Carry Trades and the Performance of Currency Hedge Funds

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January 2013

Summary

In recent years the carry trade investment strategy has been under the scrutiny of the empirical research. In fact, this popular foreign exchange trading strategy, which involves borrowing in currencies with low interest rates and investing in currencies with high interest rates, has proved profitable over the past decades. However, its positive record violates the dictates of uncovered interest parity (UIP), which states that if investors are risk neutral and form their expectations rationally, the interest rate differential across countries should be fully offset by exchange rate returns.

The academic literature has proposed various explanations for the existence of UIP violations and the profitability of carry trade strategies, including time-varying risk premia, but the growing popularity of the carry trade strategy and its well-known profitability have led to substantial growth of currency products designed to generate additional returns, or alphas, to investors. Among those investment vehicles, currency hedge funds (i.e., the ones whose main investment strategies involve exclusively directional trading on the price of currencies) experienced a rapid growth. Nevertheless, the profitability of currency hedge funds has been recently questioned. Some recent studies documented that professional currency managers generate returns that are mostly, if not exclusively, associated with passive currency-trading strategies, and the performance of currency hedge funds deteriorated during the past decade.

In this paper we combine these two somewhat separate strands of the literature and investigate whether the returns generated by currency hedge funds are simply due to foreign exchange risk premia obtained through carry trades or include a compensation for genuine active management skills. Specifically, we use a mean-variance analysis and consider the returns that an investor could generate by constructing a portfolio of international bonds dynamically rebalanced assuming that the agent adopts RW expectations (the RW strategy), therefore by neglecting potential exchange rate movements. First, we ask whether the performance of the RW strategy is better than the one exhibited by a sample of hedge funds using a large and unique consolidated currency hedge funds database. Second, when the previous exercise suggests evidence of incremental performance beyond the RW strategy over the full sample period, we investigate the performance persistence of currency hedge funds over time. We then provide a decomposition of hedge fund performance continuation in terms of exposures to currency risk-related factors and active management skills.

Our results suggest that the RW strategy is able to deliver positive net-of-all-fees returns which are similar in size to the net returns of the average currency hedge fund. However, some, but not all currency hedge funds perform better than the RW strategy. The performance of the best funds against the RW strategy tends to persist over time. In fact, the funds that perform better than the RW strategy during any past year also outperform the RW strategy during the subsequent year. These extra returns generated by currency hedge funds co-move with a set of currency risk-related factors and for all funds there is no evidence of remuneration for active management skills. Finally, the outperformance with respect to the RW strategy is slightly larger for small funds but there is no clear support for the argument that small funds better manage the trade-off between size and management costs.