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The WHY 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 WHY of hedging here.

The WHY of Hedging

In my experience, everybody begins with the what: the currency hedging product. But the product is the end result, not the beginning. You need to understand the *why* and the *how* before you get to that end result. Otherwise, the end result becomes a very binary outcome: good or bad, did it work or not.

Let's begin at the beginning: the *why* and the *why not* of hedging. I'll start with my favourite quote from Warren Buffet, the Oracle of Omaha, arguably one of the most successful investors in recent history. He says, "Only when the tide goes out do you discover who's been swimming naked."

It's a really good way to look at currency hedging. When the market is not moving (or is moving in your favour), everything's great. It's easy. Businesses often don't worry about risk then because there's no real concern around what could be around the corner.

However, when the tide goes out and you get caught, a really good hedging program can help your business manage currency risk.

As a business owner involved in import or export or both, your focus should be on generating more sales, not worrying about where the USD/SGD exchange rate is heading or where EUR/USD is going. Focus on how you can sell more product, not on the foreign exchange markets.

To hedge or not to hedge? That is the question

We're going to start off with the why: WHY should you hedge. Part of my job is to help educate you on the potential benefits and advantages of doing one thing versus the other: effectively, it's your decision to hedge or not to hedge. If you make the decision to hedge, we can support you. If you chose not to hedge, we can also support you. But together we might want to explore relevant reasons why hedging could be a prudent strategy to incorporate into your business practices.

Yes, deciding not to hedge is also your choice. There may well be a circumstance where not hedging is financially better than hedging. There's no doubt that that can happen, but it all goes back to the reason why you are doing it. To break it down simply, if you go down the 'to hedge' path, what do you get? You get potentially more certainty of gross margin and cashflows. You potentially reduce the volatility of income and you get ease of planning.

If you decide not to hedge, you *might* have an outcome that outperforms the outcome if you had hedged. However, what you *will* get is greater uncertainty of gross margin and cashflow, a potential increase of volatility of your income, which may make it more difficult to plan. If you don't know what your cashflow is going to look like over the next six months or you don't know how much profit you're going to have, it becomes very difficult to plan for the future.

Creating certainty

Deloitte[1] conducted a global foreign exchange study a few years ago. The top two reasons clients chose to manage risk—by a long way—were related to creating certainty.

Number one was to reduce income statement volatility in local earnings. And number two was to protect cashflows in the reporting currency.

Neither of the first two priorities in that study is about getting the movement in the FX market right—a very difficult thing to do. In my twenty-five years' experience, I would say even the best traders probably only get it right 65% of the time. If you are busy running a business, how can you be expected to get the FX market right?

First, protecting your margins makes your planning easier. Protecting your cashflow allows for easier forecasting. If you know exactly how much money (and profit) you've got coming in, you don't need to lean on your debt as heavily, and spending and investment can occur with less stress.

If these two outcomes are important to you—reduced income statement volatility and protecting cashflows in your reporting currency— you might consider embracing hedging.

How FX volatility might affect your business

Let's take a look at where foreign exchange fits into the business, because this is really the fundamental part of your business that interacts with the WHY.

Here is a hypothetical example of a basic profit and loss statement.[2]

ABC Imports has sales revenue of about 20 million, and the cost of goods sold is about 17 million. We've got 3 million worth of gross profit and a gross profit margin of about 15%.

[1] Deloitte Global Foreign Exchange Survey 2016

Profit & Loss Example ABC Imports	
Sales Revenue	20,000,000
Less Cost of Goods Sold (COGS)	-17,000,000
Gross Profit	**+3,000,000**
Expenses	-2,500,000
Net Profit	**+500,000**

If we then look at everything that goes below the gross profit line, rent, wages, interest payments, all of the other items, net profit is about 500,000. A relatively normal business. The magnitude of the numbers may be different from business to business, but the basics would pretty much look like this.

So where does foreign exchange fit in? Foreign exchange and hedging are all above the gross profit line, either impacting your sales number if you are an exporter, or your cost of goods sold (COGS) if you are an importer.

But what happens if the market moves? This really comes back to why we should be looking at managing the currency risk.

Let's run a scenario analysis on the profit and loss (P&L). If there were an 8% adverse move in the currency during the period, what would it mean? Our cost of goods sold in the import business goes up effectively by 8%. We still make a gross profit, but it is a significantly reduced gross profit. Our cost of goods sold have gone from 17 million to over 18 million.

