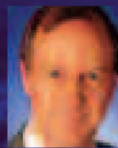
The risk/return trade-off



ROGER HEINE ASKS WHICH RISKS MATTER MOST IN TERMS OF THEIR POTENTIAL IMPACT ON SHAREHOLDER VALUE.

The rapid globalisation of product and financial markets has hugely increased the exposure of companies to various risks. But which risks really matter for shareholder value and what are the main costs and benefits of managing these risks, if they can be managed at all? In a global survey conducted by Deutsche Bank in 2005 and 2006, we posed these questions to chief financial officers (CFOs) across a variety of industries.

THREE DISTINCT GROUPS The traditional way of thinking about risks is to split them up into three distinct groups: commercial risks, external event risks, and market risks.

Commercial risks are intrinsic to a business. They include failures of internal processes, actions by competitors, and other core strategic risks. They are difficult to hedge, especially with financial contracts, but it is not clear that they should be hedged, because the exposure to commercial risks, and the investor's confidence in a company's ability to handle them, may be the precise reason why a business has attracted certain investors in the first place.

External event risks are not specific to a business and are related to non-market external events, such as natural catastrophes or changes in tax or regulatory policy. Such risks, if managed at all, are managed using insurance contracts.

Finally, market risks are related to price movements in financial markets and include interest rate risk, foreign exchange (FX) risk and commodity price risk as well as possible pension fund shortfalls.

The bulk of companies' risk management activities are focused on market risks, but some observers believe that commercial risks are actually much more significant, although the CFOs in our survey disagree to some extent with this latter notion.

We asked CFOs: "Without risk management, how costly would the following risks be to your company over the next five years, considering both likelihood and magnitude of loss. *Table 1* contains the responses ranked in order of importance, based on the fraction of respondents who gave it a mark of 4 or 5 on a 0-5 scale of importance, where a zero is not important and a 5 is very important.

THE IMPORTANCE OF FX Of all the risks considered, foreign exchange risk ranks as the most costly, while financing risk (the ability to raise funds when needed) ranks third. Four of the top 10 risks are financial in nature, and the other six are broader business risks. External event risks are still deemed relatively unimportant, even in the light of uncertainties about the effects of climate change.

The importance of FX risks reflects the global nature of our survey and is testimony to the importance of understanding and addressing FX exposures.

Understanding the full nature of FX exposures is not easy, which often leads firms to hedge exposures associated with specific transactions. *Table 2* lists the percentage of respondents who hedge specific FX exposures, together with the extent to which these exposures are hedged. The top six hedged exposures are all transaction-related, with on-balance sheet accounts receivable and payable being the most important. Just over 60% of all respondents hedge these transactions; and, as it turns out, when they hedge, they cover just over 60% of the exposure.

Hedging specific transactions is not necessarily wrong, but it is not clear that it always reduces the economic exposure of the business to FX fluctuations. Two reasons are at the heart of this concern. First, by focusing on specific transactions, companies may ignore natural hedges already in place. Second, transaction hedging is, by definition, short term in nature, while FX exposures are likely to have long-term consequences. Thus, studying the true economic exposure of a business to FX fluctuations is crucial. This may be important even for firms without direct FX transactions – they may, for instance, face import competition. But as *Table 2* shows, few companies hedge economic exposure.

It is sometimes difficult not to have a view on future exchange rates, but businesses should exercise great caution when they let these views or a change of view affect their risk management activities. Only a quarter of survey respondents say they never let their views on future exchange rates affect the size or timing of their hedges.

In addition, there is sometimes a fine line between managing risk exposures and taking active positions. In fact, only half the respondents say they never take active positions. Thus, half implicitly acknowledge that they do. These decisions are not necessarily wrong or improper, but businesses must be careful and should only take a view if they have special knowledge about future price movements unavailable to other market participants. After all, the primary goal of risk management is not to make money on the risk management activities themselves.

THE GOALS OF RISK MANAGEMENT If the goal of risk management is not to make money from risk management itself, what are the goals of risk management and what are the costs?

