

# Thinking AHEAD



## KEY TAKEAWAYS:

- Whenever market expectations become widely accepted by economic actors, those expectations get reflected in the prices of derivative contracts.
- A wholly distinct class of companies have an exposure to the risk of *falling* interest rates. The market essentially *pays* these companies to hedge their exposures, as opposed to exacting a cost.
- Any hedging decision should be forward-looking, asking what could happen in the future with a fully *unhedged* exposure. Unfortunately, in a world with uncertainty, that's a difficult judgment to make.

## Adjusting hedge coverage as the market changes

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**T**he thing about risk is that it keeps changing. Whether it's due to ever-evolving macroeconomic conditions or firm-specific developments, a firm's capacity to cope with change is anything but static. This realization justifies an ongoing process of evaluating and adjusting hedge coverage as time passes or as material price adjustments arise.

### The market challenge

One of the tricky aspects underlying the determination of how much to hedge is that whenever market expectations become widely accepted by economic actors, those expectations get reflected in the prices of derivative contracts. For example, when everyone is convinced that interest rates are poised to rise, the cost of hedging against rising interest rates incorporates these expected rate increases. The more dramatic the expected price change, the higher the cost to hedge that risk.

At the time of writing this article, for instance, the consensus view is that interest rates are expected to rise over coming quarters, with 3-month LIBOR projected to reach about 2 percent by the end of 2018. Those expectations are built into prices for interest rate swaps and other interest rate derivatives (e.g., caps, floors, collars and futures contracts). For hedgers exposed to rising interest rates, then, putting a hedge in place today generally means accepting rate increases that are currently widely anticipated. Put another way, those expectations foster a hedging cost.

A wholly distinct class of companies operate with exactly the opposite risk concerns—i.e., having an exposure to the risk of *falling* interest rates. These firms would be cash-rich companies—or more likely financial institutions—that earn interest revenues. For such firms, consensus expectations of higher interest rates actually serve as a hedge *inducement* in that derivatives pricing allows these firms to lock in more attractive (i.e., higher) interest rates than those currently available, as reflected by spot market conditions. In effect, the market is *paying* these companies to hedge their exposures, as opposed to exacting a cost. These opportunities arise when consensus expectations assess the proposed hedged risk to be a low probability event, but just because the risk is deemed to be unlikely doesn't mean that it should be ignored. Rather, this set up may present a particularly opportune time to hedge.





The vast majority of nonfinancial treasury departments face the risk of higher, rather than lower interest rates, so this consideration may not be particularly meaningful. The concept might be more applicable, however, in connection with raw material or commodity purchases and sales. With these products, nonfinancial businesses more evenly divide between suppliers and demanders, where suppliers face the risk of lower prices while demanders bear the risk of higher prices.

**Futures prices**

Whether derivatives favor one side of the market or the other can be inferred from the configuration of futures prices. Futures

contracts are readily available for a wide array of basic commodities, and they serve as the building blocks for virtually all over-the-counter derivatives instruments (e.g., swaps, caps, floors, collars, etc.). Futures prices are readily accessible on the website of the CME Group (formerly the Chicago Mercantile Exchange), the exchange that hosts trading for the vast majority of U.S. commodity contracts. By looking at the configuration of futures prices, one can readily determine whether you happen to be on the side that pays for hedging or the side that gets paid for hedging.

A listing of their most active contracts is shown in the accompanying table:

