Measuring and managing foreign currency exposures: History and markets can guide you

LAURENCE HAYWARD is senior foreign exchange advisor for Silicon Valley Bank. He has 33 years of experience in the foreign exchange and interest rate markets as a banker, broker, trader and marketer/advisor. He has worked in the major cities of the world including London, Singapore, Hong Kong, New York and Denver for Barclays International, First National Bank of Boston, Tillett and Tokyo Forex International, Gulf International Bank, and Silicon Valley Bank among others. He has been published in The Wall Street Journal, The New York Times and Consumer Reports and many periodicals.

“A quantum shakeup” is how Laurence Hayward described what has been happening in the global financial markets in the last 18 months. Addressing the conference co-sponsored by KPMG and the University of Colorado Denver CIBER, Hayward said, “It’s possible to be 100 percent hedged against any foreign currency risk 100 percent of the time provided you do it right.”

What does it take to do it right? “It’s all a matter of timing and understanding some of the things that drive currencies,” Hayward said. “The amount of time you spend on foreign exchange matters should be proportionate to the company’s exposure compared to earnings and the maximum loss that could be caused by that exposure.”

Hayward acknowledged that the subject of foreign currency exposures is complex and outside the comfort zone of most executives who are not directly involved in finance. “I don’t think it’s reasonable for me to expect people to do something they don’t feel comfortable with. So I take the education approach — educating people who want to learn before they leap.”

Defining currency risk

In broad terms, risk is exposure to anything with the potential to produce negative numbers on your company’s financial statement. In international business, companies face the risk of one currency changing in price against another. Consequently, the need to make an investment that will reduce or hedge the risk. A perfect hedge reduces the risk to nothing except for the cost of the hedge. “Risk should always be negated,” said Hayward.

Interest rate differentials need to be taken into account when choosing a hedge. “When you’re dealing in foreign currencies you’ve got different interest rates for each one. And those interest rate differentials have an effect on what you do when you are hedging. Interest rates in the US are now about 2 percent below the euro; just nine months ago we were 1 percent higher than euro rates (figures are as of May 1, 2008).

“The only thing that creates risk on an exposure is leaving time between when the exposure is known and when the hedge is put in place. Many people fail to manage their currency exposures because they don’t understand what they should do,” said Hayward.

“It helps for the company to define whether the currencies it is exposed to are high or low risk and whether or not they are fixed to the dollar. After that, company strategy should define which hedging instruments can and cannot be used.”

How the market moves

Markets are fickle, the psychology fragile, the eccentricities many. “Markets trade and react on the difference between expectations and what the reality turns out to be. The combination of chart points, data releases, news, expectations and which way the market leans in favor of one or more of these components will dictate how it moves,” said Hayward.

“Sometimes market participants try to be too clever and trade against expectations. If the expectations are wrong they quickly make adjustments, short covering or liquidating their positions.”

That said, there are ways to sort through fast-changing data and determine if market bias trends toward the bulls or the bears. “Listen to the markets,” said Hayward. “They will tell you things you can use and learn from.”

Sophisticated traders study history along with financial data and current events to forecast trends and make judgments.

MOST COMPANIES IN THE UNITED STATES DO NOT SPEND TIME ON FOREIGN CURRENCY EXPOSURES PROPORTIONATE TO THEIR IMPORTANCE.

“Looking at history and how recent history has changed can guide you as to where your investment is going and help you guess tomorrow’s best-case exchange rate.”

Also, Hayward said, be especially observant of geopolitical risk because political changes can signal instability in a country which in turn could drag down investment returns.

“A lot of equity flows and investments have been going into China and India. Their currencies haven’t been active in the way conventional currencies have been,” said Hayward.

“The Chinese yuan is state controlled and the Indian market is a very young market. You might think that the Indian rupee would be strong because it is convertible, unlike the yuan. But the highly volatile mentality of the domestic Indian investor has a huge impact on their market, and that makes me wary of the currency.”

As interest rates in the US have come down, “there has been a gradual slowdown in the amount of incoming cash flows which have helped to fund the deficit here. This has some huge economic implications,” said Hayward, adding, “the funding of the US deficit is about foreign central banks like those of China and Japan buying US Treasuries.”

For more information on US-cross border financial transactions and other trade data, Hayward recommended the Treasury International Capital system (TIC) website: www.ustreas.gov/tic.

To further your education about foreign exchange, go to the website of the Federal Reserve Bank of New York: www.frb.org/markets/foreignex.html and click on Federal Education.

To read some of Laurence Hayward’s articles, go to the Silicon Valley Bank website: www.svb.com.

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