CFA Institute
Investment Foundations

ARTICLE SERIES

COMPANIES STEP UP FX HEDGING AFTER BIG MOVES IN EMERGING MARKET EXCHANGE RATES

In October 2013, Reuters ran the following report: "After months of volatility in emerging market currencies and deep uncertainty over the outlook for the dollar, bruised companies have stepped up hedging of their foreign exchange exposure. Providers of protection against big moves in currencies, which can wreak havoc with budget plans and eat into corporate profits, say business is up."

But what does this really mean?

In today's global economy, almost every company is exposed to foreign exchange (FX) rates, be they cash flows from an overseas subsidiary or the impact of exporting sales or importing inputs and raw materials. Hedging (*covered in Module 3 of the CFA Institute Investment Foundations™ course of study*) is a common risk management strategy used to limit exposure to fluctuations in the exchange rates.

Foreign exchange transactions take place in the spot market or in the forward market.

- The spot market is where currencies are traded now and delivered immediately. The exchange rate for the transaction is called the spot exchange rate or spot rate.
- In contrast, the forward market is where currencies are traded now but delivered at some future date. In the forward market, the exchange rate for the transaction is called the forward exchange rate or forward rate, and there are as many forward rates as there are delivery dates:
    - a one-month forward rate for delivery in one month
    - a two-month forward rate for delivery in two months
    - a three-month forward rate for delivery in three months

A Supermarket Example

A French supermarket chain imports dairy products today from the UK for £100,000 and has one month to pay the invoice. The exchange rate quotes are as follows:

- Spot rate = €1.20/£1
- Forward rate, delivery in one month = €1.22/£1

If the French supermarket chain paid the British producers today on delivery, it would use the spot market and spot rate. Therefore, the French supermarket chain would convert euro immediately at the spot rate of €1.20/£1 to get the £100,000 to pay the British suppliers; so it would have to pay €120,000.

However, in reality most businesses offer their customers a time to pay their invoices. So now let's say the French supermarket chain has one month to pay the invoice, allowing it to sell the goods and realize the cash to pay the invoice. It faces currency risk because the supermarket will raise euros by selling the goods but will have to pay the invoice in pounds in one month's time and the exchange rate between the euro and the pound is likely to fluctuate within the next month.

In order to hedge the currency risk, the French supermarket chain can use the forward market. It would take the following steps:

- Enter today into a forward contract with a bank or currency dealer. The forward contract specifies the exchange rate for the transaction in one month. This exchange rate is the forward rate with delivery in one month (i.e., €1.22/£1). No actual movement of money takes place today.
- In one month, the French supermarket chain converts euros into pound sterling at the agreed exchange rate of €1.22/£1. Thus, it pays €122,000 [£100,000 × (€1.22/£1)] no matter what the spot rate is on that day.

Therefore, the French supermarket chain knows for sure how much the import will cost (€122,000) and can price its goods accordingly in euros today.

Note that if the spot rate the day of the transaction is more advantageous than the agreed exchange rate, say €1.21/£1, the French supermarket chain cannot benefit from it because it has committed to convert at €1.22/£1; therefore, it must provide €122,000 to the bank or currency trader, and it will still get £100,000 in exchange.

Our Lesson In Clarity: Hedging

Hedging is not about trying to make a profit out of currency fluctuations but about obtaining certainty around the cash flows of running a company. Today, companies import goods from around the world and export sales to overseas customers; therefore, it is often vital to limit exposure to volatile exchange rates that can impact the volatility of their earnings. Understanding the spot rate and the forward rate helps companies protect their assets and mitigate risk.