Does hedging exchange rates always make sense - it depends!

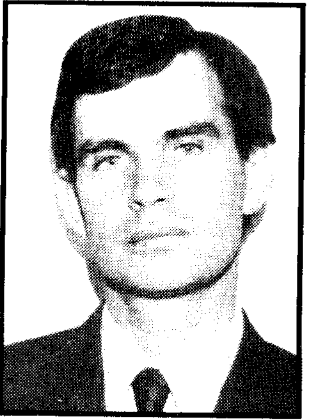
THERE is no reason why a firm has to manage risk due to exchange rate uncertainty. A fundamental tenet of finance is that risk and return go hand in hand. A firm reducing its exchange risk also is likely to remove possible gains from favourable exchange rate movements.

So, why bother hedging at all? When a chief executive stands up and proudly says that his business is not exposed to exchange rate risk, there is rarely an acknowledgement that such a practice could have a major opportunity cost in terms of eventual gains foregone.

Finbarr Bradley, Professor of Finance at Dublin Business School, and Programme Director of the M.Sc. in Investment and Treasury, explores the subject further.

He says that a co-operative/plc can only protect itself against unanticipated movements in exchange rates. It cannot protect itself from what the market expects to happen, which is implied in the forward exchange rate.

To illustrate the above concept, consider the situation faced by Kerry or Avonmore this time last year, when exporting casein to the US. Contracts would have been entered into in dollars, at around 2.0 dollars per lb. for delivery, say three months later. At the time contracts were agreed, the exchange rate was 1.61/£. At delivery date, not only had the price of casein risen



Finbarr Bradley, *Professor of Finance at Dublin Business School.*

to about 2.35 per lb., but the dollar depreciated (the pound appreciated) to about 1.81/£.

This was an unexpected occurrence. A look at Table A shows that the forward rate in April was 1.58/£., a far cry from what actually transpired to be the case, when the dollar depreciated to 1.81/£. Had a co-op/plc not protected itself in some manner against the unfavourable currency exchange rate movement, it would have lost out on the amount of punts obtained, upon conversion, when it received payment.

One way a co-op/plc might have protected itself was to hedge, on the contract date, by taking out a forward contract with a bank, thereby agreeing to sell dollars to the bank for Irish pounds on the delivery date. The key issue is that the rate of exchange is agreed on the contract date, irrespective of what eventually happens to the spot exchange rate on the delivery date.

The exchange rates in Table A show that the US dollar depreciated (Irish pound appreciated) steadily from March 1992 through to September 1992. A co-op/plc that was far-sighted enough (dare I say, lucky enough?) to have locked into a three-month forward rate of 1.59/£ in March 1992 gained (relative to what it would have obtained), since the actual spot rate on the delivery date in June 1992 was 1.75/£.

A co-op/plc which repeated the exercise by again hedging, using three-month contracts in April, May or June, would similarly have gained since in these months, the actual spot rate exceeded the forward rate prevailing three months earlier.

However, from July 1992 onward the reverse held true. A co-op/plc would have been better off remaining unhedged since for these months, a higher number of pounds was obtained by converting at the eventual spot rate rather than at the forward rate.

So, the co-op has three main alternatives available. Two of these we have discussed already: A, Do nothing or remain unhedged, and B, Hedge or lock with certainty.

These two approaches, however, are at either end of the risk management spectrum. In between these two extremes, there is a wide range of financial instruments, which permit the transfer of risk from one party to another, more willing to accept that risk.

For example, the same casein exporter above could have taken out a type of insurance policy (by buying put options) to sell dollars at a fixed exchange rate, thereby allowing them to take advantage of favourable movements in the exchange rate, while simultaneously placing a floor on the worst outcome.

Optimal approach

So, going back to the earlier question on the optimal approach to use, the answer is that it depends on three factors:

The co-op's attitude to risk, the co-op's/plc's confidence in its prediction or forecast of the eventual spot rate, and the trade-off in the cost of insurance/hedging versus the benefit of having this protection.

Table A

Date	Spot rate	Three-month forward rate
	$	$
March '92	1.62	1.59
April '92	1.61	1.58
May '92	1.67	1.65
June '92	1.75	1.72
July '92	1.81	1.78
August '92	1.88	1.85
September '92	1.86	1.80
October '92	1.71	1.66
November '92	1.66	1.59

Major contract for International meat Ingredients

DETAILS of a major new contract for an Irish company to supply meat-based pizza toppings to one of Europe's largest food outlets, Pizza Hut International, was announced this week on the CBF stand at the IFE, by Minister for Food, Brian O'Shea.

The contract was won by International Meat Ingredients Ltd., which is a joint venture between Dawn Farm Foods Ltd. and Rosani Foods Inc. of Dallas, Texas.

The business is initially worth £5m per annum and has potential to increase to £10m., as Pizza Hut continue their drive for International growth. The Pizza Hut brand is owned by Pepsico, who control over 8,800 outlets in total and sales of £3.3 billion in 1991.

CBF, the Irish Livestock and Meat Board, is supporting the Dawn Farm Foods promotional drive to expand business levels. Paddy Moore, chief executive of CBF, said that "their research has found that 50 per cent of the meat consumed in the major EC markets is processed, whereas currently just 10 per cent of Irish exports to Europe are in processed form."

Dawn Farm Foods is part of the Queally Group and is managed by Larry Murrin. The company has recently commissioned a new £7m., high technology processing plant at Naas in Co. Kildare. The objective of the new company is to become the principal supplier to Pizza Hut International in Europe, Africa and the Middle East.