02
The HOW of Hedging

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Simon Bishop, Director and Head of Corpay Singapore, has more than twenty-five years' experience in foreign exchange trading and risk management, and seven years as a business owner. His experience spans the buying and selling sides of the market, and in his career, he has seen the good, the bad and the ugly.

In this three-part series, Simon seeks to shatter the myths surrounding currency hedging. He explains:

1. The **WHY of Hedging**: to hedge or not to hedge currency risk is your decision—and if you choose not to hedge, that is also a decision;
2. The **HOW of Hedging**: building your a strong strategy, executing and monitoring it; and
3. The **WHAT of Hedging**: selecting a hedging product or structure that aligns to your strategy and your hedging policy.

Simon explains the HOW of hedging here.

The HOW of Hedging

I've been in the foreign exchange business since the late 1990s, so I've seen a lot: the good, the bad, and the ugly. What I'm looking to do in this three-part series is to share as much of my experience as I can.

The first part of the series was about the WHY, and deciding whether to hedge or not. That is the foundation. The primary reasons why you might hedge are to protect your gross margin and to help create some certainty in your cashflow. Both of these items are critical to your business being successful.

This post is about the HOW: building, executing, and reviewing the strategy. How do you build it, how do you implement it, and how do you review it and monitor it to make sure it's right?

It's important, and not as complex as it sounds. Your business will tell you what you should be doing.

It removes a lot of the uncertainty about whether or not you should be hedging now. If you've got a good strategy, you can always work on improving it, which in my opinion is a lot better than not having a strategy at all.

What is important to consider here?

— Pricing.
  Pricing is not an accounting item but a component of your business. Consider how you price your product, for how long your prices are fixed, and how often you can change your pricing.
— Your risk profile.
  Everybody's risk profile is different. Are you comfortable taking on some of the currency risk, warehousing some of the risk, yourself?
— Your budgeted rate.
  What is the rate you need to achieve on your FX in order to protect your margins? And is that rate achievable?
— Your financial position.
  If you are in a good financial position, you might decide to hedge a portion of your requirement.
— Your competition.
  In a highly competitive business sector, currency hedging might be a challenge.
— Execution.
  Can you execute the plan that you have in place and the strategy you have in place? Do you understand the products you are using and the possible outcomes? And are you able to stay the course? At times you may be tempted to change your strategy because of a view on the market.

Importantly, when you're building a strategy, many of the above items are dependent on you and your business. Each business is different. Each product is different. Everybody's got a different risk appetite. I urge you to keep that in mind when you're looking at *your* pricing and *your* business.

Not a competitor or a vendor, not the opinion of someone unrelated to your business. It's your business and you'll make the decision on your strategy based on that.

The execution piece, though, is the same for everyone. In fact execution is where the vast majority of things go wrong.

I've seen some amazing strategies. Many, many years ago, I sat down with a publicly listed company in Australia that had a phenomenal strategy tailored to their quite complex business. The hedging policy document was actually created for them by a major consulting company (and cost in excess of $100,000). It was pages and pages long, but it suited the company. When I sat down with the CFO and said, "Righto, what have you got on the books at the moment for your hedges?" He turned to me and said, "I've got nothing on the books because the board hasn't given me authority to execute." This is where it falls down a lot of the time. And that was at a public company.

That happens more often than you think, particularly in the small and medium enterprise (SME) space in Singapore, where the boss hasn't given authority to the people that run the finance team. I noted in the last post that keeping good communications with your senior managers is important when it comes to the WHY of hedging; it's very important to the HOW, the execution piece, as well.

Setting your budgeted rate

The other components are your budgeted rate and your pricing cycle. We touched on pricing, but let's define the **budgeted rate**. It's effectively the foreign exchange rate that you utilize to price your goods and services.

For example, internally, you will choose a rate and then add your gross margin on top to make a locally based price. First you need to be sure that your product can be sold locally (and is priced competitively), and next, to be sure you're making enough money out of this product.

Most likely you will set your budgeted rate at a specific time in your planning cycle, say, when you are doing your budgets or looking at bringing in new product.

One thing to keep in mind is that your budgeted rate needs to be achievable. When you set your pricing for your customer, the budgeted rate needs to be achievable in the market.

And this is important because as interest rates move, forward rates also move. It's not just a question of adding a little margin to the spot rate, which is a fairly common approach, but you also have to consider the forward rate.

Further, the budgeted rate needs to be realistic. If your budgeted rate is the current spot rate plus 10 cents in USD/SGD, it's not realistic and you may actually price yourself out in competitive terms. Just make sure that your internal rate is achievable and realistic.

