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NEWS

**Silicon Valley Index Claims Better Returns**

SUNNYVALE, CA--Successful currency fund management needs performance benchmarks that combine two contrasting investment styles found in all financial markets, says Marc Levitt, head of Silicon Valley Quantitative Advisors.

Improved risk-adjusted returns on currency trading are gained by uniting trend-following approaches, which try to identify and latch onto future price trends, with value-seeking methods that rely more on profiting from spreads between prices, he says.

With currencies, says Levitt, value-seeking means exploiting the so-called forward-rate bias anomaly--an academic way of saying that routinely buying high-yielding currencies and selling low-yielding ones produces better returns than trying to spot and follow price trends.

Levitt, whose firm is a proprietary financial market trading business catering mainly for institutional clients, was commenting in *FX Week* on his idea for a foreign exchange yield-investing index--FXYI2.

He put the case for FXYI2, which utilises the forward-rate bias anomaly, in a paper to a financial market conference in London this summer.

Levitt aims to create a transparent and easily replicated non trend-following benchmark for currency managers.

FXYI2 is intended to augment the trend-following active foreign exchange index (AFX)--formerly the FXDX index--devised by Pierre Lequeux, senior quantitative currency manager at ABN Amro bank in London.

FXYI2 uses moving averages of past interest-rate differentials between two currencies. A positive interest-rate differential is a signal to buy and hold a currency until the differential drops below the moving average. When that happens, it’s a signal to sell the currency in anticipation of buying it back later at a cheaper price, says Levitt.

He says FXYI2 shows little or no correlation with trend-following currency investment strategies. This means it provides a good hedge against a trend-following strategy that goes wrong--there is a low probability that a forward-rate bias strategy would show a loss at the same time.

Levitt maintains that an active currency manager using a simple investment strategy based on a 50/50 allocation between AFX and FXYI2 is likely to achieve very good results compared with individual indexes and with most currency managers.

A test based on prices and spreads between May 1992 and December 1999 showed a return of 3.96 per cent, after rebalancing monthly, compared with 3.55 per cent for a strategy based on AFX alone and 4.37 per cent for one based on FXYI2 alone. A dynamic currency allocation (DCA) rule using the return differential between FXYI2 and AFX produced a return of 6.48 per cent.

Perhaps even more significantly, says Levitt, the 50/50 allocation strategy did even better in terms of Sharpe ratios. These measure the relationship between risk and reward in an investment, and the higher the Sharpe ratio, the better the performance.

The Sharpe ratio for the 50/50 allocation was 0.83, compared with 0.57 for AFX alone and 0.69 for FXYI2 alone. The Sharpe ratio for the DCA strategy was even higher at 1.14.

ABN Amro's Lequeux, who is not associated with Levitt's endeavour, although the two are in contact, says the results are interesting and the issues raised should be followed through.

Levitt says his firm, which aims generally to produce superior risk-adjusted returns that are not correlated with widely used benchmarks, is using FXYI2 internally to benchmark the performance of its own currency management. The aim is to outperform the index.

Levitt says since giving the paper he's had several enquiries from hedge funds seeking to diversify their currency investments. One hedge fund with close to $1 billion under management has confirmed FXYI2 looks to be a good way to diversify from trend-based strategies, Levitt says.

*"FXYI2--A Foreign Exchange Yield Investing Index", by Marc Levitt, Silicon Valley Quantitative Advisors, San Jose, CA. Telephone: (408) ~~973 1587.~~* marcl@svquant.com; http://www.svquant.com 623-6388

Comparison between raw components and two derived portfolios based on simple construction rules, May 1992-December 1999. 50/50 is an equal allocation between AFX and FXYI2 rebalanced monthly. DCA is a dynamic rule-based allocation using the return differential between FXYI2 and AFX. All results do not employ leverage.

| | **FXYI2** | **AFX** | **50/50** | **DCA** |
|---|---|---|---|---|
| Return % | 4.37 | 3.55 | 3.96 | 6.48 |
| Volatility % | 6.34 | 6.25 | 4.74 | 5.67 |
| Sharpe ratio | 0.69 | 0.57 | 0.83 | 1.14 |
| Max drawdown | 15.3 | 8.00 | 8.83 | 6.32 |
| Positive months | 58% | 51% | 62% | 54% |
| Return/max DD | 0.28 | 0.44 | 0.45 | 1.02 |

*Source: Silicon Valley Quantitative Advisors*