



KEY TAKEAWAYS:

- Successful trading requires operating on somewhat of a knife's edge.
- There's no right answer to the question of how much of an exposure to hedge.
- The benefit of derivatives shouldn't be measured by the profit that they generate, but the possible trouble that they can avoid.

Hedging the **HEDGE**

How treasurers can decide how much to hedge

IRA KAWALLER

Suppose you expected gold prices to rise, and you decided to speculate by buying gold futures contracts. Higher prices would generate profits; lower prices, losses. Saying things could get worse before they get better translates to saying that the gold futures price could go down before it goes up. In fact, four possible scenarios could play out:

- You buy the futures and (eureka!) you really did call it right. The price rises from that entry (and break-even) price. Presumably, at some higher price, your bullish sentiment erodes, as you come to believe that the price has gone as high as you can reasonably expect; and you liquidate at a profit.
- Subsequent to buying the futures contracts, the futures prices rises, but you end up waiting too long. The futures price retreats, and your unrealized profits erode.
- After buying the futures, contrary to your expectations, the futures price moves lower. Even so, you maintain your bullish sensibilities. In this case, the price drop allows you to buy more contracts and build a more substantial speculative position. The added positions serve to lower your effective break-even price. Subsequently, you turn out to have been correct in your market view; and the gold futures price moves higher. You're able to liquidate your position at a profit.
- You buy a futures contract, and the price moves lower... and lower still. At some point you realize that you blew it. Your original bullish orientation was a bad forecast, and you have to pay the piper.

All along the way, irrespective of the price moves, the attentive trader is (or should be) evaluating whether the original price forecast still holds. Even if the originally expected direction of the price change still holds, material variations in the price – *either up or down* – could likely influence the strength of your conviction vis a vis that forecast, justifying making an adjustment the size of the position, if not a determination that the trade should be liquidated, altogether.

continued on page 24

AFP[®] TRAINING

Master the skills of your current role. Prepare for the roles to come.

CAREER SKILLS

Communication Skills for Global Financial Professionals

JUNE 8-9 | 11 A.M.-1 P.M. EDT

CREDITS:

4.5 CTP | 4.5 FP&A | 4.5 CPE

VIRTUAL SEMINARS

FINANCIAL PLANNING & ANALYSIS

Financial Modeling: Techniques & Best Practices

JUNE 16 & 23 | 10 A.M.-1 P.M. EDT

CREDITS:

7.2 CTP | 7.2 FP&A | 7.0 CPE

CORPORATE FINANCE

Basics of Valuation: How to Determine the Value of Anything

JUNE 22 | 1-5 P.M. EDT

CREDITS:

4.5 CTP | 4.5 FP&A | 4.5 CPE

Learn more and register.
www.AFPonline.org/Training

Successful trading requires operating on somewhat of a knife's edge. Too frequent adjustments could result in whipsaw trading losses from entering and exiting positions due to noise, as opposed to meaningful price change information. Too frequent adjustments could also foster the realization of losses prematurely, foreclosing the opportunity to recoup those losses when adverse price changes self-correct. Similarly, closing winning positions too soon could preclude realizing more generous gains if the beneficial price movements were to continue. The other side of the coin is that too *infrequent* adjustments could also be a problem. They could result in realizing losses in excess of true risk tolerance or, alternatively, giving back some or all profit that might have been realized with an earlier trade termination. Finding the right balance is the trader's challenge.

The trading orientation presented above might have some value to hedgers, as well—albeit with some caveats.

A hedging example

Consider the example of a U.S. importer, expecting to make €20 million purchases per month from European suppliers over the coming 12 months. In considering how much of this exposure to hedge, one could argue that taking no hedge position would be suited for the entity that was confident that the exchange rate was poised to move favorably, while hedging 100 percent of the exposure would go with an expectation that an adverse exchange rate move (ignoring the hedge) was a virtual certainty. With that perspective, the firm might reasonably opt to hedge 50 percent of the exposure—i.e., €10 million of purchases per month—by buying 12 forward contracts, each for €10 million, with one contract maturing in each of the coming 12 months. Effectively, half of the exposure would be hedged, and the other half would remain exposed to market risk.

