The FX Markets
Challenges and Opportunities from a Hedge Fund Perspective

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The goal of the hedge fund is to maximize risk adjusted returns through opportunistic position taking. In doing so the hedge fund also provides liquidity to the markets. Broadly speaking hedge funds buy and sell assets believed to be mispriced.
Hedge Fund Participants

Participants follow many different strategies, which include:

- FX only – Macro – Multi Strategy
- Systematic – Discretionary
- Short Term – Long Term
- Directional – Mean Reverting
Our Approach

Investment decisions are the result of a multi-faceted process that integrates macroeconomic and geopolitical analysis, technical analysis, market sentiment and positioning, and risk management.
Medium-to-long-term investments: occur in markets where there will be a sustained directional move in the price of an asset, caused by a normal event such as a business cycle, or changing interest rate regime.

Tactical trades: add incrementally to returns over shorter periods of time, particularly when the markets are expected to consolidate or are not in a defined trend.

Recent markets have required the increased use of tactical trades; which rely more on technical levels, timing, data and announcement calendar.

“Special Opportunity” investments: offer unique risk/reward opportunities caused by a non-recurring event. These investments maybe for any time frame and are not correlated with the rest of the portfolio.
Risk management is one of the key ingredients providing the basis from which to develop, maintain, and maximize profitable investments, while limiting losses on unprofitable investments.
**Europe**

**Macro Economic Picture**
How does the European economy withstand the multiple external shocks that it is being exposed to? For example, the large appreciation of the Euro, substantially higher oil and food prices, credit problems facing European banks, and a significantly weaker United States economy.

The challenge of the Euro area is that some countries need higher rates to slow inflation (France and Germany) while others might need lower rates to offset the effect of housing slowdowns (Ireland and Spain).
How is the circle squared?
What are the prospects of expanding the Euro area to new members?

**Inflation**
Primary attention is given to keeping inflation below 2% target. Does a slower European economy bring inflation down from 3.5% to target?
What sort of gap is needed between the product and labor market to achieve the goal?

**Credit**
How does the credit crisis affect European Banks?
And how might it impact lending behavior?
How large are the losses and why does the pace of recognition seem to be slower than in the US?

**Lending Window**
Are there limits to the lending to banks in places like Spain with real problems because of declining housing and foreign borrowing?

**FX**
Is there a competitive problem with a strong EUR, especially versus CNY?
What are the chances of intervention and what would the outcome be?
United States

**Housing**
How much more of a slowdown is expected?
What will the impact on consumption?

**Fiscal Package**
How much stimulus will the fiscal package actually provide given the offsetting impact of the rising cost of energy and food?

**US Election**
Will the U.S. election begin to play a more prominent role in market dynamics as issues such as protectionism, taxes, housing legislation and geopolitics become key topics.

**Commodities**
Is this a bubble or sustainable trend?
Is globalization inflationary or deflationary?
Trade Example 1

New Zealand Dollar – Dec 2005
Medium-to-long-term

Investment Thesis:
We expected Reserve Bank of New Zealand (RBNZ) to indicate an end to its tightening cycle, as both inflation and growth are likely to slow, this would lead to a decline in the New Zealand dollar (NZD). The large Current Account deficit, at roughly 8% of GDP, would become more of an issue as the Capital Account may no longer be able to fund it, as investors interest in New Zealand’s slowing economy.

Investment Expression:
Bought a 3-mth, 25 delta NZD put vs. USD. And sold NZD versus a basket of currencies, to diversify USD risk.

Timing, Catalyst and Entry Point:
Heading into the RBNZ monetary policy meeting in Dec 2005, we felt market positioning and sentiment indicators reflected extreme levels of NZD bullishness.

Risk Management:
In addition to the stop loss indicators we use on all trades, a “time stop” was also used in this instance, since the view was somewhat predicated upon the market reaction to the RBNZ announcement.

Outcome:
The market perception was that the RBNZ policy shift would be more gradual than expected and the market was unwilling to liquidate long NZD positions. This market moved sideways for 6 weeks and we were able to make a profit of 1.3% of NAV on initial risk of 1%, despite paying carry the whole way. At that point our position was significantly reduced, due to the time stop mentioned above. This proved to be a learning experience as the market validated our thesis, after we had removed most of our risk.
Trade Example 1

New Zealand Dollar – Jan 2006
Medium-to-long-term

Time stop caused us to take profit too soon
Euribor – Jan 2001
Medium-to-long-term

Investment Thesis:

In Q1 of 2001 the prevailing market view was that the ECB would continue to tighten monetary policy given inflation above the 2% target. One of the great concerns of the ECB was that wage pressure would intensify over the course of the year, thereby placing upward pressure on prices. The ECB was concerned that with unemployment around the level estimated to be full employment (8.3%) above trend growth (estimated at 2.5%) would lead to accelerating wages.

In contrast, it was the fund’s view that the most likely outcome would be below trend growth, and the increase in inflation was largely attributable to sharp increases in food and energy prices. Regarding growth, the reasons it was expected to lag were two-fold: first, the slowdown in the U.S. would be greater than commonly expected and exert a negative force on Europe, and second, surveys indicated that consumer and business confidence were falling across Europe suggesting a sharp deceleration in domestic activity. For example, the expectation sub-component of the IFO survey pointed to sub 1% growth over the year beginning in the fourth quarter of 2001. Importantly, growth in this range would cause the unemployment rate to rise above the full employment level, with the consequence that wages would withdraw, not add, to inflationary pressure. As this outcome became apparent, the ECB would become more confident that inflation would fall below target and ease monetary policy. In terms of inflation it was believed that food prices were event driven, due to foot and mouth disease, they were not part of an inflationary process. Energy prices were expected to go lower as global economic weakness would exert downward pressure on prices throughout the year.
Trade Example 2

Euribor – Jan 2001
Medium-to-long-term

▲ Investment Expression:
The purchase of low delta call options on Euribor contracts (futures on 3 month interest rates in Europe) was anticipated to provide the optimal combination of risk-reward, investment horizon, management of potential volatility around ECB statements and policy, and market positioning.

▲ Timing, Catalyst and Entry Point:
It was believed that over the course of the next few months the economic data would begin to weaken. As economic weakness become evident it was expected the market would begin to price in increased easing by the ECB. The fund anticipated the ECB would begin easing by early to late summer of 2001 with the total amount of easing in the order of 100-150 basis points by the beginning of 2002.

▲ Risk Management:
Expressing the trade via options limited the risk to the initial premium. As the markets moved in our favor, trailing stop losses were used to ensure profitability

▲ Outcome:
The options turned into a futures position as the easing cycle began and the position was held for several months.
Euribor – Jan 2001
Medium-to-long-term

EURIBOR
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