Profit & Loss Example ABC Imports	
Sales Revenue	20,000,000
Less Cost of Goods Sold (COGS)	-18,360,000
Gross Profit	**+1,640,000**
Less Expenses	-2,500,000
Net Profit	**-860,000**

The expenses are effectively fixed, and with an 8% move in the currency market, we've gone from having 500,000 in net profit to a loss of 860,000.

We are dealing with the same fundamental business, a previously profitable business. But because we didn't manage our risk, we've had the pain of going from being a profitable business to being a loss-making business.

Now you may be wondering why I chose 8%. On average, USD/SGD moves 8% every year. Look at the percentage moves from high to low for other currency pairs: (2022): USD/SGD is generally a fairly non-volatile currency.

But look at the percentage moves from high or low in 2022:

USD/SGD	8%
AUD/USD	24%
USD/JPY	35%
GBP/USD	33%
EUR/USD	21%

Imagine, then, if you had a business where the currency moved 24% against you over a given period. You're facing not just a small loss, but a significant loss. This could impact the business, or even see it go broke. There are many examples of strong, decades-old businesses going broke due to bad management of FX risk.

What happens next?

One of four things would be most likely happen in the circumstances where gross profit margin is eroded, where we've seen our business go from projected as being profitable to potentially being in loss.

1. Increase prices. We might just increase our prices—sounds easy enough. We might see a more consistent gross profit margin, but sales revenue may drop because your clients might not buy from you anymore. Further, many, many things may restrict you from changing your prices: the competitive landscape for instance, or fixed-term contracts.

2. Reduce expenses. The next most common thing is reducing expenses. But it is not particularly easy to make this happen quickly. You may think, "Oh, actually, we're just going to have to lay off some people. We reduce the wage bill. We might have to move to a different facility that's cheaper to rent." But that might cost you money. You could look at saving money on insurance or utilities, or marketing, which

[2] All examples presented in this article are hypothetical and for illustration only.

is usually the first area to cut. Cutting marketing, though, might affect your future sales revenue.

With any reduction in expenses, there is often a flow-on effect.

3. Dip into reserves. The third option might be to dip into your reserves. You say, “You know what? 2022 was a tough year. We’re just going to take the hit and roll on into 2023 .” But that working capital may well have been earmarked for a new product line, an expansion. The lack of profitability—and the decision you make—could affect your future.

4. Borrow money. The last one, which is also extremely common, is ramping up the overdraft for a period of time until things settle down. The problem is that that gets exacerbated in future years because number one, you’ve got to pay off the debt, and number two, it increases your interest expense.

   If the reason why you hedge is gross profit protection, the ramifications of not appropriately managing risk can be very, very negative into the future as well.

Why you might hedge...

Recapping the reasons why you might hedge your currency risk then:

You should consider hedging if you want to reduce income statement volatility and reduction in volatility of local earnings. It’s as simple as that. If you want certainty, embracing the hedging path is a good option.

And again, to protect cashflows. Making sure your profitability stays consistent and predictable, and likewise, your cashflow.

And why you might not

As I noted earlier, *not* hedging is also your decision.

First, don’t hedge if you’re not fully committed to it. When you’re facing that choice to hedge or not to hedge, it’s okay to be a little bit concerned, but history and experience has shown me that if clients go down the hedging path when they’re not fully committed to it, it becomes a little bit of a luck-of-the-draw about whether or not they’re happy. Make the decision, have a look around at the reason why, and commit to your strategy. We can help you run through the advantages and the disadvantages of hedging or not hedging when it comes to your business.

Next, do not hedge if you want to speculate. You might speculate in the market with your own investments, but not with your business. Hedging is about protecting your business. It’s not about trying to outperform the market.

Another reason not to hedge: you don’t have FX risk.

You might have a ‘natural hedge’ with flows on both sides of the market. For instance, if you are selling in USD and buying in USD, you have no need to hedge.

I had a client many years ago who had a volume-based contract with the government to sell a hundred thousand units of a particular product. The price was set on the day that the government paid. Our client ordered the product and paid for it on that same day, so there was no FX risk. We advised them not to hedge as a result.

In short: if there’s no FX risk, do not create risk.