|                    |   |
|--------------------|---|
| <b>ENERGY</b>      |  <ul style="list-style-type: none"> <li>Crude Oil (WTI)</li> <li>Natural Gas</li> <li>Gasoline</li> <li>No. 2 Fuel Oil</li> <li>Crude Oil (Brent)</li> </ul>                              |
| <b>FX</b>          |  <ul style="list-style-type: none"> <li>EUR/USD</li> <li>JPY/USD</li> <li>GBP/USD</li> <li>AUD/USD</li> <li>CAD/USD</li> <li>MXN/USD</li> <li>CHF/USD</li> </ul>                        |
| <b>AGRICULTURE</b> |  <ul style="list-style-type: none"> <li>Corn</li> <li>Soybeans</li> <li>Chicago SRW Wheat</li> <li>Soybean Oil</li> <li>Live Cattle</li> <li>KC HRW Wheat</li> <li>Lean Hogs</li> </ul> |
| <b>METALS</b>      |  <ul style="list-style-type: none"> <li>Gold</li> <li>Copper</li> <li>Silver</li> <li>Platinum</li> <li>Palladium</li> </ul>  |

With the exception of the currency contracts (FX), most futures contract prices will typically be said to be in *contango*. This term simply means that prices for more distant valuation dates move higher and higher, as you extend out in time. This pricing configuration thus tends to favor the suppliers (i.e., sellers) of these commodities, as it allows these firms to lock in more attractive prices for future sales than the firm can realize today. While this situation is fairly typical, it's not always in effect. That is, sometimes, futures prices will be lower for more distant months, which would favor demanders (i.e., purchasers). Futures prices would be said to be in *backwardation* in those situations; and *backwardation* favors the demanders.

Foreign exchange rates are another story. For the currencies of countries with developed capital markets, forward pricing is determined by covered interest arbitrage, which causes the forward prices of foreign currencies (i.e., non-USD) to be at a premium to spot prices whenever U.S. interest rates are higher than foreign interest rates, and vice versa; but these conditions change over time. As of this writing, forward prices for euros are at a premium to spot prices, while forward prices for Mexican pesos are at a discount to spot prices. Thus, under these conditions, U.S. exporters to the eurozone enjoy the benefit of forward pricing, while importers from the eurozone would be subject to somewhat of a forward pricing penalty. These characterizations would be reversed with counterparties to U.S./Mexican trade. Here, the U.S. importers would have the hedging advantage, while the U.S. exporters would bear the penalty.

Critically, whether futures prices are in *contango* or *backwardation* is certainly a consideration, but in most cases, it shouldn't be overriding. That is, even if the pricing of futures—and hence all related derivatives—are adverse for a given entity, this consideration needs to be balanced by the risk for which hedging is being considered. In other words, even if the cost of hedging may seem high, the consequence of not hedging might be far greater. The decision to hedge or not to hedge is one that requires assessing the trade-off of bearing known cost, today, versus bearing the risk of a far greater cost in the future.

In the normal situation, if there is one, most hedgers will tend to view forward price premiums or discounts as being minor relative to magnitudes of prospective price changes, such that the incremental cost or benefit discussed above would be seen as acceptable. Occasionally, however, hedges can appear to be either overly cheap or overly expensive. And, presumably, if and when such judgments can be made, they should reasonably influence the decision to hedge, or, more specifically, the determination of how much to hedge.

### Looking ahead

Ultimately, any hedging decision should be forward-looking, asking what could happen in the future with a fully unhedged exposure. Unfortunately, in a world with uncertainty, that's a difficult judgment to make, as one can never be sure if most recently observed price changes will be extended or reversed. In any case, independent of these expectations, to the extent that unacceptable prospective outcomes are recognized to be possible, derivatives can be used to mitigate these risks. Critically, the decision to hedge needn't be all-or-nothing. Rather, hedges can be phased in and out, as the perceptions of risk and hedging costs vary. But you have to pay attention.

My own sensibilities lead me to prefer making periodic reassessments of hedge coverage, augmented by reassessments whenever unanticipated price adjustments arise that challenge previously held expectations. Additionally, I favor reliance on a rules-based process for determining how hedge coverage should be adjusted, as opposed to reliance on purely subjective judgements of any group or individual. By rules-based, I'm suggesting the use of objective criteria for deciding on how much to adjust hedge coverage. Incorporating such practices adds discipline to the hedging process and reduces the chances that ill-considered transactions will be consummated just when market conditions are most volatile.

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