there is no fixed, centralized location: transactions take place around

Forex is a largely unregulated marketplace. Some national regulatory bodies police brokers and market makers, and some countries try to control the currency-trading activity of their citizens, but this is by and large a democratic market.

the world among counter-parties who agree to trade over the phone—or, increasingly—over an electronic network.

This is a truly global marketplace, active 24 hours a day, six days a week. Trading begins Monday morning in Sydney (Sunday afternoon in New York) and moves around the globe through various trading centers. The major centers are London (with about 50% of the market), followed by New York, Tokyo, Zurich, Frankfurt, Hong Kong and Singapore, Paris, and Sydney.

Over 85% of all forex transactions involve seven major currencies: the U.S. dollar (USD), the Japanese yen (JPY), the Euro (EUR), the Swiss franc (CHF), the British pound (GBP), the Canadian dollar (CAD), and the Australian dollar (AUD).

More than 50 currency pairs are traded, with most activity concentrated in:

Major pairs

EUR/USD
USD/JPY
GBP/USD
USD/CHF

Minor pairs

AUD/USD
USD/CAD
USD/other

The quotation of currency pairs is not arbitrary. The “base” currency in one pair is quoted first, according to an established hierarchy in forex: the Euro dominates as the base currency, followed by the British pound and the Australian and New Zealand dollars.

Exchange rates are quoted with a bid—ask spread, meaning that the price maker (for example, a bank) will buy the base currency at the bid price and sell the base currency at the ask (or “offered”) price.

Market Participants

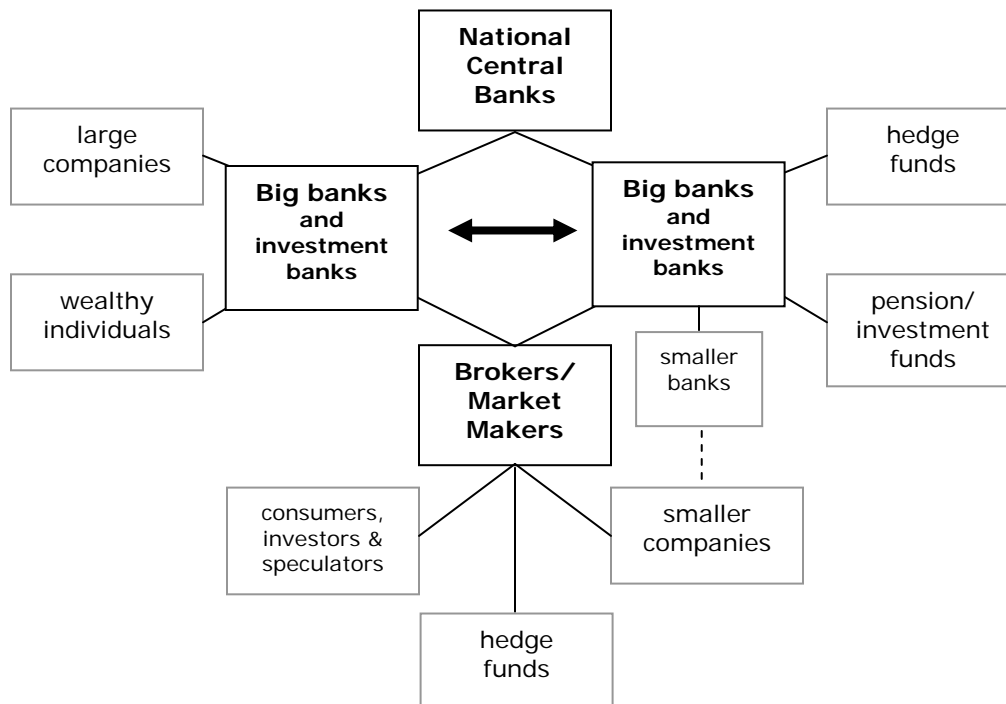
Forex is often described as an “inter-bank” or “inter-dealer” market, because most of its activity is among hundreds of major banks around the world. About one-half of daily trading volume is in the form of *swaps*—big banks exchanging currency positions with other big banks. A much smaller component (about 10%) is in the form of *forwards*—contracts sold by banks that guarantee a fixed exchange rate at some point in the future. One-third of daily volume is “*spot trading*,” where positions are bought and sold for immediate delivery (within two business days of the transaction).

