

Forex Retail Online Trading: Why does this business continue to grow?: APitch

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1. Introduction

This pitch letter applies the template developed by Faff (2015) to an academic research regarding the retail electronic foreign exchange (FX) market. The retail FX trading, which was essentially non-existent in 2000, is now estimated to have exceeded the 5 percent of the market¹. Rolling spot foreign exchange contracts (which are the main instruments traded in this market) are OTC derivatives issued by a dealer/ broker and are traded between the retail investor and the dealer/ broker. These contracts require margin payment and are non-transferrable (an FX Contract bought from a specific dealer/ broker cannot be sold to another broker, trader or market maker). Rolling spot forex contracts are significant financial derivatives and no prior academic research analyzes them in depth.

In terms of my personal background, during the last years I have kept a balanced approach between academia and the financial industry. For the last 15 years, I have worked in the financial sector in Greece dealing with several markets and financial instruments in various positions (trading, research and administration). At the same time, since 2004, I have been a Lecturer at the International Faculty of the University of Sheffield, CITY College, in Thessaloniki, Greece teaching several finance courses at both the undergraduate and the postgraduate level.

The particular research idea has been vaguely in my mind for quite some time now as the particular market has been expanding exponentially over the last years. Then, in January 2015 the unexpected move by Swiss Central Bank to withdraw the franc's ceiling against the euro, resulted in the biggest move in the modern history of developed market currencies. Among other issues arising from this extraordinary move, several retail FX broker/ dealers were faced with significant losses, while others applied for insolvency. Furthermore, numerous retail traders were left with a negative equity and it is up to their broker's discretion to require traders to cover their negative balances. The Swiss Franc move uncovered all the risks that retail forex customers are exposed to. The January events spurred my interest in the particular market, but it was the call for papers for the Centre for International Finance and Regulation (CIFR) "Pitching Research" Symposium that I considered to be as a great opportunity for me to actually formulate my research idea and put it on a piece of paper

¹ The exact size is difficult to estimate as it is a non-centralized over-the-counter market, but King and Rime (2010) report based on anecdotal evidence that retail FX reached 8 percent to 10 percent of the market in 2010, while the 2013 BIS Triennial Central Bank Survey report lower levels (3%-4%), as by design, it only records retail trades that end up with dealers and does account for trades that are internalized within the electronic platforms.

(using a very helpful template, which I wasn't aware of). Furthermore, hopefully if I participate in the symposium, I will have the chance to receive an initial feedback and insightful comments and ideas from leading academics and practitioners.

The remainder of this pitch letter is organized as follows. Section 2 contains a concise commentary on the completed pitch, while Section 3 includes personal reflections on the exercise of completing the pitch. Section 4 includes the concluding remarks and thoughts.

2. Brief Commentary on the Application of the Pitch Template

Table 1 includes the completed pitch template for the retail online FX market analysis. The key research question is why retail investors, who strive to be rational and informed investors, are insistently participating in an opaque and risky market, in which, on average, they lose money². The particular research will attempt to shed light on whether retail investors fully understand the characteristics of rolling spot foreign exchange contracts and the risks of trading in this market. In order to achieve this, we will conduct our own survey using a large group of respondents using an online questionnaire and social media tools (e.g. Omnibus Survey by LinkedIn). Subjects will be invited to take the survey by e-mail, linking to a webpage with the questions. There is not going to be a specific geographical constrain in the sample, as the particular survey will try include as a more diverse sample as possible in terms of geographical coverage and demographic and socioeconomic characteristics; given initial considerations, the countries that are going to be included are UK, Spain, Greece and Bulgaria. Furthermore, the qualitative research will include a primary analysis of the brokers/ dealers account opening forms, advertisements, marketing and website material, seminars and Product Disclosure Statements.

Academic literature in finance is abundant with stylized facts about investor behavior. A narrower strand of literature analyses irrational determinants of individual investors' trading activity in stock and derivatives markets (indicatively, Bauer et al, 2009; Grinblatt and Keloharju, 2009; Kumar, 2008; Dorn and Sengmueller, 2007). There is also a growing body of research suggesting that investors' ability to make effective financial decisions has not kept pace with their exposure to an exploding array of innovative and complex financial instruments and their risks [see van Rooijetal et al (2011) and references herein]. The particular research effort will extend existing literature by studying a relatively new instrument that attracts growing interest from retail investors. Specifically, the empirical survey and analysis will attempt to document the demographic, socioeconomic characteristics and the investment experience and knowledge of retail forex traders and ultimately

² According to the profitability report of non-discretionary retail forex accounts held with US based reporting forex brokers (US forex brokers first released such report in 2010) and a relevant study by the French financial regulator (Autorité des Marchés Financiers) in 2014, the overwhelming majority (65% to 90%) of retail investors lose money.

