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Say When



The starting point for any hedging program is identifying some source of risk, which then becomes the candidate for becoming the “hedged item” in a prospective hedge. Once this risk is identified, assuming the manager knows *how* to hedge (i.e., what instruments can be used to offset assorted financial exposures, how these tools are priced, where to affect a transaction, and how the tools are likely to perform), the next critical step is deciding *how much* of the exposure to hedge.

Any determination about the portion of an exposure to hedge is inevitably the outcome of a business judgment. Underlying this decision is consideration of *current* price levels, *prospective* price forecasts, and some estimate of what is achievable on the basis of transacting derivatives now, at their current prices. In some sense, then, initiating a hedge transaction might be considered to be a pricing decision—a decision to accept the consequence of hedging now, as opposed to leaving the exposure unhedged and thus accommodating to pricing conditions that arise later. Thus, the idea of fully hedging any exposure at one point in time reflects a view that current pricing opportunities are likely to be better than those that are likely to arise over the risk horizon prescribed by the derivative’s termination date. Maybe that will be the case, but maybe not.

A prudent risk manager should recognize the folly of trying to pick the best time to institute a hedge. Perhaps the better approach might involve phasing into hedges over time, thereby avoiding the prospect of getting stuck

Determining how much to hedge is a critical ingredient to any hedging program

with an adverse price extreme by happenstance. Critically, a phase-in approach leaves open the possibility that the desired protection won’t be in place in advance of an adverse price move. Alternatively, plunging into a hedge all at once comes with the opposite concern—that the hedger might miss out on the possibility of trading derivatives at more favorable prices later. Like it or not, the imposition of the hedge is a timing bet. If you’re right, you win; if you’re wrong, you might not lose, but you’re won’t win by as much as you might otherwise have.

A practical way to approach this dilemma is to specify a target coverage range—say, between 45 and 55 percent of the exposure under consideration. With this range explicitly determined, a hedge of 50 percent would be initiated at the start, but if and when the derivative

become more attractively priced (i.e., cheaper for long hedges; richer for short hedges), the hedge coverage would adjust upward to a maximum of the upper bound of the range. Similarly, as the derivative becomes less attractively priced, the hedge coverage would be reduced. Conceivably, the company could end up with hedge coverage oscillating between 45 and 55 percent of the exposure, perhaps multiple times throughout a hedge horizon. Ultimately, the approach institutionalizes a program that buys low/sells high (or sells high/buys low), contributing beneficially to the bottom line even if prices remain in a relatively narrow channel.

One potential impediment to implementing a program like the one suggested above may be the question of scale. Some aggregate exposures may simply be too small, making these types of incremental adjustments impractical. But even this concern may be overstated. In general, futures contracts may likely serve as viable tools for such incremental hedge adjustments when exposure sizes are limited.

Under a phase-in approach described above, hedgers should appreciate that they would add to the hedge coverage precisely when previously initiated hedge positions are registering losses, and vice versa. Admittedly, this process may be a difficult discipline to follow. After all, when our hedges are generating losses, doesn’t that suggest that the rationale for imposing the hedge in the first place may be suspect? If we impose a hedge to protect against the risk of rising prices and then prices fall (thereby fostering losses on the

hedge positions), doesn't that suggest that we might want to reduce coverage, rather than increase?

In essence, this question relates to whether our original range for hedge coverage deserves adjustment. It's not clear that it necessarily does, but consideration of this possibility is certainly in order. It's not at all clear whether the change in circumstances will dictate an adjustment of the original target range for hedge coverage. This decision continues to require a business judgment; but the issue deserves to be addressed rather than ignored.

This recommendation—that targeted coverage ranges require ongoing scrutiny—strikes at the heart of, arguably, one of the most common errors for relatively new or inexperienced hedgers. These hedgers often tend to view their hedging decisions as sacrosanct. Once put in place, hedges remain in place until that derivative termination date, regardless of any new information that might be revealed over time. This approach is shortsighted. Exposures are not static, nor are derivatives prices, nor are companies' appetites for risk; and as these parameters adjust, so, too, should any associated hedge coverage.

The directive to re-consider the hedge coverage range comes with a caveat. It's one thing to adjust positions in response to perceived trends that might develop over the course of weeks or months. It's quite another to respond to perceived trends that develop over minutes or hours. Inevitably, with any market move, one can't be certain as to whether the observed price change is indicative of a trend that will continue, or evidence of a temporary price adjustment that is likely to reverse in short order. Ultimately, this determination should be the basis for any subsequent adjustment in the portion

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of the exposure to be hedged. Decisions relating to adjusting hedge coverage should be forward looking. The same issues underlying the original decision should apply, reflecting consideration of the latest price levels, prospective price forecasts, and what is achievable on the basis of derivatives' pricing as of the point of reconsideration.

Accounting considerations

It may be useful to clarify two accounting issues related to managing a hedge in the manner prescribed above. First, it should be understood that the kinds of hedge adjustments envisioned with the above approach are fully consistent with all guidance pertaining to hedge accounting. That is, reporting entities are free to de-designate and re-designate hedge relationships (or portions of hedge relationships) at will. Such de- or re-designations have no consequence in terms fostering any acceleration of reclassification of

previously deferred hedge results.

That said, there is one prospective concern that deserves mention. Qualifying for hedge accounting requires that the hedge must offset the risk being hedged during the period for which the hedge is designated. There are no requirements (or impediments), however, relating to the performance of multiple hedge relationships pertaining to the same hedged item. For instance, one could place a hedge to cover a particular risk, remove that hedge, and then later re-hedge that same exposure. Conceivably, the same price move could evolve in each of the respective hedging sub-periods, in which case, the two hedges, together, would end up offsetting twice the impact of the hedged item's price change. This consequence is perfectly fine and has no subsequent impacts if the derivative generated (excess) gains. On the other hand, excessive losses could possibly stimulate the requirement to reclassify losses early, in consideration of impairment requirements. While this outcome is probably of low priority, it shouldn't come as a surprise.

The above caveats need to be appreciated, but they shouldn't obscure the main points of this article: Hedging allows us to harness the power of derivative instruments to mitigate the effects of uncertainty, but employing derivatives to their best advantage requires making ongoing adjustments to hedging coverage to respond to new market information as it arises and/or changes of circumstance.

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