



# Trading PLACES

*Ira Kawaller*

Tactical considerations of  
hedging currency exposures

**KEY INSIGHTS:**

- Traders may offer valuable lessons to hedgers.
- Hedgers should consider a hedging process that requires terminating losing hedges before their natural termination dates.
- If an organization understands the nature of its exposures and their hedges, outcomes should be reasonably predictable.

**I**t's not easy to forecast foreign exchange rates. Sometimes large exchange rate moves are abruptly reversed, and sometimes, after relatively brief pauses, the trend reemerges. Moreover, prices frequently stutter and change direction in a seemingly random manner, often with non-trivial counter movements during trends that may persist for years.

Speculative currency traders, for the most part, live and die on the basis of how well they can anticipate—or react to—imminent market moves. Their ability to forecast, however, may not be paramount. Often, the source of their income derives largely from their trading rules that serve to limit their losses. If you pick the market direction correctly only half of the time but you earn more on your winners than you lose on your losers, you'll be a successful trader. Of course, you need to have sufficient capital to trade another day, following losing episodes that inevitably will occur.

Hedgers generally have a somewhat different orientation. Rather than being concerned about minor market gyrations, they're typically willing to bear some variability of exchange rates while seeking to mitigate the effects of more substantial market moves. That said, the traders' orientation may still offer valuable lessons to hedging entities. After all, it would seem hard to justify a hedging strategy that doesn't presume the ability to earn positive expected returns for derivative positions—not necessarily for every hedging instance, but certainly overtime. Unfortunately, given the volatile nature of currency markets, it may be overly optimistic to expect to realize those positive returns

without the benefit of some kind of a disciplined trade execution plan.

This perspective suggests that hedgers may want to consider a hedging process that requires terminating losing hedges before their natural termination dates. For example, consider a U.S. importer who buys from a European supplier with payments to be made in Euros. Assume further that the hedger initiates a hedge of 50 percent of its Euro exposure by buying Euros in the forward market at a price of \$1.1500 per Euro. In this instance, the company is still exposed to the risk of a stronger (i.e., more expensive) Euro, relative to the U.S. dollar; but 50 percent of the risk (as well as 50 percent of the beneficial opportunity of a weakening Euro) has been eliminated by this hedge.

With the predilection of limiting hedge losses, one tactical approach might be for the hedger to decrease the hedge coverage by liquidating portions of the starting hedge position as the exchange rate falls—i.e., as the hedge positions generate losses. For example, for each drop in the exchange rate of, say, \$0.0100, a fifth of the initial hedge position could be liquidated. In that way, the entire hedge would be terminated if and when the exchange rates were to fall below \$1.1000 per

Euro. This hedger would clearly lose on these hedge positions, but at least those losses would be constrained, and throughout the process, the degree of exposure to the beneficial rate change would be increasing (i.e., improving).

A logical extension of this plan might be to increase hedge coverage when hedges are winning—presuming the starting point were less than 100 percent of the existing risk is initially hedged. Returning to the starting 50 percent hedge coverage in our initial example, this entity might want to increase the hedge coverage in increments of 10 percent of the exposure with each \$0.0100 increase in the exchange rate. In this way, if and when the exchange rate rises above \$1.2000, the hedging entity would be fully hedged and protected from any further strengthening of the Euro. Clearly, at this point, with the exposure fully hedged any further accumulation of forward contracts beyond that coverage would have to be considered as speculative trade, as opposed to being a hedge.

### **A problematic approach?**

This approach is not without its problems. Note that under the adjustment process just described, the firm would be buying and selling Euros forward at pre-determined price points. Given the way currency markets trade, however—often gapping from one level to the next—there's no guaranty that these trades can be executed at desired levels. As a result, the outcome from the hedge may not be realized with the level of precision that might be desired. Additionally, under this approach, the hedging entity would be buying

Euros forward as the exchange rate rises and selling forward as the exchange rate falls. Thus, if the thresholds for making these exit/enter adjustments to the hedge position are too narrow and exchange rates gyrate within a confined trading range, adjustments to the hedge position would have the hedger buying high and selling low, thus fostering trading losses that would be largely independent of any meaningful adjustment to exchange rates. And finally, with the termination of a hedge in response to losses on that derivative, the entity would again be exposed to any subsequent adverse market move unless or until a new hedge is applied.

These realities notwithstanding, it's important not to lose the forest for the trees. Although this approach could yield hedge losses from the adjustment process that may end up being unrelated to the realized market move for the exchange rate being hedge, these losses would likely arise in periods of relatively low volatility; and most likely, the losses would be relatively minor. On the other hand if a truly sustained market move were to arise, this approach would likely be successful in constraining adverse earnings impacts while at the same time allowing for possibly substantial beneficial earnings impacts to be realized if the exchange rate moved beneficially.

The careful reader might realize that this strategy would be expected to perform much like a purchased call on Euros. That is, with a long call, the hedger can be assured that a worst case (maximum) exchange rate equal to the call's strike price has been established, with the allowance to enjoy a lower (cheaper) exchange rate if spot Euro exchange rates remain lower than that critical maximum.

In fact, traders typically understand that the dynamic approach presented above synthetically replicates a call option in that both deliver the asymmetric outcome of limited risk with unbounded opportunity. For the actual call, however, the cost of the strategy is explicitly known, up front—i.e., the price required to buy the option. For the dynamic strategy, on the other hand, neither the costs nor this effective worst case outcome can be known with certainty at the onset of the strategy. Both would depend on the path of exchange rates during the hedging process. Sometimes the dynamic strategy will deliver a better result; sometimes the purchased call option will be better.

You look like a hero if, when hedged, you experience an adverse exchange rate move and your hedge delivers a profitable offset. On the other hand, if that risk doesn't come to fruition, the hedge will generate a loss.

The decision of whether to hedge and how much to hedge is anything but win-win. You look like a hero if, when hedged, you experience an adverse exchange rate move and your hedge delivers a profitable offset. On the other hand, if that risk doesn't come to fruition, the hedge will generate a loss—a loss that might, in retrospect, seem to have been avoidable. Still, if an organization understands the nature of its exposures and their hedges, outcomes should be reasonably predictable. That is, hedges should reliably constrain effective costs and prices (post hedge) to be within acceptable ranges. Of course, what is deemed to be acceptable is an

individual business judgment. But the point is, prospective hedge losses for any given hedge, by themselves, are really beside the point.

Complicating the calculus in the hedging decision is the fact that companies are often compared to their peers. Differences in performance between a company that hedges and a peer that doesn't would be inconsequential if exchange rates stay steady. But with a substantial exchange rate move, the difference could be considerable. And, perhaps as often as not, the company that hedges a larger portion of its risk may end up with the less attractive earnings outcome. The hope and expectation would have to be that the disciplined risk management

orientation will prove to be more profitable, over time.

Unfortunately, whether or not stock valuations will appropriately reflect the idiosyncratic hedge processing practices that each company pursues is an open question. Ultimately, it falls to the management to explain their hedging program in the firm's disclosures in a way that allows the investment community to evaluate whether the hedging program is, in fact, disciplined, or if it is ad hoc.

*Ira Kawaller is founder of Kawaller & Co., LLC, a consulting firm that specializes in assisting commercial enterprises in their use of derivative instruments. Reach him at [kawaller@kawaller.com](mailto:kawaller@kawaller.com).*