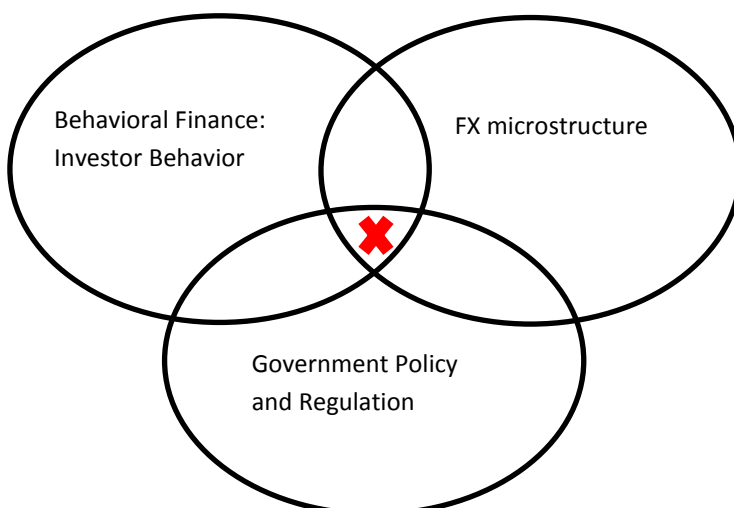
explore if retail investors comprehend the risk and return attributes of these complex instruments and whether they are able to use them successfully.

The key papers identified are King et al (2013) and Dorn and Sengmueller (2009). The first paper is selected because it is basically a review paper that covers the key findings from FX microstructure over the past 30 years and actually proposes a similar research idea as a promising topic for future research. The second paper by Dorn and Sengmueller surveys investors trading stocks and attempts to analyze their underlying psychological traits. The motivation of my study originates from the lack of research conducted for the electronic retail FX market despite its size and popularity. The remainder of Table 1 includes concise information to all the remaining required fields by Faff (2015); that is Idea, Data, Tools, What's New, So What, Contribution, and other Considerations.

3. Personal Reflection on the Pitch Exercise

As suggested by Faff (2015) starting any research project is a major challenge and the pitch template provided me a systematic tool in order to form and put on paper my idea. Although, at the beginning, I thought that it would be an easy task, actually completing the provided template proved to be a particularly challenging and time-consuming task. The most difficult part was forming the research questions, which have actually significantly evolved during this month that I am working on the pitch. The second biggest obstacle impeding any research project, that is finishing it, relates to the limitations that all investor surveys have; namely, the self-selection bias (the responders may not be representative of the underlying population) and the non-response bias (as typically only a minority of investors invited to participate in the survey chooses to do so). Hopefully, the proposed survey will indeed elicit information on the profile, demographic and socioeconomic traits and investment knowledge and experience of current and prospective retail FX investors. In concluding, I also found extremely helpful and interesting the Mickey (Figure 1) which helped me position my research idea and project in the existing literature.

Figure 1: Mickey Mouse Diagram applied to my Pitch



4. Conclusion

This letter outlines my preliminary pitch for a proposed analysis of the retail electronic foreign exchange market. The particular pitch is still at a very early stage and definitely requires refinement and further thought and development. I consider the application of the template proposed by Faff (2015) as an extremely helpful tool that significantly contributed to the formation of my research idea.

Although there is scarce academic literature on retail currency trading, the complexity and the risks of rolling spot foreign exchange contracts combined with the aggressive – and sometimes misleading – marketing promotion by several FX brokers/ dealers has raised the attention of financial regulators and, in my opinion, demands a more thorough analysis as it an interesting and important policy/ regulation theme.

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Table 1: Pitching a New Research Topic – “3-2-1” Pitching Template