This 50/50 starting position might have particular appeal to those entities that claim no particular expertise or confidence in forecasting market moves; but even so, it deserves further scrutiny. It's not for everyone. In particular, a large segment of hedging entities will favor more certainty—i.e., lower earnings volatility, all else being equal—achievable by hedging a larger portion of any original exposure. Choosing the coverage ratio of any hedge, however, is a business judgment that must be made by each hedging entity, individually, balancing a variety of competing considerations, including sensibilities as to the likely distribution of prospective price changes of the unhedged exposure, the tolerance for uncertainty of outcomes, and some sense or expectation as to how peer group companies are likely to cover their exposures. Taking a hedging position that's markedly at odds with peer group practice potentially could make your company out-perform when hedges generate profits, but that same coverage ratio could cause under-performance when hedging derivatives generate losses.

The traders' orientation presented above might also suggest that it would be reasonable to adjust the hedge over time, as prices change. Just like the trader, the hedger is confronted by the dilemma as to whether any observed price change is indicative of a trend that will continue or an effect that will more likely be reversed. New pricing information assimilated by the hedger could cause a revision in the strength of conviction of the original forecast, or even a reversal of the direction of the expected price change. With that updated assessment, it would make as much sense for the hedger to adjust the portion of the exposure being hedged as it does for the trader to adjust the size of his or her speculative position. That said, for the entity that steadfastly refuses to impose *any* judgment about future price trends, the

“One of the most challenging aspects about implementing a hedging program is figuring out how much to hedge. Is 50 percent coverage the right amount? Should it be 30 percent? Should it be 80 percent? Unfortunately, there’s no right answer to this question.”

strategy that persistently applies a hedge that covers 50 percent of any exposure would be both logical and consistent.

Regardless of the particular degree of hedge coverage selected, again, taking cues from the traders’ orientation, it’s a reasonable question as to whether that hedge should be executed as a single transaction, or over time. A single trade execution yields certainty as to the effective starting price of the aggregate hedge position, while the phase-in approach introduces a path-dependent set of derivative transactions with some inherent uncertainty. This dynamic effort may succeed in generating a more attractive outcome, but maybe it won’t. That tactical decision—placing a hedge in full or phasing in a hedging position over time—is one that deserves consideration. Under some market conditions, the dynamic approach may seem more promising than others; and in those cases it may be a prudent business decision to try for it.

No right answer

These tactical considerations aside, one of the most challenging aspects about implementing a hedging program is figuring out how much to hedge. Is 50 percent coverage the right amount? Should it be 30 percent? Should it be 80 percent? Unfortunately, there’s no right answer to this question, which makes it hard for management teams to coalesce on a course of action. Moreover, whatever the degree of

hedge coverage chosen, it’s easy to take a retrospective look and realize that the firm would have enjoyed a better outcome (i.e., higher profits) at one or the other extreme—hedging nothing, or hedging everything, depending on which way prices happened to have moved. With that retrospective perspective, literally *any* intermediate hedge coverage ratio would be wrong. Unfortunately, as wrong-headed as this perspective is, it’s immobilizing. The fear of second-guessing often leads decision makers to do nothing, which boils down to chronically leaving their exposures unhedged. This posture reflects a critical error in way the performance of derivatives is assessed.

The benefit of using derivatives shouldn’t be measured by the profit that they generate, but rather by the *possible* trouble that they can reliably avoid. To the extent that these contracts preclude unacceptable outcomes from being realized, they should be deemed to be effective, irrespective of the profit or loss that they may end up generating. The challenge for the hedging entity, then, is devising and carrying out disciplined policies and procedures that assure the implementation of a level of hedge coverage that appropriately responds to the changing economic conditions facing the company and the company’s associated risk tolerances, on an ongoing basis.

Ira Kawaller is the founder of Kawaller & Co., LLC. He can be reached at kawaller@kawaller.com.