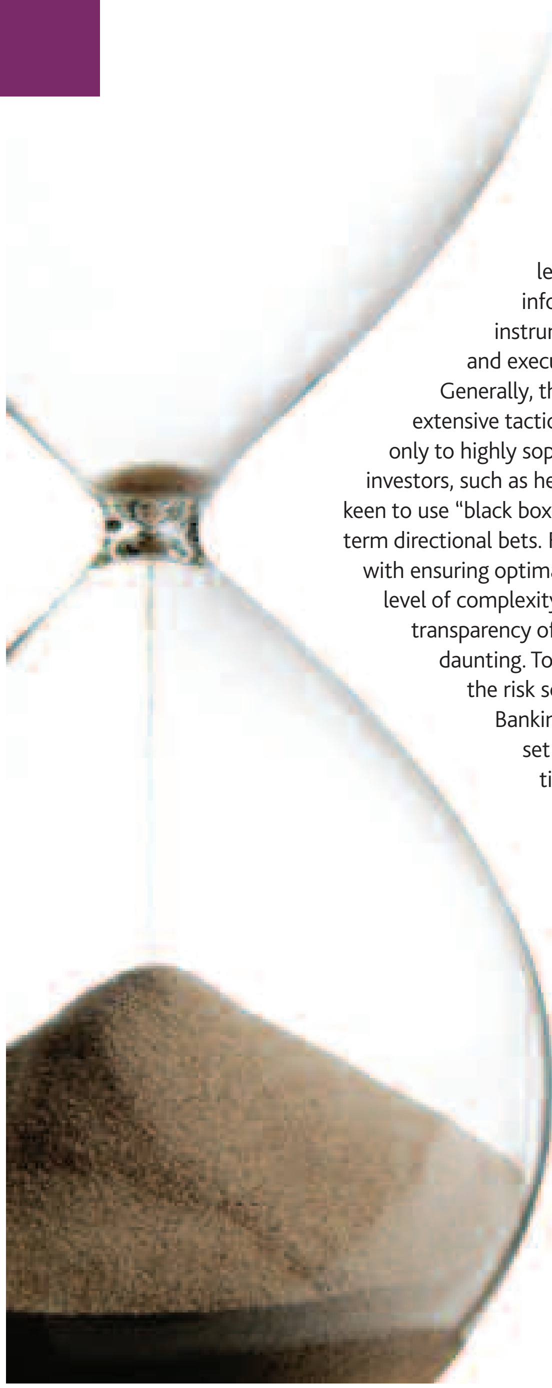
Timed to perfection

TREASURERS SHOULD CONSIDER ADDING SOPHISTICATED MARKET TIMING INDICATORS TO THEIR DECISION-MAKING ARSENAL. **JWAN MELLA** EXPLAINS HOW.



All too often, treasurers do not have access to the level of insight and information that could be instrumental in determining and executing hedging strategies. Generally, this in-depth and extensive tactical research is available only to highly sophisticated financial investors, such as hedge funds, which are keen to use "black box" models to place short-term directional bets. For treasurers concerned with ensuring optimal hedging strategies, the level of complexity and lack of transparency of these models can be daunting. To address this challenge, the risk solutions group at Lloyds Banking Group has developed a set of proprietary market timing indicators both for currencies and interest rates which are designed to be accessible, meaningful and transparent.

Treasurers are well versed in the need to develop an optimal strategic hedging framework based on a plethora of metrics derived from the business's various risk exposures. Through an extensive inward-looking exercise, factors are gathered that will form metrics to determine the optimal strategic hedging profile. This base scenario will differ from company to company and between industry sectors. Highly leveraged companies will tend to focus on interest rate risk while relatively cash-rich companies may put more emphasis on foreign exchange (FX) risk management and yield enhancement.

The factors to consider in determining the optimal strategic debt profile include income cyclicality and volatility, gearing, cash balance, foreign currency exposure, financing structure, cost of funding, interest rate volatility, ratings, risk appetite and debt covenants, to list but a few.

As for FX, both translation and transactional risks need to be evaluated. Translation risk is assessed by looking at the asset liability breakdown by currency and at the relationship that each of the currencies have with each other. There are, of course, other components in quantifying this exposure, such as the long-term business plan within the domicile of the currency since translation hedging should be looked at as a long-term, through-the-cycle strategy. The transactional risk element is derived when assessing the timing and magnitude of expected cashflows, the certainty of cashflows and any existing relationship between those cashflows.

Commodity risk may be assessed in isolation, but often it is helpful to combine the risk of commodity purchase/sales with currency cashflows to identify any diversification benefit embedded in the business.

Once all these metrics are examined, the strategic benchmarks can be deduced. For example, a firm might decide to hedge the full FX exposure relating to its foreign currency denominated assets and 50% of all its currency cashflows. Equally, it will decide how much of its debt should be fixed, floating and inflation-linked. Once this is set, the crucial questions of implementation – in particular, those of timing and execution – become critical.