The pricing cycle

The pricing cycle determines how long your prices can be fixed. For example, you might have a product sheet that you provide to your customers for a set period: monthly, quarterly, or annually. In some businesses, prices may be contractually fixed for a given period.

From time to time I ask a client for how long a period their prices are fixed. They say, "Our prices aren't fixed. We can change them any time." When I ask when they last changed their prices, though, quite often it's twelve months or more, even though in theory, they could have changed their prices monthly. They just haven't done it. The key here is not necessarily the contractual issue, but more a practical one: how long in reality are your prices fixed.

Here are some real-world examples of pricing cycles and budgeted rates for some of our clients, and I've chosen some extremes.

One extreme example is a high-volume, very tight margin business—a meat exporter in Australia. Their margins are probably between 6% to 8%, but they price their product on a daily basis.

When their customer rings up or emails to place an order for $100,000 USD worth of beef, our client prices that order on the AUD/USD rate at that moment plus their gross margin. Because their pricing cycle is just a single point in time, they hedge on a deal-by-deal basis, generally via forwards. So a very, very short pricing cycle, and their budgeted rate is usually close to, if not exactly, the forward rate.

Another example is a quarterly cycle, a Singapore toy importer selling to a major department store. They manufacture or import from China and price their goods on the SGD/CNH exchange rate, valid for one quarter. Their risk window is that particular quarter, because they don't know what the price is going to be the next quarter until they update their price list.

If your prices are fixed for the quarter, you need to make sure your hedge is in line with that.

Many of our clients have longer pricing cycles, contractually or not. Let's look at a UK tech company importing hardware and selling it locally on a twelve-month contract. Their prices are in GBP, but they're buying in USD. Their budgeted rate will be set now for the next 12 months or for the period of the contract. As such they have to hedge according to their pricing cycle (i.e.: they hedge for 12 months).

Talk is cheap

But it can go wrong at times as well. Years ago, AUD/USD was about at parity, close to 0.9700. I had experience dealing with a toy importer client who had a quarterly pricing cycle. The CFO was at a barbecue, and heard someone saying, "The Australian dollar's going to go to 80 cents, fire and brimstone, four horsemen of the apocalypse, it's all over," or words to that effect.

So the CFO went back to the office and hedged for twelve months at 0.9700. And what happened?

The market went straight back up to 1.0500. For the first quarter he was all right: priced at 97 cents, and hedged at 97 cents.

When it came to quarter number two, he was still hedged at 0.9700 and priced accordingly. His department store client said, in effect, "No, you need to price us off 1.0500 because that's where the market is right now. It doesn't matter to us that you're hedged at 0.9700. Either adjust your price so your products are cheaper (in line with the market), or we'll source them somewhere else." The result was less gross margin for the toy importer client.

That's the importance of understanding your business.

Opinions about foreign exchange are everywhere, but concentrate on your business because *your business will tell you what you should be doing.*

Risk appetite

When it comes to defining your risk appetite, there are a few considerations. The first one's your financial position.

You might be comfortable taking on a little bit of risk. If your business has a very high gross margin, is very profitable and has a strong balance sheet, you may say, "I'm happy to be in a position where I can warehouse some of this risk."

However, if you're a company that runs a low cash position, low gross margin, and your financial health is not that great, the last thing you want to have is a situation where, in a challenging period, your profitability becomes questionable because you haven't hedged properly.

The competitive landscape

The next piece is the competitive landscape. Sometimes you might be in a position where you can't hedge, or hedging could be a challenge, because the competitive landscape is so tight.

I mentioned a client in a highly competitive business where the landscape was saying he shouldn't hedge.

But he had a very strong risk management philosophy and continually hedged. It worked out brilliantly because that unforeseen risk event saw a large number of his competitors go to the wall. So do take the competitive landscape into consideration.

Your personal preference

The last piece is personal preference. I mentioned earlier where your risk appetite comes in—what makes sense for your business. My risk tolerance might be quite different from yours, for instance.

Have a think about what's happened in the past, have a think about what you are comfortable with, and go from there.

