

ETF PERSPECTIVE

May 2007

CurrencyShares Provide Entry into the FX Market

In 2005, Rydex Investments issued the NYSE listed CurrencyShares Euro Trust. It was the first Exchange Traded Fund to provide investors specific spot currency exposure. Rydex Investments has issued seven more CurrencySharesSM, CurrencyShares Japanese Yen Trust is the most recent addition listing on February 13th at the NYSE. Each Share represents a proportional interest based on the total number of Shares outstanding, in underlying currencies owned by the Trust, plus accrued and unpaid interest less accrued but unpaid expenses of the Trust¹.

Prior to the creation of CurrencyShares, it was difficult for individual investors to gain exposure to the Foreign Exchange Market. The foreign exchange market is the most liquid asset market with a daily turnover of \$1.9 trillion dollars². It is still rare for a US bank to offer foreign currency accounts to individuals. The Patriot Act now requires US citizens to disclose all foreign bank accounts with deposits above ten thousand dollars to the Department of the Treasury. Foreign Currency Futures provide exposure, but require margin accounts and a necessity to roll positions. International index ETF funds offer portfolio diversification and some currency correlation, but they are not intended to provide pure exposure to the currency market.

Table 1:

Trading Symbol	CurrencyShares Name	3 Month ADV	AUM (mm USD)
FXA	CurrencyShares Australian Dollar Trust	13,428	50
FXB	CurrencyShares British Pound Trust	6,777	59
FXC	CurrencyShares Canadian Dollar Trust	9,223	45
FXE	CurrencyShares Euro Trust	90,228	1,015
FXF	CurrencyShares Swiss Franc Trust	18,934	82
FXM	CurrencyShares Mexican Peso Trust	3,198	14
FXS	CurrencyShares Swedish Krona Trust	6,953	22
FXY	CurrencyShares Japanese Yen Trust	215,861	449

Table 2:

CurrencyShares NAV Correlation Matrix							
NAV Data Source: CurrencyShares.com June, 2006 – March 2007							
	FXA	FXB	FXC	FXE	FXF	FXM	FXS
FXA	-	61%	29%	65%	53%	40%	61%
FXB	61%	-	28%	79%	73%	22%	72%
FXC	29%	28%	-	30%	25%	20%	35%
FXE	65%	79%	30%	-	92%	19%	91%
FXF	53%	73%	25%	92%	-	12%	87%
FXM	40%	22%	20%	19%	12%	-	29%
FXS	55%	68%	23%	87%	79%	21%	-

CurrencyShares ETFs provides more choices for investors to manage foreign exchange exposure. CurrencyShares can be hedged against other CurrencyShares and other asset classes to help reduce market risk. The CurrencyShares correlation matrix in table number 2 illustrates the high level of correlation between the currencies in Europe (FXE, FXB, FXF, and FXS). Also, the high correlation between the CurrencyShares Australian Dollar Trust (FXA) and the CurrencyShares British Pound Trust (FXB) is 61%, table number 2, which can be attributed to the fact that the British and Australians both annually invest thirty five billion USD in each other's economy³.

¹ Source: prospectus available at www.currencyshares.com

² Source: www.bis.org 2004 Triennial Survey

³ Source: Australian Government Department of Foreign Affairs and Trade

It is interesting to analyze the positive correlation relationship between certain international equity ETFs and CurrencyShares to understand the degree to which CurrencyShares can serve as a hedging tool for institutional traders. Table number 3 lists the results of one factor regressions where the CurrencyShares one day returns were the independent variables and the related iShares® international equity ETF one day returns were the dependent variables. The results showed that all of the iShares were positively correlated to the CurrencyShares and they were statistically significant with a 99% degree of confidence. The results also show that the iShares equity index funds and the CurrencyShares are not a perfect proxy for each other, since there is equity market risk with the index funds.

Table 3:

CurrencyShares NAV International / iShares NAV Regression Analysis						
NAV Data Source: CurrencyShares.com and iShares.com June, 2006 – March, 2007						
Ticker	CurrencyShares	iShares Equity Index Hedge	R2	Beta	T-Stat	
FXS	CurrencyShares Swedish Krona Trust	iShares MSCI Sweden Index Fund	0.24	0.21	7.89	
FXM	CurrencyShares Mexican Peso Trust	iShares MSCI Mexico Index Fund	0.24	0.13	7.82	
FXA	CurrencyShares Australian Dollar Trust	iShares MSCI Australia Index Fund	0.24	0.21	8.04	
FXB	CurrencyShares British Pound Trust	iShares MSCI United Kingdom Index Fund	0.22	0.24	7.49	
FXE	CurrencyShares Euro Trust	iShares S&P 350 Europe Index Fund	0.19	0.20	6.91	
FXC	CurrencyShares Canadian Dollar Trust	iShares MSCI Canada Index Fund	0.19	0.19	6.89	
FXF	CurrencyShares Swiss Franc Trust	iShares MSCI Switzerland Index Fund	0.14	0.22	5.68	

It has been over thirty five years since the collapse of the Bretton Wood Agreement and the end of the gold standard, but even in a free float currency economy there still remains a correlation between the foreign exchange market and the gold market. Table number 4 displays the results of seven regressions for the CurrencyShares one day returns using the street TRACKS® Gold Shares (NYSE: GLD) one day returns as the dependent variable. The streetTRACKS Gold Shares has a statistically significant positive correlation to all the CurrencyShares; however the results are not high enough to justify that a GLD position is creating exposure to currency markets.