Pitcher’s Name	Dr. Athanasios P. Fassas
(A) Working Title	Forex Retail online trading; why does this business continue to grow?
(B) Basic Research Question	Retail foreign exchange is an opaque, volatile and risky market, in which market participants, on average, lose money. This raises an important question: Why does this market continue to grow?
(C) Key paper(s)	<ul style="list-style-type: none"> • King, M. R., Osler, C. L. and Rime, D. (2013) The market microstructure approach to foreign exchange: Looking back and looking forward. <i>Journal of International Money and Finance</i>, 38, pp. 95-119. • Dorn, D., and Sengmueller, P. (2009) Trading as entertainment?. <i>Management Science</i>, 55(4), pp. 591-603.
(D) Motivation/Puzzle	<p>The rapid growth of retail Forex trading market over the last ten years means that many retail investors are relatively unfamiliar with its risks and properties. Rolling FX contracts are generally complex and difficult to comprehend financial instruments, especially for unsophisticated retail investors. Exacerbating this, most FX brokers/ dealers aggressively promote their business and thus, retail investors may have an unclear view about the risks involved.</p> <p>The particular research will attempt to shed light on whether retail investors fully understand the characteristics of rolling spot foreign exchange contracts and the risks of trading in this market.</p>
THREE	Three core aspects of any empirical research project i.e. the “ IDioTs ” guide
(E) Idea?	<p>Academic literature in finance is abundant with stylized facts about investor behaviour and how retail investors struggle to be rational and informed investors. The aggressive expansion of the retail Forex market has raised our academic attention and thus, the particular study will attempt to analyze in-depth which are the drivers of this growth.</p> <p>The three testable hypothesis are:</p> <ol style="list-style-type: none"> 1. Finance literacy and direct participation in retail FX products 2. Demographic and socioeconomic characteristics of retail FX market participants 3. Clarity, consistency and comparability of retail FX broker/ dealers educational and informative material and tools (advertisements, marketing material, seminars, Product Disclosure Statements)
(F) Data?	<p>There is very little public information about retail investment in electronic FX contracts; there is also limited available commercial data</p> <ol style="list-style-type: none"> 1) Data sources: we will conduct our own survey using a large group of respondents using an online questionnaire and social media tools (Omnibus Survey by LinkedIn); Research assistance needed?: “minor” assistance; if possible, involve post-graduate students to assist with the online surveys; Funding/grants?: desirable, but not essential for viability. 2) Country/setting: there is not going to be a specific geographical setting; the particular survey will try include a more diverse sample as possible in terms of geographical coverage and demographic and socioeconomic characteristics; given initial considerations, the countries that are going to be included are UK, Spain, Greece and Bulgaria. Unit of analysis: Individual investors, who have invested (or plan to invest) in rolling FX contracts. 3) Expected sample: no limit; we expect a response rate between 5%-10%, which is in line with response rates reported for other large-scale surveys. 4) Standard data – High quality standard data. 5) Will there be any problem with missing data/observations? Investor surveys have limitations, with the most significant ones being a self-selection bias (the responders may not be representative of the underlying population) and a non-response bias (as typically only a minority of investors invited to participate in the survey chooses to do so). 6) Will your test variables exhibit adequate (“meaningful”) variation to give good power?: Yes.

(G) Tools?	<p>The research will employ both qualitative and quantitative research tools:</p> <ul style="list-style-type: none"> • A preliminary analysis consisting of grouping the survey respondents to homogenous categories by their respective responses and testing for statistical significant differences • Multivariate ordinary least squares (OLS) regressions, with some measure of trading activity as a dependent variable (e.g. the number or the size of trades or the number of different currency pairs traded) and investors' investment experience and knowledge and demographic and socioeconomic attributes elicited by the survey (indicatively, geographical area, gender, age, education and wealth). • Probit estimation to study the decision of whether to trade or not. • Primary analysis of brokers/ dealers advertisements, seminars and Product Disclosure Statements <p>Econometric software: Eviews, WinRats Compatibility of data with planned empirical framework?: yes, already used in the existing literature. Knowledge of implementation: yes, own and collaborations</p>
TWO	Two key questions
(H) What's New?	Despite the size and popularity of the electronic retail FX market, to date there has been no academic research into the characteristics of this market and the profile of its participants. The particular market has created controversy and has raised regulator concerns. The lack of research regarding rolling spot foreign exchange contracts can be attributed to the de-centralized and lightly regulated nature of this market.
(I) So What?	If retail investors are better informed about the characteristics and risks involved in the market they are participating, they are better suited to make decisions that meet more effectively their investment profile and objectives. In order to improve the quality of the information available to the average retail investor regarding rolling spot foreign exchange contracts, we first need to understand the profile of investors who trade these instruments (or intend to trade them in the future) and also evaluate the quality of disclosure currently available to investors.
ONE	One bottom line
(J) Contribution?	<p>Generally retail investors do not seek independent professional advice about these products before investing in them and heavily rely on material and technical notes provided by representatives of the broker/ dealer, who may have a conflict of interest.</p> <p>Therefore, the overall aim of this work is to contribute in the dissemination of independent, clear and accessible information about these instruments and improve the quality of disclosure available to retail investors by enhancing the clarity and consistency of broker/ dealer's marketing materials.</p>
(K) Other Considerations	<p>Is Collaboration needed/ desirable?</p> <ul style="list-style-type: none"> – idea: yes internal and external collaboration; – data: yes; external collaboration in order to expand (geographically and demographically) the survey sample – tools: no. <p>Target Journals: Journal of International Money and Finance, Journal of Banking and Finance.</p> <p>“Risk” assessment:</p> <ul style="list-style-type: none"> – “no result” risk: MEDIUM; Relatively high risk given outcome is not known. – “competitor” risk: MEDIUM – Retail electronic FX market is a fast growing market, but hasn't attracted notable academic interest yet; the regulatory concerns and the general controversy will likely change that in the nearby future. – risk of “obsolescence”: LOW – Research into this area is expected to grow as the particular market is gaining popularity; – other risks: investor surveys have limitations (e.g. self-selection and non-response bias)