In addition to spot trading, forwards and swaps, currency investors have a growing number of instruments at their disposal—including currency-based options and structured derivatives such as currency baskets.

Spot trading is of greatest interest to individual currency investors because it is accessible to everyone, is usually quite

liquid, and offers transparent spreads. Trading in the spot market is typically commission-free when done over an electronic platform, and the cost of trading (the spread) has fallen dramatically over the last five years as a result of improved technology and increased competition among brokers and market makers.

Who's in this marketplace?



[Note that this diagram includes providers as well as consumers of currency-based investment products. Among *providers*, there is a great divide between the “big banks and investment banks” (which offer premium, comprehensive services to a select clientele at a premium cost) and the “brokers and market makers” who specialize in retail trading. Banks may require a minimum investment of \$1 million or more; retail brokers have a much lower minimum investment, and many offer so-called “managed currency accounts”; but before you commit your funds to one of these lower-end providers, investigate their offer with care: do they really have an investment strategy...or is the managed account just a package for speculative trading?]

The players

Governments and Central Banks: Official monetary and economic policies implemented by these agents play an important role in the forex market. Their primary role, however, is not to trade for profit but to maintain reserves and support the stability of the national currency.

Banks and Investment Banks: These institutions are responsible for much of the trading activity in forex. They may trade billions of dollars each day—either as a service for their commercial customers or for their own accounts.

Hedge Funds: Because of the size and liquidity of the forex market, hedge funds have allocated increasingly large portions of their portfolios in forex speculation. Hedge funds are attracted to forex primarily because they can leverage their investments to a much greater extent than would be possible in the equity markets.

Businesses: International trade is the backbone of forex. When companies export goods and services they are usually paid in a foreign currency that must be converted before it can be booked in their home accounts; similarly, if they import foreign goods they will have to pay for those in the currency of the country of origin, invoking another currency conversion. As a result, international business is a huge participant in forex every year; the timing of when they convert currencies has a critical effect on their profitability.

Consumers: Consumers experience forex first-hand (whether they realize it or not) when they travel or buy products produced outside their home countries. The global marketplace encourages consumers to buy what they want when they want it, often camouflaging the effect of exchange rates on the true cost of their purchases. Credit-card companies exploit this hidden cost of global consumerism by applying exorbitant exchange rates and tacking on service charges.

Investors and Speculators: Investors and speculators trade currencies in order to benefit from movements in forex. Speculators typically focus on very short-term pricing discrepancies—sometimes lasting only a few seconds, while investors tend to be more interested in pricing patterns and flows that yield less spectacular but more dependable incremental returns. Until recently, forex was dominated by two groups at different ends of the market: the in-and-out

speculative players and the very large institutional traders. Over the last five years this scenario has changed.

As the cost of trading has come down, more investors have been attracted by the liquidity and return potential of forex. Large institutions have begun to cultivate this market as a source of return by demanding more understandable strategies with greater control of risk. The spillover effect for retail investors has been lower-cost products that increasingly find a place in average portfolios that can benefit from diversification into currencies.

Why The Diversity of Participants Matters

To understand forex it's important to recognize the diversity of these market participants—their reasons for investing, their time horizons, and their greater or lesser sensitivity to currency pricing.

In the equity markets we are accustomed to simple explanations for the ups and downs of performance: a big mutual fund decides to sell stock A and its price falls; an investment bank brings company B to market and at the IPO the price of the new issue skyrockets; the housing market declines, and construction and supplier stocks fall. Such simple cause-and-effect relationships are rare in forex.

Even very large currency traders and institutions are rarely able to single-handedly drive the direction of prices. The global need for currency is constant; the immense scale of forex diminishes the potential impact of one participant or group of participants; pricing flows reflect a host of strategic expectations and need for capital that operate according to dynamic time frames.

Because these time frames are never synchronized, there is always opportunity in forex. The conventional view is that opportunity comes from the straightforward exploitation of pricing discrepancies; a more sophisticated approach (with more reliable results) is to focus on the market's requirement for liquidity, to predict and recognize even momentary lapses in liquidity, and to take positions that will be rewarded for providing it.

How Forex Works

This brief introduction highlights a few, very important things you should know. The emergence of forex as a global retail marketplace means there is a flood of information about how this marketplace works and what it can do for you. Unfortunately, most of this information is directed at speculative traders, not investors. The following should be considered basic principles of which no investor in currencies should be ignorant.