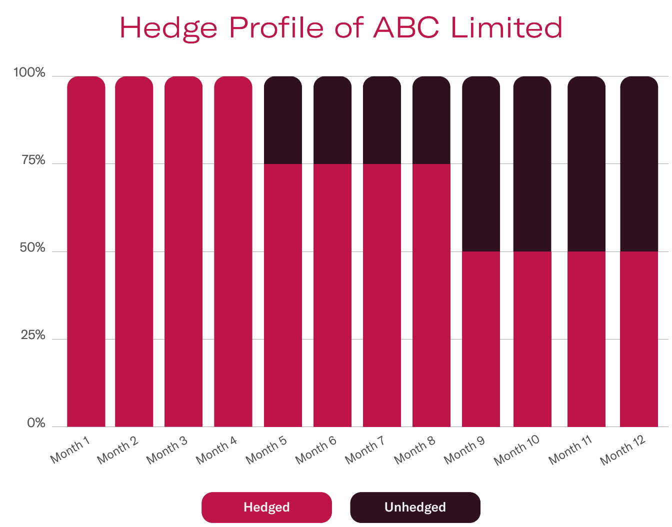
I am making a generalization; this isn't a hard and fast rule.

If you have a higher risk appetite, you'll most likely choose to hedge a lower percentage of your requirement, or consider more complex products. If you have a low risk appetite, you'd probably hedge a higher percentage across your portfolio, and probably use simpler products, like forward contracts.

I was talking with a client recently around a risk that they just wanted to remove. They have a strong financial position and a quite unique product: not too many troubles in the competitive landscape. Their personal preference is to remove risk, so most likely they will be hedged somewhere about 80% to 90% via forwards.

For most businesses these considerations don't carry equal weight so they make a choice that they are comfortable with for their strategy.

What is the outcome when you build your strategy this way? You've effectively created your hedge profile:



In the hedge profile above, the client is fully hedged for the first four months, 75% hedged for the next four (months five through eight) and 50% hedged in the back end. Now, this may be because of their forecasting, their pricing cycle, or their budgeting, any number of reasons. Effectively the vertical axis is the percentage hedged, from zero to a hundred percent, and the horizontal represents the timeline.

We have a client whose pricing cycle is three months and they plan to hedge 50% of their exposures in those three months. We don't even look at month number four for now because they haven't set their pricing yet. The number of months you would plan your hedging depends on your pricing cycle, and the percentage hedged is higher or lower, according to your risk profile.

Remember, though, that the selection of the hedging product within that framework is completely independent of the percentage you wish to hedge and the time frame.

Let me use an example here. If you want the potential to outperform the market, you would choose a participation product and still hedge to the percentage you planned in your hedging profile for the period in question. If you wanted protection, you would choose a different product but still hedge to the same planned percentage.

Independently, you decide on your hedge profile and then you look at the product or products to fill that 100%. But once you've decided on what your hedge profile looks like, make sure you stick to it and then choose the products within it based on your pricing cycle, budgeted rate, and risk appetite, and different performance outcomes.

Execution

I read an article in Forbes recently about why execution of a strategy fails. The top two reasons? Number one is communication. A lack of communication or unclear, nonexistent, or insufficient communication. Number two is commitment (or lack thereof). As I noted in the piece about the **WHY of Hedging**, if you go down the hedging path, stay true to the reasons why you're doing it and stick to it. The challenges begin if you flip-flop around.

So really clear communication and strong commitment are critically important to the successful execution of your strategy.

Documentation

You don't need a 500-page document like that other client had commissioned. It can be as simple as a one-page document describing what you're going to be doing, what percentage you're hedging, and what products you going to use. Make sure the communication is clear and it's documented.

Delegation

Make sure you have the authority, and make sure the authority is delegated out. It's as important for a big company as for a small one. Make sure the people who are in charge of executing the hedging strategy are comfortable and aware that they're allowed to do it.

Critically important: make sure that the reason why you are doing this is agreed to. And then follow up regularly to ensure compliance with the strategy.

I occasionally attend clients' board meetings, and the first question about foreign exchange should be, "Are we adhering to our strategy? Are we hedged at 70%? Yes. Agreed? Okay, let's move on."

Make sure that you are following this up, and for those of you who are business owners who have delegated this to somebody else, in your regular finance catch-ups, just have a conversation: "What's our hedge ratio? How much are we hedged? Let's move forward."

Let's move forward ourselves, to the review.

Review your strategy

It's critical that you regularly review how your strategy is performing. You can align the review to your business cycles, but it should be done at least annually. The reason is that your business may change. You may have a strategy that's based on a one-year pricing cycle, but something happens during the year that requires a more dynamic strategy and more frequent pricing changes. In the face of a change, do your review more quickly, and make sure you're happy with the outcomes.

Benchmarking

I mentioned outcomes earlier. Please do not—I'll say this again—please do not benchmark your performance against the current spot rate. The important benchmark is your budgeted rate.

To go back to the beginning, the reason why we're looking to hedge is to protect gross margin. If you've done that, it won't matter where the spot rate is.