WHEN IT COMES TO IMPLEMENTING TACTICAL HEDGING DECISIONS, TREASURERS OUGHT TO HAVE ACCESS TO SOPHISTICATED ANALYTICAL TOOLS AUGMENTING THEIR EXISTING RESEARCH.

To help with these, Lloyds Banking Group's risk solutions team has devised a set of tactical indicators designed specifically to assist and inform treasurers on the timing of their hedging decisions. The indicators' aim is to inform treasurers when it comes to answering the perennial questions of timing and duration. Is it a good time to fix interest rates? Should the fix be at the short or long end of the yield curve? Is it advantageous to hedge FX exposure now or at a later stage? And for which tenor?

TRAFFIC LIGHT SIGNALS FOR INTEREST RATES This indicator (see Figure 1) is based on three key technical metrics. First, we consider the attractiveness of outright swap rates. The idea is to help lock in funding at levels that are historically low. Second, we compute the cost of carry across a range of different tenors. Finally, we look at where we stand in the interest rate cycle. This is based on the view that interest rates are mean-reverting and cyclical in nature, so the peaks and troughs in the cycle can be identified: bias towards floating rates at the top of the cycle and bias towards fixed rates at the bottom of the cycle. For example, the current environment where the Bank of England rate is at an all-time low is likely to represent a historical low point of the cycle.

In addition to these metrics, we add a relative value analysis which is designed to indicate where the best value along the yield curve can be found. For example, given that there is an indifference to hedging tenors, the relative value analysis highlights the sweet spot on the curve.

CURRENCY RANKER Like the interest rate traffic light signals, the currency ranker is a decision-making tool that ranks the G10 currencies against each other, producing a set of currencies that are expected to weaken and a set that are expected to strengthen. This is designed specifically to help a treasurer determine the optimal strategy in managing the FX exposures of their company. The aim is to ensure treasurers have the sophisticated tools and analytics to assist them in the implementation of dynamic FX hedging strategies.

The analysis behind the currency ranker is based on a comprehensive set of metrics applicable over the short, medium and long term such as spot momentum, volatility, carry, trend and value. Then, a risk-return optimisation methodology is employed to combine these metrics, with the aim of creating a composite ranking as shown in Figure 2.

Finally, the ranker also tracks the previous performance of the individual signals, highlighting when different technical metrics go in and out of favour. This is useful in showing which technical attributes are driving the market at any given time. For example, past good performance in the value ranking might be an indication that currencies are reverting to their long-term equilibrium after a sustained period of trending.

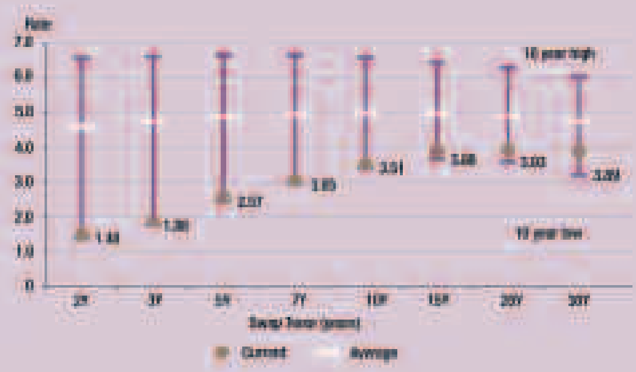
In practice, the currency ranker analysis can assist decision making. In the case of a British manufacturer exporting to the euro zone, the firm would likely have costs in sterling and revenue in euros. The company's competitiveness would therefore be linked to the level of the EUR/GBP exchange rate. Typically this risk would be hedged on a rolling basis. The currency ranker could be used to decide when to implement the hedges tactically. For example, if the analysis is showing sterling is due to strengthen, it may be an opportune moment to lock in an advantageous rate. In addition, medium and long-term indicators such as trend, carry and value can be used to inform strategic decisions. These can range from deciding the funding currency for a long-term investment at home or overseas as well as adding an important angle to the decision-making process relating to corporate deal-making such as asset purchase and disposals.

When it comes to implementing tactical hedging decisions, treasurers ought to have access to sophisticated analytical tools augmenting their existing research. They can use them to take full advantage of the potential value-generating opportunities that interest rate and FX markets regularly offer. This would not affect the overall strategic framework within which companies operate their hedging policies.

Better timing in FX execution and adjusting the bias within the tactical corridor of borrowings towards a higher proportion of fixed or floating rates can generate significant cost improvements. In a "new world of austerity", the availability of such tools to identify value and tactical opportunities could materially benefit a business's financial performance.

Figure 1: Absolute rate metric for sterling

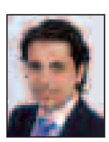
The absolute rate metric highlights the relative attractiveness of rates across different tenors



Source: Lloyds TSB Corporate Markets

Figure 2: The currency ranker

Source: Lloyds Banking Group



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