It's Always A Pair

In every currency transaction, **two currencies are involved**. Whether you are buying or selling *the pair*, you are offering to make an exchange—meaning that you are buying one currency and selling the other.

How Pairs of Currency Are Quoted

USD/CHF
(U.S. dollar/Swiss franc)

The currency on the left is always the **base currency** (here, the U.S. dollar), also referred to as the **bid** or **buy** currency

The currency on the right is the **quote currency**, also referred to as the **ask** or **sell** currency

1.3000/1.3005

The dealer's quote: this is the rate for one unit of the base currency in terms of the quote currency. You can exchange 1 USD for 1.3000 Swiss francs.

Most currencies are quoted to four decimal places. The Japanese yen is quoted to two decimal places.

When you see one exchange rate posted—as at an exchange kiosk in an airport—the one number you see is the **BID**

You will also see this quotation in other forms:

BUY
1.30
00

SELL
1.30
05

This notation emphasizes the smallest increment of the quoted price, known as a "pip": the fourth decimal place (except for Japanese yen)

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USD/CHF 1.3000/1.3005 5

The number **5** in this quote is the difference between the two rates quoted for the base and the quote currency.

This is the **spread**, expressed in pips.

Spread is important, because this is what you pay to make your trade.

For very active currency pairs with narrow spreads, you may also see this notation:

EUR/USD 1.2646⁰/47⁵ 1.5

This is a shorthand way of showing the BASE rate as 1.26460 and the QUOTE rate as 1.26475. Note that one decimal place has been added; this 1/10th of a pip allows for more finite pricing. In the quote above the spread is 1.5 pips.

Placing the order

USD/CHF 1.3000/1.3005 5

Once the trader has examined the quote, she has to declare whether she is *buying* or *selling*:

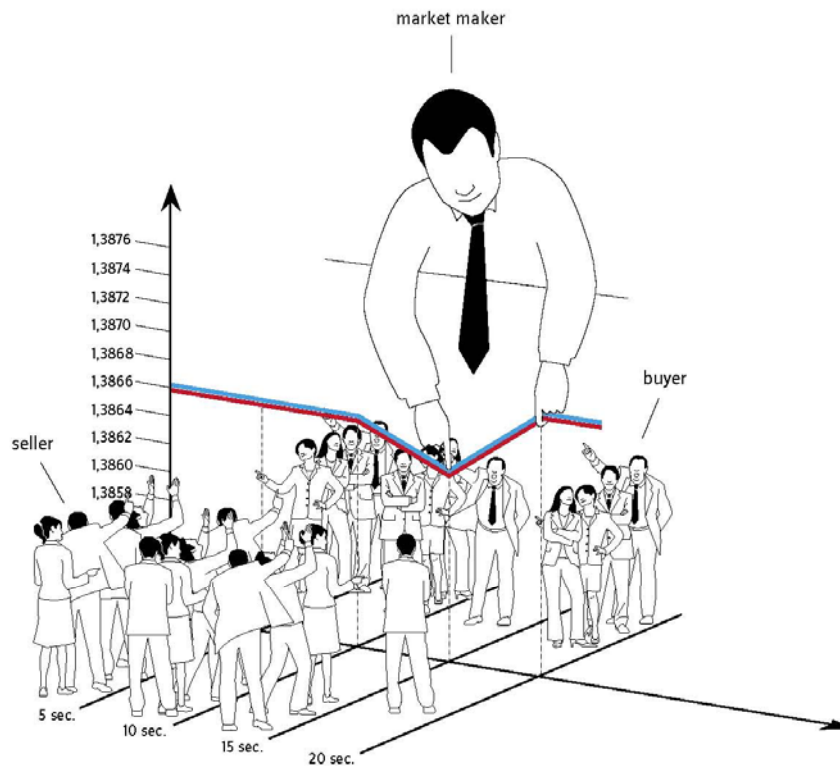
SELL 100 USD/CHF means she is offering to sell 100 U.S. dollars and buy 130 Swiss francs (at the rate of 1.3000).

BUY 100 USD/CHF means she is offering to buy 100 U.S. dollars for 130.05 Swiss francs.

The Market-Maker Effect

Remember that forex is the largest and fastest-moving financial market. This fact has led many people to assume that forex is an “efficient” market. Meaning, since so many people are buying and selling, that competition must drive down or contain the cost of trading, that the quote you see is the price you’ll get, that prices will be fair, and that you can make a trade more or less whenever you like.

providing liquidity that can restore prices to more reasonable levels.



