Diversifying Investment Portfolios: the case for FX Managed Accounts

The FX market is attractive to investors because it is uncorrelated with equity markets. A managed account provides an investor with the opportunity to participate in the FX market and benefit from its high profit potential without having to trade for themselves. Accounts are also actively managed, so the investor is not invested in the market all the time. Heather McLean looks at what's involved and the key importance of trading technology in FX Managed Accounts.

Profitable FX trading involves gaining experience and developing criteria to trade against; using a managed account ensures that all beginner mistakes and emotions are taken out of the trading equation as trades are only made based on strict criteria, and are executed by experts. That is the theory, anyway.

The four benefits of a managed account are, for Joe Conlan, global head of FX sales at FC Stone, safety of the money invested, the option for notional funding, account transparency and control over funds.

Alain Broyon, CEO at Dukascopy (SWFX Swiss FX Marketplace) in Switzerland, states that managed accounts allow less experienced or time-lacking investors to benefit from a market that can boast being the biggest market in the world with 24/6 market open hours. "Investors in managed FX accounts are able to diversify their portfolios by choosing different types of trading strategies and risk ratios, according to their invest profiles," he says.

Short life span

The big problem for people trading independently, rather than using a money manager, is they tend to burn out and go bust long before they hit their big break. Hope, fear and greed are mixed with a dash of ego to create a money burning, sans-risk controlled disaster that results in a three to six month life-span for the average retail trader.

Christopher Cruden, CEO at Insch Capital, comments: "People become dangerous to themselves and their wealth. People think it's Johnny Big Bollocks standing at the desk with three phones to their ears, yelling and screaming, buying and selling, who is the model for how they should handle their own money in FX. But those are order clerks, not managers.

They aren't trading in the same way that professional money managers do. Many investors are in the market for the same reasons they go to Epsom; they like the thrill and the rush, the excitement. Take out the emotion and ego and you've got an edge."

Joe Conlan
"safety of money invested, option for notional funding, account transpar ency and control over funds"

Choice of manager

The alternative is managed accounts. However, the client must do their own research into the managers that will be doing the deals, as ultimately the investor will take the brunt of any losses. “Managed accounts in currency are surely a good idea for anybody, as long as the client knows what they are doing,” Cruden states. “The problem is, some of the online brokers want commissions and turnover, and aren’t concerned with making money for the client. These type of brokers suggest money managers that have a high volume of turnover as it’s better for them.”

Additionally, if a retail client has entered the market for the thrill of having a gamble, when they have finally been burned enough to consider letting someone with more experience control their money they are not necessarily going to be able to pick the best manager. These people will be drawn to a currency manager who will do what they have failed to do; gamble. They will use the flawed criteria they used in their own trading to select a money manager, and they will continue to loose money because of that flawed criteria, states Cruden.

Alain Broyon
“Investors in managed FX accounts are able to diversify their portfolios by choosing different types of trading strategies and risk ratios, according to their invest profiles,”

Managed accounts are a market for investors with experience. Cruden explains: “Trading FX really should be delegated to professionals. On the other hand, if you’re into self-harm, trading your own FX account may be the ideal market for you. If you just ‘know’ as a fact that you’re going to make that big winning trade and get ten times your money back – and you will, if you don’t go broke first – then FX is your for you. Unfortunately the probability is that you will go broke first.”

Diversification

In most trader’s opinions, managed accounts are for people looking for diversification away from the stock and bond market, which at this time of global financial turbulence seem very weak. “If you’re afraid of the bond market, and have huge profits in commodities, you should consider managed FX accounts,” says Conlan. “This isn’t an area for people with no knowledge of trading; it’s for someone looking to create a portfolio that’s efficient.”

Anastasios Katsoulakos, CEO at AKFOREX, states that anyone can invest in FX managed accounts as long as they have analysed their financial position and use risk capital, that if lost will not affect their lifestyle. “Forex offers high

Chris Cruden
“Take out the emotion and ego and you’ve got an edge”

returns due to the leverage factor, so the higher the risk, the higher the return,” he comments.

“We have all different levels of traders as clients in our managed accounts, from people who don’t care to know how to trade and simply like the idea of having their money working for them, to experienced traders, some of whom can learn from watching their accounts being traded,” he continues.

Type of account

Choosing a managed account is tricky. Ultimately, it comes down to what an individual trader can do with your cash. The investor needs to match their return goals and strategy to a manager. If the investor is able to find a manager that can create a decent return, they will be able to leverage up their portfolio, or the part of it they wish to diversify, Per-Erik Karlsson, co-CEO and head of trading operations at Avantage Financial, claims.

Karlsson states he sees managers becoming more flexible on

Anastasios Katsoulakos
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leverage and structure of managed accounts. They are allowing investors to use high margin FX on a high leverage account, while keeping most of the investor's cash in other asset classes. This gives the investor the opportunity to get FX exposure without altering their original portfolio too much.