Table 4:

CurrencyShares NAV/ GLD Regression Analysis			
NAV Data Source: streettracksgoldshares.com and CurrencyShares.com June, 2006 – March, 2007			
CurrencyShares	R2	Beta	T-Stat
CurrencyShares Australian Dollar Trust	0.14	0.14	5.77
CurrencyShares Swedish Krona Trust	0.12	0.15	5.26
CurrencyShares Euro Trust	0.12	0.20	5.33
CurrencyShares British Pound Trust	0.12	0.12	5.19
CurrencyShares Swiss Franc Trust	0.10	0.11	4.59
CurrencyShares Canadian Dollar Trust	0.09	0.22	6.89
CurrencyShares Mexican Peso Trust	0.06	0.24	3.45

Footnote:

Beta: A mathematical measure of the sensitivity of rates of return on a portfolio or given stock compared with rates of return on the market as a whole. A beta of 1.0 indicates that an asset closely follows the market. A beta greater than 1.0 indicates greater volatility than the market.

F-Statistic: A value resulting from a standard statistical test used in regression analysis to determine if the variances between the means of two populations are significantly different.

R2: R Squared is a statistical measure of how well a regression line approximates real data points. R Squared is a descriptive measure between zero and one, indicating how good one term is predicting another.

T-Statistic: after an estimation of a coefficient, the t-statistic for the coefficient is the ratio of coefficient to its standard error. That can be tested against a t distribution to determine how probable it is the true value of the coefficient is really zero.

Multi-factor regressions provide a tool for analyzing methods for combining asset classes for hedging exposure. The in-sample multi-factor regression in table number 5 and chart number 1 analyzes the CurrencyShares Australian Dollar Trust daily returns against the streetTRACKS Gold Shares, iShares MSCI Australian Index Fund and the iShares Lehman 1-3 Year Bond Fund daily returns.

The purpose for including the iShares Lehman 1-3 Year Bond Fund was based upon the theory of interest rate parity which states that the differential of short term interest rates between two foreign countries should have a positive relationship on the valuation of their currency rate. As interest rates and bond prices have an inverse relationship, the regression supported the hypothesis and we observe that the return of the iShares Lehman Bond fund had a positive beta against the CurrencyShares Australian Dollar return, holding all else equal. The three factor model had an adjusted R squared or goodness of fit of 32%.

This relationship could weaken if Australian interest rate volatility increased, a factor not incorporated in the model. Also if Australia’s dependency on the mining sector shifted to another economic sector, then it is possible the model will diverge from the path of the Australian Dollar.

Chart 1:

CurrencyShares Australian Dollar Trust NAV Cumulative Return/ In-Sample Model Return
June, 2006 – March, 2007

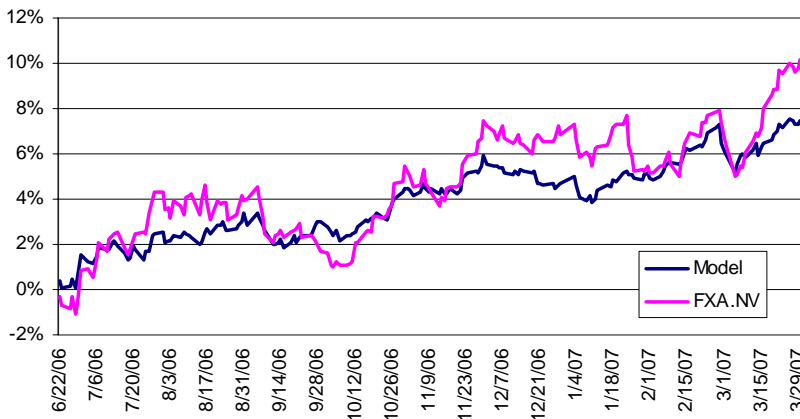


Table 5:

FXA Multi-Factor Regression		
Adjusted R2: .34 F-Statistic: 34.38		
NAV Ticker	Beta	T-Stat
GLD.NV	0.08	3.42
EWA.NV	0.17	6.26
SHY.NV	1.23	4.69

Summary: The regression model results and charts look compelling for institutional traders to analyze the potential to add CurrencyShares in their ETF hedging strategies. Even though global asset correlations are at their highest levels in years, these statistical relationships may diverge over time. Also intra-day market volatility was not included in this analysis as the tests were all run with the Net Asset Values. The analysis does prove that the only way for investors to be certain of attaining specific currency exposure in ETFs is through CurrencyShares.

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