

THE FX CONUNDRUM

IF TREASURERS ARE TO ARGUE THE CASE FOR A NEW FX HEDGING STRATEGY, THEY WILL NEED TO PROVIDE REASSURANCE THAT ANY NEW PROPOSALS FIT WITH THEIR BOARD'S VIEW OF RISK. MARK O'GORMAN PROVIDES A FRAMEWORK FOR A MORE FLEXIBLE APPROACH



There have been many articles written in the treasury and risk management press in the past year on the relative benefits or costs of using FX option contracts versus FX forwards contracts for managing transactional risk.

With current euro weakness (the euro/US dollar exchange stood at around 1.06 at the time of writing) and relative US dollar and pound sterling strength against a range of other currencies, this is no surprise. Treasurers seeking to sell euros or buy pound sterling or US dollars forwards are now squarely stuck in the classic treasurers' conundrum – hedge with forwards to lock in a poor rate or leave their business exposed by reducing cover.

Faced with this conundrum, options – the ability to protect against adverse movements but benefit from positive

ones – are attractive. However, options are often dismissed on other grounds: they cause profit and loss volatility (an issue soon to be banished from IFRS accounting rules), they are expensive or are considered an expression of a 'view' on future rate movements.

Many corporate treasurers currently using an all-forwards strategy also take the philosophical view that hedging is a strategic matter – manage risk within their given mandate and stick to it. Using options would therefore be a tactical change, an expression of a view that the rate is about to improve.

In this article, we suggest an approach for treasurers aimed at building a strategy incorporating options to manage FX transactional risk. This is done using a framework where optionality may be used objectively, in a predetermined

SHUTTERSTOCK

way and within a corporate's specific risk appetite. Critical to the analysis is to help treasurers form a new hedging policy and robustly test it relative to their current one and a range of other strategies under different market conditions.

A strategic solution

For illustration, we look at a UK corporate that uses an all-forwards hedging strategy – layering forwards monthly out to 18 months. The corporate is view-agnostic, but believes that at least its 'majors' (euros and US dollars) tend to revert to their long-run averages. It therefore envisages that, relative to this long-run average, there will be times when the currency may be considered under- or overvalued. It will nevertheless not 'position' with a view on how soon the rate will mean revert. The corporate recognises that since implied volatility (the expected variation in the FX rate over time) is a key driver of option cost, there will be times when using options appears 'cheap' or 'expensive' relative to other times.

These assumptions – spot may be under- or overvalued and options cheap or expensive – create the basis for the strategy. The aim of the analysis is to identify conditions that have historically favoured option

use to devise an objective, view-agnostic hedging policy that employs favourable product combinations.

Favourable strategies may be defined as when:

- on average the strategy produces a greater positive return than other strategies, including the all-forwards strategy; and
- the 'worst' deviation (95th percentile confidence) from the all-forwards strategy is exceeded by the average positive return.

A back-testing approach for devising go-forwards strategies may well encounter scepticism. However, the goal here is only to indicate that options may be introduced in a controlled and simple manner to produce favourable outcomes. Forwards points and option premium are accounted for in the analysis.

Any strategy, if selected, must be easy to execute. For example, if spot and volatility are both high, a favourable strategy may suggest using 100% forwards for the given amount of cover that month, while if spot is low and volatility high, the strategy may switch to using 25% options, 25% collars, 50% forwards and so forth. The same combination of products is used whenever the same combination of spot and volatilities arise irrespective of where each has been or

EFFICIENT FRONTIER OF HEDGING STRATEGIES

