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Trade Currencies Like a Hedge Fund

A new ETF allows you to profit from the disparities between national interest rates. **BY LEWIS BRAHAM**

SEEING THE WORDS "currency" and "hedge fund" together might cause investors who remember the financial crises of the late 1990s to raise their eyebrows. The collapse of the Thai baht in 1997 and the Russian ruble in 1998 triggered massive hedge fund losses that cost investors billions.

Now, through adroit financial engineering, Deutsche Bank and PowerShares Capital Management have come up with an exchange-traded fund that replicates a hedge fund strategy known as the "carry trade" used in currency markets. Since its September launch, PowerShares DB G10 Currency Harvest Fund has grown to $180 million in assets and 130,000 shares in daily volume.

Here's how it works: An investor buys the currencies of countries with high interest rates while selling short those with low rates. The return comes from both interest income and the expected strengthening of the high-rate currencies and the weakening of the low-rate ones.

INTERNATIONAL SPREADS

Current holdings of PowerShares DB G10 Currency Harvest Fund

LONG POSITIONS	INTEREST RATE*
Australian dollar	6.31%
New Zealand dollar	7.59
U.S. dollar	5.36
SHORT POSITIONS	
Japanese yen	0.54%
Swedish krona	3.39
Swiss franc	2.16

*Jan. 24 **Data:** DeutscheBank

The ETF's benchmark is the Deutsche Bank G10 Currency Future Harvest Index. Although the carry trade is an old strategy, the index was created for the ETF and is only five months old. But a Deutsche Bank back-test of the index generated noteworthy returns: an 11.4% annualized average over 10 years (through Jan. 24), compared with 8.2% for the Standard & Poor's 500-stock index. The returns, which are just hypothetical, also showed that the index had less than half the volatility of the S&P 500. What's more, the carry trade's returns had almost no correlation with stocks, meaning the ETF should be an excellent portfolio diversifier.

SHORTING THE YEN

STILL WARY? Unlike Long-Term Capital Management, the once-stellar hedge fund that invested in currencies and collapsed in 1998, this ETF invests only in the currencies of developed nations with high credit ratings. There's no leverage, either—a big factor in LTCM's implosion.

One reason for the carry trade's success is that Japanese interest rates have hovered near zero for years because of a weak economy. That has enabled hedge funds to short the yen and go long on currencies from countries with healthier economies and higher interest rates. In the ETF, the yen accounts for one-third of the short position, as does the Swiss franc and the Swedish krona (table). The New Zealand, Australian, and U.S. dollars are on the long side. With interest rates in Japan at just 0.5% and those in New Zealand at 7.6%, the spread between the highest and lowest rate countries is still wide. Of course, a much stronger yen or a weaker greenback could spoil the play.

Another wrinkle is the ETF's tax treatment. The fund uses futures contracts as proxies for currencies. With futures, 60% of any capital gains are taxed under long-term capital-gains rates and 40% under short-term rates, no matter how long the holding period.

More problematic is that the currencies' securities interest is not paid out but instead is part of the way the futures are priced. So at tax time, shareholders end up having to report "phantom income"—money they've earned but never received—to the IRS. The fund made a special distribution at yearend to cover those taxes, but there's no guarantee that it will do so every year. ■