Benchmarking

Last but not least, adapting to change. Have a look at your business holistically:

- What's happening within the business? Are we able to manage this?
- Are we happy with the outcomes? Or did we choose a product that we're not particularly happy with? Okay, we'll look at the product set.
- Are we comfortable with our 100% hedge ratio or our 70% hedge ratio? Do we want to change that?
- What's happened over the period? Communicate the results.

Let the team know what you're happy with, let the team know what you're not happy with. Give the finance team and the sales team the ability to weigh in.

Why the sales team? The sales team are ultimately going to be impacted by how well you hedge. If you hedge poorly and you've got to change your prices all the time, or there's gross margin changes, the sales team gets frustrated, so communicate.

Now, with all these things in mind, you can formulate your strategy.

The last thing I'll say here is 'lean on us.' At Corpay, we do this all day, every day. We see a lot of clients, we see a lot of things that are working, things that are not working. Pick up the phone, and tap into our experience.

We're happy to have a review session with you. We'll come out to your offices, we'll run through what you've done in the past.

How's it been working? Do we need to make any changes? Are we happy? Move on.

Are we not happy? Let's make some changes.

Again, lean on us. This is what we do.

Q & A

Q. *Our finance team sets their rate each month; should I hedge for one month?*

A. The better question is, how long are your prices fixed for? If the pricing hasn't changed in the last three years, you might want to hedge for longer than one month at a time. I'm not saying you go out and hedge for three years, but look at the option of longer hedging periods.

The monthly rate, the rate set each month, is quite often an accounting rate, not your budgeted rate. Your budgeted rate is the rate that you set internally for the price of your goods for a period of time. That's the number you need to be looking at. Make sure you remove the noise and concentrate on your strategy and execution.

Q. *We don't have a system to help us monitor our hedge. How can we look to manage the risk?*

A. You don't need a full-blown treasury management system, and in fact, many of our clients can do it on a spreadsheet. We can help you create that. In fact, for a lot of our clients we send through their hedge profile.

Keeping it simple is extremely important. If you have a spreadsheet that effectively replicates that bar chart up to 100%, with your time plotted out on the horizontal access, you can look at it from there.

In fact, we're developing tools that are designed to give you more visibility and more autonomy in creating your hedge profile. Watch this space!!!

Q. *We have a board member who's firmly against hedging and thinks we're better off not to hedge and keep playing the market. What would you suggest?*

A. Oh, I have met some armchair experts over the journey. I have seen clients whose finance teams and even members of the board want to implement a hedging strategy, but either an owner or other board insists that it won't work.

My advice to clients on that front is to quantify it. And make sure your reason why is clear: "We want to make sure we've got gross margin protection. If we don't do this and the market moves 5% against us, this is what the impact will be on our profitability." We can help you with some scenario modelling.

Let your armchair expert be seen as the expert. Take their opinion into consideration, but argue against them with the numbers. Quantify your argument.

Q. *We've got a long-dated government contract, more than two years. How should we hedge?*

A. You should always to try and match your hedging tenor to your risk window, particularly if you have a tight margin. If you have a two-year risk window, you might consider hedging for two years.

It can be quite scary to look out two years, though. Part of the challenge of looking out two years at this moment is the forward points. If you're a USD buyer in Singapore, for instance, your forward points are actually a long way in your favor, but if you're a seller, it is against you. Take that into consideration when you're looking to hedge out.

Let me explain what I mean by forward points. At this point in time, a client that's looking to buy USD out two years will get a significant discount and a better rate, but a client who's looking to sell dollars will get a worse rate because of the interest rate differential—the difference in interest rates in Singapore and the US.

But don't let forward points scare you away from your risk management. Just because the forward points are against you, whether it be long-dated USD seller, long-dated JPY buyer for instance, it is a fact of life at this moment.

The cost of your forward points will more than likely be a minuscule amount relative to what the market could move. Don't let the forward points scare you away from doing something to protect your margin.

We've gone through the WHY, and now the HOW. In the next piece, we have the WHAT: the product selection. We'll go back to the bar chart, the hedge profile, and have a look at the different types of products that you can utilize to fill up your bar charts.

To keep it simple, there are effectively forward exchange contracts and there are FX options. The outcomes for FX options are a little bit more complex relative to a forward, which has a binary outcome: If it goes up, you do this, if it goes down, you do that. It's simple.

Some of the FX options we offer have more variability in their outcome. We'll explain that in our next post.

If you would like to learn more about hedging and the WHY of hedging, please reach out to your dealer or request a call-back here.

To watch Simon's webinar on the HOW of hedging, please click here.