Another approach the investor can use is to just notionally fund the managed account and use the deposit as a kind of ‘stop out’. Karlsson says this approach can work very well, particularly if the

Per-Erik Karlsson
“Sees managers becoming mor e flexible on leverage and structure of managed accounts”

investor has several fund managers at his disposal, thereby creating a multi manager, multi program approach to increase diversification. This is furthered by allocating just a notional amount to each manager or program.

FC Stone has fund managers with different trading strategies available, so that investors have diversification with their FX investment. The stable of managers at FC Stone trade a range of high frequency strategies, systematic strategies, prop trading, trend following and mean reversion. Conlan comments: “We’re trying to create a portfolio of guys that enable the investor to diversify. Diversifying strategies is good, so you want to look for a company with lots of different opinionated traders. Testing out the manager is something we very much encourage.”

But which money manager to choose? There are a lot of sham companies out there with extensive means of scamming people out of their money, states Katsoulakos. He says a good money manager should be able to show live accounts. It also makes sense for customers not to fund their accounts too heavily until they are comfortable with the results and transactions being made, he adds.

“Our managed funds do not require clients to hand over their money, but rather, to open their own account with Ikon Royal, a leading NFA registered broker; this account is then traded by our money managers who have no access to it, except to trade it

Joe Conlan
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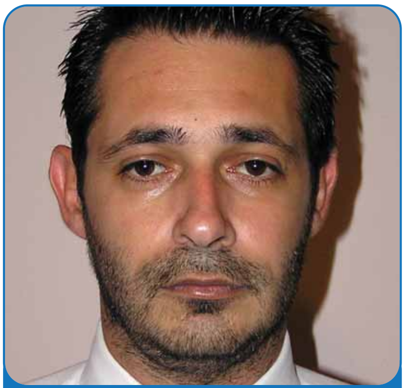
collectively with other accounts,” Katsoulakos explains.

Conlan agrees: “When I’m talking to investors on managed funds, I like to talk about safety of funds. There is always this concern about parting with cash, giving it to someone who may depart for a desert island. But power of attorney is given to the fund manager, not the cash, which is held at FC Stone.”

It is also important to be aware of a money manager’s strategies, mainly risk strategies, which protect client accounts against draw downs and losses. A smaller number of trades every month should be preferred to many, because it indicates that the trader has strict criteria and does not enter the market unless conditions are perfect, Katsoulakos comments.

Monitoring and due diligence

One way of verifying a managed account and fund manager is by talking to the individual fund manager, finding out what their



Anastasios Katsoulakos
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investment goals are, and then cross referencing that with live trading statements provided by the fund manager to see if his ideas and the actual figures match up.

Clients should find out if they will be able, as clients of a particular fund manager, to monitor trading reports at any time with up to date information. At the same time, transparency of the trading reports is essential; investors need to be able to clearly see every trade. Having an easy and rapid way of contacting the investors' account managers is also crucial, making therefore customer service another important consideration.

Yet due diligence is the area that trips up less experienced investors. Broyon comments: "Trading strategies need to be carefully selected according to the amount of risks that investors are willing to take, due diligence is the critical point."

There are many factors and points to consider when searching for that exclusive money manager that will make the client rich. Dukascopy suggests the following: Monitoring aspect - possibility for clients to monitor managers' real time performance; proof of performance; team experience of the managed account; asset under management - it is always a good sign if there is already a reasonable amount of funds under managed account; some static ratio - sharpe ratio, risk ratio, volatility ratio; recommendation of existing clients; where the funds are placed; if the funds are frozen; the platform that managers choose to trade with; and liquidity that the providers are able to give.

Alain Broyon s
"due diligence is the critical point"

To select the right money manager, investors need to look at, in this order of importance, pedigree, philosophy and performance, according to Insch Capital. If someone says they are an ex employee of various big companies, the investor has to ask themselves why is this manager now working at Po-Dunk Online Bucket Co? Philosophy is also crucial, yet the third rating, performance, is the one that many people often mistake for the most important. Performance is history. It is not the future.

Technology and trading strategies

To perform well, trade managers need to be allowed to trade in the way they feel most comfortable, so each good fund manager will take a great deal of care in the technology and partners they choose. Quality of execution should not be a concern for investors, states Conlan. What they should be looking for is finding the right fund manager; the fund manager will look after the technological side.

Technology is crucial for many fund managers to attain optimum trading standards. From the managers' side, best execution price and ample liquidity are important trading conditions. In more detail, online order systems (SL, TSL, TF, OCO) and back testing solutions help traders apply their trading methodologies and risk controls better; by trading with automated solutions (Fix API, JforexAPI), managers are able to catch all possible market opportunities.