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The cost of trading—the spread you pay, plus any commission—depends on who you are, what sort of dealer you're using, the size of your trade, and the market maker's inventory at that particular moment.

When prices go up and down, it may be because of a news announcement (*the government of Brazil declares a cut in interest rates*), or it may be because of a momentary break in supply and demand for a given currency in the open market. More insidiously, sudden changes may be because one market maker has artificially skewed prices to move his inventory.

Forex market makers don't care about *the absolute value* of any currency or pair of currencies. Their primary concern is *the relative value* that will result in a trade.

Such an arbitrary approach to pricing means that liquidity and volatility are impossible to predict, quotes quickly become meaningless, and prices move suddenly to higher or lower levels with no trading points in between.

- Competition among trading platforms *has* reduced the cost of online forex trading by 500% over the last few years, but artificial manipulation of supply and demand frequently counteracts this benefit. (See the display above.)
- Transaction prices can “slip” away from quoted exchange rates for legitimate reasons, but usually not by much. Because market participants have different objectives (not all are day-trading speculators), this has become an accepted reality of forex: longer-term traders are willing to accept the slight difference.
- Prices are not “fair”; they are a function of supply and demand—however that may be determined.
- Online platforms (not banks and brokers) offer “24/7” trading, but global market volume drops sharply between Friday afternoon and Sunday night (U.S.), and on national holidays around the world. During these periods liquidity diminishes, spreads widen, and volatility usually goes up.

For an unregulated global market, forex *is* surprisingly efficient. But gauge your expectations on what you can control and your tolerance for risk. Follow these basics instead of relying on

Slippage is the unexpected discrepancy between a quoted rate and the execution price for a trade.

Gapping is a break in orderly price movement that prevents orders from being filled or triggers execution of limit orders without the opportunity to place a counter-trade.

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promises that will be made or assumptions about forex you may bring from markets that trade much more slowly and have more established long-term patterns.

The Quoted Rate
vs.
The Executed Rate

Quoted exchange rates are not necessarily the same as *executed* rates. This is not just the largest market in the world, it's also the fastest. By the time you see a quote, the price has more than likely already changed. Even if you're working directly with a trader at a bank, there's no guarantee you'll get *precisely* the price you expect. (Note that some dealers and brokers will promise a "guaranteed" rate, but to protect themselves they will offer that rate at an inflated spread.)

The Spot Market
vs.
The Futures Market

In forex there is a so-called *spot market* (trades settle in two business days or less) and there is a *futures market*. Forwards, futures and options settle in longer than two

business days, but all these transactions are based on the spot market rate—the exchange rate in effect right now.

Interest Rates
Associated With
Currencies

When you open a position *and hold it for longer than one business day*, you pay interest on the currency you sell and you receive interest on the currency you buy. Because currency investors tend to hold their positions for longer than

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one business day, interest rates and the difference in interest rates (*interest-rate differential*) between the two currencies in a traded pair are important.

85% of forex volume is intra-day: most market makers pay no interest on these short-term positions and no interest is owed. By removing interest from the buying and selling equation, the market creates an artificial bias toward shorting currencies with higher rates of interest and rewarding buyers of stronger currencies. The result? Distorted pricing flows that upset trends, create valuation havoc, and give rise to bubbles.

If you pretend that currencies as diverse as the Euro, the U.S. dollar, the Argentine peso and the Polish zloty are all the same, you're ignoring a basic risk that distorts relative value. The payment of continuous interest, second-by-second, recognizes that currencies are different. That assigning appropriate risk is a rational part of forex trading.

Margin
(The Risk of Excessive
Leverage)

Margin is the cash you're required to put down as collateral before you take a trading position or open a contract for a transaction in the future. *Most transactions require margin.*

Leveraging your margin capital looks great at first because it allows you to take positions with a face value much larger than what you put down. *Beware this apparent advantage.*

Leverage can increase your profits if you're on the right side of a trade, but it also magnifies your losses if you're not. Your forex provider will offer a margin ratio as part of opening the transaction. Do the math. If they offer a margin ratio of 100:1, you can trade 100,000 units of a currency for deposit of a mere 1,000 units. But if the value of your position drops below the minimum margin requirement, in most cases your position will be closed, locking in your loss. No margin call, no wait-a-minute: you lose your collateral.

