



International Outlook

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IN THIS ISSUE:

Overcoming Objections to FX Hedging



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Is Foreign Currency Hedging Speculating?

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In this era of market globalization, it is virtually impossible to avoid being exposed to some form of foreign currency risk. Whether your company is exposed directly in the form of foreign currency receivables or payables, or indirectly, through an overseas competitor's pricing agreements, identifying and taking steps to manage these risks before they impact your bottom line has become crucial to running an effective business. Unfortunately, many companies have misconceptions about FX hedging and don't explore it as a risk management technique. Today we'll look at three of the most common objections to hedging and separate the facts from the myths.

Is Hedging FX Speculative?

We sometimes hear this comment from clients, particularly those new to doing business internationally. Hedging is simply a form of risk management, similar to buying insurance. Hedging involves taking an equal and opposite position in response to an underlying FX exposure to protect against adverse price movements. The end result is that a gain incurred by one position is offset by an equal loss in the other. In a perfect hedge, all currency risk is taken out of the equation and you are left with the exact numbers you anticipated at the time of the commitment. This allows you to focus on your core business, and trust that your numbers are undiluted by FX fluctuations. For instance, let's suppose you agree to sell a \$1,000,000 piece of equipment to a customer for EUR 800,000 at the exchange rate of 1.25 (\$1MM equivalent) with 30 day payment terms. The moment you enter into this contract you are now at risk of currency fluctuations, and have entered into what we call an Embedded Derivative. Although you did not purchase a derivative in the open market, you have created risk for the company by the way you structured the transaction.

Speculation, on the other hand, involves taking an uncovered position (consciously or unconsciously) in the market in hopes of achieving a gain. Many people do not realize that choosing not to hedge a known FX exposure is the most speculative stance one can take, as one is subjected to 100% of the market movement between the time the

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contract is written and when the currency is actually exchanged. In the above example, a company that does nothing has instantly decided to enter the world of currency speculation.

My company is not exposed to foreign currency risk because we deal only in US dollars.

Perhaps the best way to illustrate the fallacy behind this is through a couple of examples:

Suppose you are selling a product to a customer in France, and decide to invoice your French client in U.S. dollars, because you feel that this will eliminate your foreign currency risk. The dollar then strengthens against the euro by 10 percent over the next three months before the client is required to pay for your product. So even though the U.S. dollar price invoiced to them has not changed, you have effectively raised the price of your product because dollars are now more expensive in France. You risk losing customers and sales to a competitor who bills his French clients in euro, because they are selling their product for 10 percent less.

Here's another example from my experience: a client insisted they had no FX risk, since they sold everything in U.S. dollars. One of their markets was Mexico, and they regularly gave their client in Mexico 3 months to pay for their orders. During this time, the Mexican peso devalued overnight by about 50 percent. The Mexican company now owed our client TWICE as many pesos as they did just the day before. So, what did the Mexican company do? They kept the entire product order, and did not pay their bill (as they were financially unable to pay). This caused a huge loss to the U.S. manufacturer, and their Mexican client went out of business.

FX rates even out over time, so hedging is unnecessary.

Given an unlimited time frame, this statement may prove true. Unfortunately, treasury decisions have to govern much shorter time spans; usually a few months to 1 or 2 years. Take a look at the movement of the euro over the past 10 years:



One could hardly say that the euro has evened out in this period, nor in any given short-term time span within it. Assume your company is purchasing product in euro on a monthly basis. Let's consider the change in price of the euro for the 2-year period starting in 2006

The euro appreciated from 1.2156 in January of 2006 to 1.4589 at the end of 2007. That's a 20 percent increase in two years! Just think: how would a twenty percent increase in your cost of goods sold impact your company's financials?

Conclusion

Effective risk management is about identifying, analyzing, and implementing procedures to minimize unnecessary risks to your core business. It is also about ensuring some level of financial predictability to future earnings. To this end, structuring a proper FX hedging strategy can dramatically improve the bottom line of any company exposed to foreign currency risk.