The survey shows that the direct costs of purchasing risk management products, forgone opportunity costs (akin to having locked in the price of an input, but seeing general input prices decline

Executive summary

- Academic theories of risk management focus on sustaining investment programmes, avoiding costly financial distress, and minimising taxes.
- The hoped-for corporate benefit from risk management is better decision-making.
- Companies are in the business of taking risks to earn returns. A well-functioning risk management regime improves a business's ability to make the best trade-off between risk and return.
- Although executives see risk management as informing the strategic and tactical decisions made throughout the company, they are unsure of the value of their risk management function.

afterwards) and the difficulty in explaining risk management to the board of directors are judged more severe than the costs of running a risk management group, compliance and reporting, explaining the activity to investors or minimising rogue trading.

On the benefits side, the overwhelming perceived plus is risk management's ability to improve company-wide decision-making. Whereas academic theories of risk management focus on sustaining investment programmes, avoiding costly financial distress and minimising taxes, the executives in the survey see risk management as generally helping them make better decisions. After all, companies are in the business of taking risks to earn returns. A well-functioning risk management regime improves a company's ability to trade off risk and return. Executives see risk management as informing the strategic and tactical decisions made throughout the company, so the hoped-for benefit from risk management is better decision-making.

WHERE RISK MANAGEMENT BREAKS DOWN The survey highlights two areas of concern. First, around 40% of respondents cannot estimate the value of risk management. This may reflect CFOs' frustration in companies where they do not have a handle on their risks, or the risk management function itself. This is a result of the second observation: that nearly half the respondents do not explicitly measure the performance of their risk management activities, leaving the mandate of risk management groups unclear. Even companies that articulate performance measures for their groups have multiple measures. If these goals come into conflict (for example, stabilising earnings versus mitigating cost increases), performance measurement is complicated. In addition, finance executives bemoan the sheer difficulty of measuring success. And without measures, it may be difficult, if not impossible, to judge how the group is doing.

In short, while CFOs are concerned about a variety of risks, FX risk exposures stand out as the ones deemed most costly if left unmanaged. When managing these risks, it is important to consider a business's economic exposure and to exercise caution about letting your market views determine the hedging strategy. Risk management, when properly executed, will undoubtedly improve the quality of decision-making in a business, but it is important to determine how much value risk management creates, which implies setting up proper mechanisms to measure the performance of the function.

TABLE 1: RISK EXPOSURE "Without risk management, how costly would the following risks be to your company over the next five years, considering both likelihood and magnitude of loss?" Scale: not important (0) to very important (5).

RISK FACTORS	% who rank it 4 or 5
Foreign exchange risks	53%
Strategic risks	47%
Financing risk	40%
Competitive risks	39%
Failure of company projects	36%
Execution risks	35%
Reputational risks	33%
Commodity price risks	32%
Operational risks	31%
Interest rate risks	31%
Credit risks	28%
Regulatory or government risks	26%
Loss of key personnel	26%
Property and casualty risks	22%
Litigation risks	21%
Natural catastrophe risks	17%
Employee misdeeds	13%
Terrorism risks	13%
Political risks	11%
Pension or healthcare shortfalls	10%
Weather risks	9%

TABLE 2: FX RISK MANAGEMENT FREQUENCY The frequency with which businesses engage in foreign exchange risk management (on a scale of never (0) to always (3)). and the proportion of exposures typically hedged NB: 'na' indicates that the extent of this activity is not quantifiable as a proportion of the exposure.

FACTORS	FREQUENCY	Extent
Hedge on-balance sheet AR & AP	62%	63%
Hedge anticipated transactions (< 1yr)	56%	51%
Hedge foreign repatriations	39%	52%
Hedge off-balance sheet commitments	35%	47%
Hedge committed M&A transactions	29%	56%
Hedge anticipated transactions (> 1yr)	25%	39%
Hedge balance sheet (book value)	23%	43%
Hedge profit and loss statement	22%	41%
Economic/Market value balance sheet	7%	30%
Undertake directional trading	7%	na
Arbitrage	5%	na
Hedge economic/competitive exposures	5%	27%
Hedge anticipated M&A transactions	5%	31%
Exploit relative value opportunities	4%	na

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Deutsche Bank's Danny Witter is running a session at The Treasurers' Conference 2007 entitled "I'm a risk manager, get me out of here". See page 28 for more details of the conference. For more details of the Deutsche Bank global survey of corporate financial policies and practices, see www.dbbonds.com/lsg/reports.jsp