Instead of accepting the first margin ratio that's offered, know what you can afford and how this use of capital will affect your overall funding needs...and for how long.

Managing Your Exposure (Controlling Risk)

The business of *taking a position* (which may remain open for an indefinite period of time) is different from *placing an order*.

In the traditional forex trading environment you call your bank or broker and request a bid/ask quote or “rate” for a certain currency pair, specifying the amount you would like to trade. You receive this quote, consider it, and decide to place your order—*or not*, depending on how the market has moved since you got the quote.

This is a **market order**, meaning that your order is executed immediately.

With online, electronic trading the process is somewhat different. You may place a market order, but you may decide instead to qualify the conditions (price levels) under which the trade will actually be made. You take a position, and that position remains open until your conditions are met.

You stipulate these conditions through **limit orders**. A limit order specifies that your trade should be executed *only* if the exchange rate of your currency pair crosses a threshold you have set.

The most common types of limit orders are **stop-loss** and **take-profit** orders.

Stop-losses limit downside risk: the market moves against your position, the exchange rate for your pair hits your stop-loss threshold, your position is automatically closed.

Take-profit orders work the opposite way: they lock in profits when the exchange rate for your pair has moved in your favor and hits the upside level you set.

A **limit order** triggers a trade when the price hits a level that is “better” than where you entered the position.

If your trade is a BUY, your limit order must be *lower* than the current market price; if your trade is a SELL, you have to set your limit order *higher* than the current market price.

Stop-loss and **take-profit** orders are important because they allow you to control your exposure.

Note that unlike generic limit orders, stop-losses and take-profits close out your position once they are executed. And they are based on specific price points—not trading ranges or bounds.

Irrational Pricing of Currencies

Currency investors range in a steep hierarchy from central bankers and large institutional traders to professional traders and CFOs managing cross-border capital exposures, to importers and exporters, to intra-day speculators. Among these diverse agents only a few things are certain: they will take positions of dramatically different sizes, for periods ranging from less than a minute to two years, with totally different perceptions of risk and reward.

Let's say that in one year the price of USD goes up or down by 15%; this gives us a framework to speak of its "value." But the more closely you analyze price changes, the greater volatility you find. If USD goes up or down by 0.1% in six seconds—which can happen several times every week—the annualized price change is 360,000%. Where, then, is the equilibrium value of the dollar?

In forex there is no fixed frame of reference, and so traders get by with bidding and asking more than a rational assessment of value would dictate. They overshoot.

Different participants in the market are subject to different imperatives: some are voluntary...one trader can wait for an acceptable price; some are opportunistic...another trader is in a big hurry to profit from a micro-move. But the most damaging imperatives are involuntary: traders get a margin call or hit predefined limits, or market makers hit hard limits and have to move prices in order to comply with their exposure controls.

All of these scenarios are quite real, and each contributes to pricing uncertainty. In the most dramatic cases this uncertainty can tip the scales and move pricing action into a new orbit, creating a completely different price history.

In forex uncertainty comes about because the underlying "property" or "good" that is the basis of the transaction is two currencies. The infrequent trader who is in the market to hedge the value of assets in a foreign currency may be more accepting of price and more willing to wait; the speculative trader looking to take advantage of a 0.2% price change has to act now.

So, do price changes reflect new perceptions of intrinsic value...or a more personal necessity?

At any moment, a change in market price—no matter how slight the volume—triggers the re-pricing of all open positions in the underlying instrument. And this short-term disruption further triggers a recalculation of exposure: *are margin requirements still being met?*

As all positions are re-priced, margin calls close out positions; involuntary sales add momentum and scope to the unexpected change; market imbalance accelerates—an anecdotal *effect* has become a fundamental *cause*.

The information is in the price, but what is it telling us? Any up-tick or down-tick is a signal, but an ambiguous one. Is this just a break in supply and demand, or does it signal a fundamental redefinition of value? No one will know whether this is a refreshing breeze or the beginning of a hurricane. But every change in price redefines the playing field for everyone, undermining tacit assumptions about value.

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Olsen Ltd is a research and development company and investment manager based in Zurich, Switzerland. Olsen has yielded practical applications and managed accounts and third-party products, investing in currencies as a separate asset class or as an overlay to an existing currency exposure.

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