Lastly, don’t hedge if you don’t understand the hedging product that you’re considering using. There is a vast array of different currency hedging structures, from a basic vanilla option where you pay a premium, or a forward exchange contract that guarantees certainty, right through to enhancement and out-performance products like knockouts and target approval redemption forwards (TARF).

If you don’t understand the variables that might affect the outcome, the product is potentially not right for you.

This is our job. We’ll spend the time with you to help you understand the reasons why you might (or might not) hedge; what approach might be right for your business and your objectives, and the products that might help you achieve those objectives, and the advantages and disadvantages.

Q & A

Here are a few questions that I hear frequently from clients about their hedging.

Q. *Many bigger firms have a no-hedging policy. In your opinion, why is this, and how can we advocate for hedging?*

A. We often get this question in Singapore because it is a hub for multinationals. Often companies with large-scale operations across the globe will have a central treasury.

Central treasuries look at the overall risk of the business and often they will net it out. While one currency may move, the overall business isn't affected because another part of the business might be getting an advantage.

I understand the difficulty, though: quite often local subsidiaries can be on one side or the other of that movement.

You might consider having a conversation with your central treasury, or with your CFO or your senior finance team, to quantify the pain and the challenges that you're feeling. Spend some time with the numbers and talk with them about whether you might be able to hedge in-house.

I've seen that happen a few times, where the head office gives autonomy to the subsidiary. But it's all about quantifying the risk and making sure you can demonstrate why you want to be able to do this.

Q. *I don't hedge because I was burnt when the market moved in my favour. My competitors benefited but I couldn't take advantage of the move because I was locked into the hedge.*

A. This is probably the biggest reason why clients don't hedge, the perception of being burnt.

Here is an example of a Singapore-based USD buyer, who hedges at 1.3500 to buy USD. Then the USD drops to 1.3100, a very common circumstance. The buyer hasn't been burnt as long as the budgeted rate that they are looking to achieve is at or above 1.3500.

This is what I mean: if you are looking to sell an item locally where you have an internal conversion rate of 1.3500, and you achieve that on your hedge, you have ticked the box on achieving a gross margin.

Yes, you could have achieved a more favourable exchange rate if you had done nothing, but this goes back to the decision about why you want to do this to begin with.

If you want to hedge to protect gross margin, hedge and be happy with that. Make more money by selling more items. Don't make more money by trying to pick the market direction correctly.

I address this in my next post, the HOW of Hedging, but it's good to note that hedging does not have to be an all-or-nothing proposition. Most of our clients don't generally hedge everything. You might be 50% hedged, you might be 75% hedged, allowing the potential to participate in favourable moves if they occur (but also potentially feel the pain of adverse moves).

In my third post in this series, the WHAT, I'll address product. There are some structures that allow you to protect an underlying exposure, and at the same time, participate should the market move in your favour.

Again, think about why you are looking to hedge to begin with. If you want to protect your gross margin and that's what you've accomplished, you haven't been burnt.

Q. *Our competitors don't hedge. In theory, we could be at a disadvantage if we do. What are your thoughts on this?*

A. Let me give you another example, of a client we had in Australia. He'd been in business for more than thirty years in a very competitive market, tight margins and high volume.

This client had a beautiful hedging policy—and he always hedged his exposures. He told me, "If the market moves in their favour, my competitors can lower their prices and it does have a slight impact on me. But I'm looking longer-term, protecting against that unforeseen risk event."

And then we had a year where the Australian dollar dropped 25%. All of his competitors who were unhedged went out of business and he sat there happily making his gross margin.

So in a competitive landscape, your unhedged competitors might get a little advantage. However, experience has shown me that clients that play the long game often end up with a better result.

Q. *My boss complains when the market goes against us if we don't hedge, but I'm worried that if I do hedge, we could have got a better rate and I'll get in trouble.*

A. Very, very common situation in Singapore. The solution I propose is a conversation with senior management, so they understand why you're doing this.

There are two sides to this:

Number one is making sure senior management understand why you're doing it.

And number two, which we'll talk in the HOW piece, is execution autonomy. If you have a good hedging strategy in place, there needs to be a very strong line of communication between the decision makers. So give your people the authority to do it. Let them make the decisions, based on your hedging strategy.

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 WHY of hedging, please click here.

To learn more, visit
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