However, the two different methodologies of automated and manual trading have their own advantages. The number of currency pairs that managers choose to trade with, and whether they trade with technical or fundamental information, differentiate one managed account from another. In order to match investors' needs, it is also important to have different types of strategies (conservative and aggressive leverage and return).

Insch is a technical and systematic trader on managed accounts. Cruden comments: "Trend followers need cast iron balls, not crystal balls! We're not predictive in any sense; I can tell you lots of things, but I can't tell you what tomorrow's prices will be." Avantage Financial is 100% technical also. Karlsson says he uses some data input, but that he is strictly technical when it comes to trading. This is down to the short to medium term time span that he trades within, where technical works best, in his opinion.

Chris Cruden
"Trend followers need cast iron balls, not crystal balls!"

"Most guys I see trade on fundamental on the shorter time frame also use technical to pin point their entries," he adds. "On the short term, you use technicals so you can enter the market right. I don't see many guys trading short term on fundamentals as you need to look at the charts to get your entry points. Technicals work on any time frame, but I myself feel that you get shorter signals and it works better on a shorter time frame. The signals aren't strong enough to take the market out to 12 months."

Trading technically, Karlsson uses a number of programmes to tell him what is happening in the market. He uses automated risk control measures with stops, that enable him to keep risk control up to the second, per tick. He is not interested in black box trading, although he recognises that interest in automaton is increasing throughout the managed FX account market as a whole.

Karlsson points out that the way an individual trader trades is as individual as his or her personality. "It's down to matching your trading strategy to your personality. If you're patient, then go for the long term approach. If you're not patient, go for short term. There are many ways to make money in managed FX trading; it's just important to match the strategy to the personality of the person that is trading."

Money for management

The size of managed accounts can start from as low as $10,000, and go right to the top. Small fund managers will take any amount of money, for any amount of time. Larger, more credible fund managers are likely to have higher minimum requirements and will normally expect a longer term commitment in terms of time from the investor. This means that as an investor, the more money you have, the higher your prospect of finding a fund manager with good prospects, a solid track record, who has been in the business for a while.

Investors can also proceed by using partial funding in some

Per-Erik Karlsson
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brokers, that means the money manager will use more leverage – which brings with it bigger volatility - on the account.

The minimum investment for a managed accounts program at AKFOREX is $10,000. Katsoulakos comments: "Our managed accounts provide full and flexible reporting techniques which can be utilised by individual clients for accounting and tax purposes. Reports specify all fees and commissions, which can be claimed as tax deductions, as well as every trade made on the account, lot sizes dates and figures in real time."

Fees

Fees on managed accounts can sometimes be negotiated directly with the fund manager. Otherwise, there is often a choice of fees available. At Insch Capital, investors are offered either a 2% management fee charge paid quarterly in arrears plus 20% of net new profit, or instead, 0% management fee and 25% of net new profits paid monthly.

"Other risks of diversifying investments"

FC Stone's managers typically charge a 2% management fee and 20% to 30% as an incentive fee on money made is typical of the market. Some managers demand higher incentive fees, but if they are getting the returns, the client is probably going to want to pay them.

Cruden warns that no matter how good the deal sounds, the investor will always pay: "When a manager says there is a 0% fee, you might want to put your hand on your wallet and walk slowly to the door, backwards, as it's likely that manager will end up making more money than he would by charging a management fee. From high volume trading and commission rebates, for example."

Yet Cruden adds: "The great beauty of managed accounts is people can negotiate their own fees, decide their own gearing and nominate who they to execute trades through. There's a great degree of flexibility in managed accounts that is simply unavailable in other structures."

Turbulent times

Managed account trading is a safer option in today's volatile market than self-directed trading. With people trying to work this rapidly changing market and come out on top using their own ideas and their own risk strategies, it is easy to loose a lot, fast. Managed accounts provide the experience and controls that a lot of investors need, however. Thanks to the transparency and control that investors can have over a managed account, they can literally sit and watch as experienced traders deal their cash. They can move money from one trader to a preferred one as money is made and lost, making them a trader of traders.

Market turmoil is good for the managed FX account business, comments Karlsson. He explains: "It's down to the managers. If a manager has a good track record and hasn't been affected by the volatility and the turmoil in the market, the investor, through diversification, can limit the draw down and volatility across all his assets.

"This does depend of course on how much the investor puts into FX; 1% overall won't do much," Karlsson continues. "The investor needs to have a sizeable allocation in a managed FX account, of 20% or more of their total investments. This will affect the bottom line and have a positive effect on the portfolio."

Yet Katsoulakos sums up: "Money managers do not have to be investing at all times and with current volatility it is difficult to find money managers who are able to avoid the negative impact of a turbulent market. Managed accounts in FX trade both ways and can profit on both the upside and the downside by holding short and long positions in line with a profitable criteria system. We analyse the market searching for low risk opportunities that offer a high probability of profit and we are careful to protect ourselves and our clients from unexpected market fluctuations and potential losses and draw downs."