Forex hedging: the 'new normal'?

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ALL OF US WILL HAVE TO LEARN NEW TRICKS TO COPE WITH THE COMING 'NEW NORMAL'. GETTING MORE JUICE OUT OF THE BUSINESS WILL BECOME A NECESSITY DURING A PERIOD OF STAGFLATION, ESPECIALLY FOR COMPANIES ENGAGED IN GLOBAL TRADE, GIVEN THAT GLOBAL ACTIVITY AS A WHOLE MIGHT REDUCE OR STAGNATE. FOREX HEDGING IS AN AREA WHERE SUBSTANTIAL ROOM FOR VALUE CREATION EXISTS.

Even though the currency market is the largest market in the world, it is only about 35 to 40 years old, having come into its own with the advent of floating exchange rates, circa 1970. Currency hedging remains a 'new' field for many manufacturing and trading companies and is perceived to be something of a necessary evil. This is because companies still lack felicity with forex hedging as a function, as compared to say manufacturing and marketing, where they have had more than 100 years to hone their skills. This chapter will suggest some new ways of looking at old issues, so that companies may no longer be victims of forex fluctuations, but can actually start benefiting from it.

Two defeatist myths

Forex is not our business

Most companies have had it drilled into them that 'forex is not our business'. Agreed, forex 'trading' is not the business of most companies. But a company engaged in exports or imports is inherently running a currency 'position'. We consider the example of a diamond company, domiciled in India, which imports uncut diamonds, invoiced in US dollars. It cuts and polishes the diamonds and exports them back, invoicing the exports in US dollars.

As Exhibits 1 and 2 show, the company, as an importer, has an obligation to buy dollars, which is the same as running a short position in USD/INR (Exhibit 1). As an exporter, it holds a long position in the export dollars that it needs to sell (Exhibit 2). This is the true picture of its foreign exchange exposures, shorn of any theories.

What should the diamond company do? The company would attempt to buy its import dollars (or cover its original 'short' position) at a low rate and at the same time it would want to sell its export dollars (or cover its original

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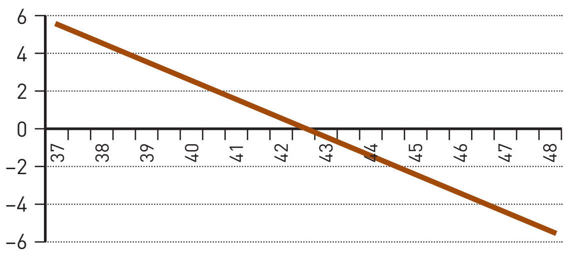
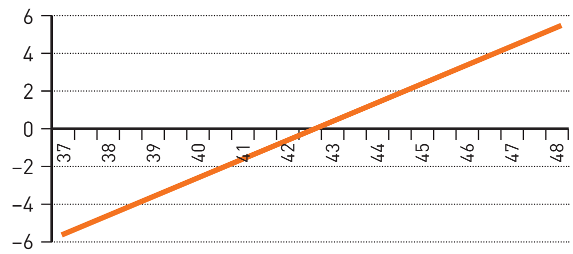
Payoff on US$/INR imports **Exhibit 1**



Source: Kshitij Consultancy Services

Payoff on US$/INR exports **Exhibit 2**



Source: Kshitij Consultancy Services

'long' position) at a higher rate. Suppose the company is indeed able to buy dollars at 42.00 and to sell dollars at 44.00, it would have captured a net export-import margin of INR2.00 per US dollar, or 4.65% (2/43) for itself from the foreign exchange market. This 4.65% net margin is the result of judicious management of the forex rates that the company pays and receives, not from the core business of polishing uncut diamonds. Is there anything wrong in trying to capture this profit? In a competitive world, every variable that a business is exposed to needs to be managed with the intent of adding to shareholder value. Forex is no exception.

We have a natural hedge

Secondly, conventional wisdom says that a company that has both imports, on the one hand, and exports on the other hand, has a 'natural hedge' and needs to hedge only the residual net exposure, or excess of exports over imports. Say, the company imports diamonds worth US$100 and exports diamonds worth US$110. Conventional wisdom would ask the company to hedge/sell only US$10. Doing that, however, would imply that it should not try to earn an export-import margin from forex on US$100. At most, it may attempt to earn a forex margin on US$10. But that would not really be worth writing home about, would it?

Thankfully, there is enough literature that agrees that a 'natural hedge' exists only in theory, given the realities of time and amount of mismatches. Even if we assume a situation where the utopian concept of 'natural hedge' does exist, a profit-seeking company would still want to buy US dollars for its imports at a lower rate and to sell its export dollars at a higher rate.

What would you think of a grocer who displays a rate list like the one shown below?

JONES GROCERY STORES

Item	Buy Price	Sell Price
Brown Bread	$3.00	$3.00
Rice (4 lb)	$6.00	$6.00
Burger	$3.50	$3.50
Milk (1 gallon)	$4.50	$4.50
Curd (2 lbs)	$2.50	$2.50

Every grocer seeks to be compensated by the customer for taking the trouble of bringing the goods from the wholesaler to a well appointed store in the neighbourhood, for the convenience of the customer. Similarly, the diamond manufacturer should not be faulted for wanting to secure a reward (difference between its export-import rates) for the currency risk it carries on the entire US$110, not only on US$10.

Three reasons for underperformance

Absence of benchmarks

The unadmitted, but implicit, objective of forex risk management in a very large number of companies is to try and beat the market. There is a lot of pressure on the forex desks in companies to make profits. Do not go by what companies say in their annual reports; ask the dealers and risk managers in the treasury departments of companies to verify this statement.

This happens because most companies set no benchmark by which forex risk management is to be guided. As a result, the market becomes the default benchmark and everybody tries to beat it. Hedging decisions are assessed on whether or not the hedge beats the market.

Fixed benchmarks, if at all

The few companies that work with benchmarks tend to have a fixed benchmark for the whole year. One particular US$/INR rate is decided upon during the annual budgeting exercise in February/March, and then hedges are undertaken accordingly. This is done because: (a) a fixed benchmark lends itself easily to budgeting; (b) the marketing and production departments in a company do not want to deal with a 'non-domain' variable; and (c) there is still an innate 'wish' in the minds of most people that exchange rates should remain steady.

However, this approach is far removed from reality. The currency market, like most other markets, is volatile and given to wild swings. The factors on which the annual currency forecast (and benchmark) is based are likely to change. As such, there is a need to revise the benchmark. Unfortunately, the system is inflexible and does not allow for changes in benchmarks or for any course correction.

No hedging cost budget

It would be a very rare company, indeed, that had set aside a budget for hedging in 2007 and 2008. Although every activity in business has a budget allotted to it, be it as mundane as the daily upkeep of toilets, forex hedging is supposed to be, or so it seems, costless. That is why forex hedging budgets are unheard of. And that is why we witnessed the phenomenon of hordes of companies taking on 1x2 put risk reversals in 2006 and 2008 to hedge their exports.

Buying a simple, plain vanilla put costs money and no company had provided for that. So everybody tried to go in for 'zero cost options' and ended up with losses that were several times higher than the option premium they could have chosen to pay earlier on plain vanilla puts.