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# IT'S HEDGING TIME – 4 TIPS TO START A HEDGE PROGRAM

## CURRENCY VOLATILITY IS HERE TO STAY. HERE IS WHAT YOU NEED TO KNOW ABOUT HEDGING AGAINST CURRENCY RISK AT YOUR ORGANIZATION

By IMD Professor Nuno Fernandes – April 2015

**IMD**
Chemin de Bellerive 23
PO Box 915,
CH-1001 Lausanne
Switzerland

Tel: +41 21 618 01 11
Fax: +41 21 618 07 07
info@imd.org
www.imd.org

2015 has been an especially volatile year so far on the foreign exchange markets. Recent rises in the values of the US dollar and Swiss franc are causing woes in those two countries, especially for their exporting sectors. The steady drop in the value of the euro due to the European Central Bank's quantitative easing is good for Europe but bad for some of their trading partners. A loss in value of the Singapore dollar against the US dollar is causing anxiety in Asia's most competitive country.

Here's the bad news: high volatility on the foreign exchange markets is here to stay.

But here's the good news: organizations can minimize the risk they face to foreign exchange volatility by creating hedging programs.

If your company is already hedging, keep it up. The time is right. If your organization isn't hedging against currency risk at a volatile time like this, you are just speculating and hoping for the best. And managers at industrial companies should not speculate on foreign exchange market trends.

Now that you know volatility is here to stay, it is time to start hedging. Here is what you should consider.

**1] Direct exposure**
First you have to find out if your organization is exposed to currency risk. This one is easy. How much do you sell in a particular foreign currency, such as the US dollar? If the dollar goes up 20%, you make 20% more. Direct exposure is based on how much your costs and revenues fluctuate when foreign exchange rates go up and down.

**2] Business exposure**
This one is more important and more complicated. What will your competitors do if there is a sharp currency change? Will they drop prices? What will your clients do? Will they stop buying your product?

Sometimes clients are willing to let companies pass higher costs onto them; sometimes they are not. You also have to analyze your cost structure and flexibility. Can you cut your costs?

**3] Decision making and internal processes**
After extensive experience helping companies put hedging programs in place, I have come to realize that this is one of the most important steps and it is also one where many companies fail. For this step you need to be able to forecast your company's near future, including expected revenues and sales. If you cannot forecast, you cannot hedge. You have to forecast on orders as well as actuals. The majority of companies do both and most have a formal currency risk committee and policy.

But, there is one area where most companies definitely need to improve and that's increasing employee understanding of hedging. If your employees don't understand hedging, you cannot really have a hedging policy. The currency risk management process and the role of the treasury are not well understood in most organizations. While it is a common misconception, the treasury's role is not to forecast exchange rates.

Many purchasers or commercial managers are trying to avoid currency risk by buying everything they need to buy in their own reporting currency. This is a big problem. I worked on putting a hedging program in place in a huge global company whose foreign suppliers were charging them a premium to bill the company in its home currency. After removing the premium by paying in the different suppliers' local currencies, this company started saving more than USD $12 million per year.

An organization's internal processes are as important in a hedging program as the actual financial market instruments and strategies. Companies need tools to make sure their employees understand hedging discussions such as weekly commercial currency reports and hedge analytical tools. These show internal stakeholders very clearly how hedging will benefit them.

**4] Right instruments and strategies**
There are a number of different financial instruments that can be used in a hedging program. Some of the more basic instruments are: options, futures, swaps and forwards. There are advantages and disadvantages of every instrument. For example, forwards can be customized to clients' needs while futures are traded on the public stock exchange and cannot be customized but are, however, very liquid. The drawback of both forwards and futures are that they have very short maturity.

Swaps can transform companies' assets and liabilities into different currencies. These are a better long term solution.

With options there is less risk of losses than with futures, but options cost a premium.

Generally speaking, managers who do not want to pay for their hedging programs are subject to ups and downs; while if they are willing to pay a premium, there is less risk that they will lose.

There are more complicated hedging strategies such as collars, spreads, and straddles; these are today's best practices. Used correctly, they allow non-financial companies to achieve good protection, at a reasonable (or even zero, in the case of collars) cost.

More detailed information on these instruments and strategies can be found in my text book: "Finance for Executives: A Practical Guide for Managers".

**Considerations for Switzerland**
An important lesson for managers hedging against currency fluctuation is that inflation exists everywhere in the world except for Switzerland. It is well known that exchange rates depreciate over time for countries with inflation. And there is nothing that tells us that there will be inflation in Switzerland in the future. This trajectory will continue. The Swiss franc is already close to parity with the dollar and the Euro. With the pound, given the current forecasts of inflation, it will be at parity in 5 to 10 years.

**In conclusion: to hedge or not to hedge?**
If your business is exposed to risk due to currency volatility, then you have a duty to hedge. Particularly if your shareholders are unaware of that risk, and do not want to be exposed to it. If you don't hedge, you might as well just be speculating on your company's future. If you want to speculate, you should do it with your own money.

Most companies should be hedging if they are not already. But, they must think carefully about internal and external processes as well as the different instruments and strategies available.

Currency volatility is here to stay for the next many years.  Now is the time to hedge.

*Nuno Fernandes is Professor of Finance at IMD, where he directs the Strategic Finance program and also Finance Fundamentals for Executives, a new IMD "Global Leadership in the Cloud" program. He is the author of Finance for Executives: A Practical Guide for Managers.*

*Read Nuno's Five Golden Rules for Mergers and Acquisitions or his recent commentary on the Holcim and Lafarge merger.*

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