

The Long View

First steps in designing a risk management program

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Deciding whether to hedge starts with the acknowledgment that the firm faces some exposure. Companies with debt bear interest rate risk, those that operate internationally bear foreign exchange rate risk, and those that buy or sell basic commodities bear commodity price risk. Every enterprise likely faces at least one of these kinds of price risks, but not all companies elect to manage them.

There is a difference, however, between electing not to hedge, as opposed to not hedging by default. The former course might be fully justified and understandable, but it is hard to view the latter course as anything other than an abrogation of fiduciary responsibility. After identifying one or more of the above price exposures, management should determine the desired degree of exposure to maintain, and any residual exposure should be a candidate for hedging.

The hedge horizon

One of the first issues that must be confronted in this process is that of setting the hedge horizon. Should we think about managing exposures expected to arise during the next year, next three years, next five years, or even longer? Clearly, there is no unique, correct answer; different firms will make different determinations. But whatever the horizon chosen, we should realize that risk still lurks beyond that horizon. Put another way, we can only expect a hedging program to mitigate the effects of adverse price moves through the term of the hedge. Ultimately, after the term of the hedge horizon, the company would again be subject to market conditions.

A critical consideration in setting this horizon is that companies should only seek to hedge exposures that are expected to be realized with some reasonably high degree of confidence. Management certainly would not want to find that it acted to lock in prices for exposures that never materialized. And more likely than not, the longer the hedge horizon, the lower the confidence we are likely to forecast exposures that will necessarily arise. It is one thing to project financing needs in the next 12 to 18 months. It is quite another thing to forecast those requirements 15 years out.


The nightmare scenario would be one where a company implements a hedge for a forecasted exposure, generates losses on that hedging derivative, and then finds that the exposure never comes about. In such cases the hedge losses would stand alone, rather than offsetting any bona fide risk. On the other hand, if the risk materializes without being hedged and an adverse price move develops, the company also suffers. Which is worse? Unfortunately we are stuck not knowing until it is too late.

A pragmatic response to this structural problem is to revisit the question of whether or not to hedge on a periodic basis. Irrespective of the stipulated duration, this discipline will foster a process that serves to phase in hedges over time, as the hedge horizon extends to farther and farther time brackets. This outcome has some intuitive appeal.

To a certain extent, entering into a hedge is a pricing decision. Hedging now would be most appropriate if you thought that the current opportunity (i.e., current pricing of the derivative) was the best it would likely be before the critical exposure date. Waiting—or perhaps never hedging—would be best if you thought that better terms likely would be available later. The lack of certainty with regard to this issue would seem to be an argument that would discourage an “all-or-nothing” process.

Rolling hedges

Even assuming the forecast of the prospective exposure can be made with sufficient confidence, some companies might feel that they cannot address more distant exposures because of the lack of actively traded longer-dated derivative contracts. A work-around for this concern might be to maintain uninterrupted hedge coverage using a series of shorter-dated derivatives. While deserving consideration, this “rolling hedge” strategy should not be expected to perform perfectly. The imperfection arises because the ex ante difference in the price of the replacement derivative versus the original derivative is uncertain. That is, we will not know what this price difference is until we actually execute the roll. Ultimately, this price difference will foster a cost or a benefit, depending on which contract is being purchased and which is being sold. A look at history



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might help in estimating the likely magnitudes of these price differences, but prices pertaining to coming roll-overs won't necessarily be similarly these past price differentials.

Critically, while using a longer-dated derivative that covers the entire span of the desired hedge duration likely has a more predictable outcome, the end result will not necessarily be better in terms of dollars and cents than that which would arise with a rolling hedge strategy. The rolling hedge may end up delivering a more attractive outcome—or it could be worse. No way of telling, beforehand.

Even after the above considerations are sorted out, another part of the calculus underlying the determination of the hedge horizon may be what your peers or competitors are doing. Suppose your company hedges against adverse price changes, and your competitors do not. Obviously, your company would have the comparative advantage if the adverse price change arises, but if it prices move beneficially, your competitor would likely outperform your firm.

Your competitors are unlikely to be fully transparent about their risk

policies, but at least some information should be reflected in their disclosures, as companies are now required to disclose on a quarterly basis when their derivatives mature. The longest dated derivative thus might reasonably be a clue to that company's minimum horizon underlying their risk management decisions—at least, with respect to the category of risk associated with those derivatives. That is, companies may typically apply different hedge horizons in connection with their interest rate risk, say, as opposed to their foreign exchange rate risk. In any case, it is important to realize that disclosures reflect past decisions; and if the reporting company is operating prudently, these positions will be adjusted periodically.

Once the length of the risk management horizon is determined, the fun begins. Whether or not to hedge a particular coming exposure within that time frame depends on finding either that: a) the un-hedged position leaves an unacceptably large probability for an unacceptable outcome due to an adverse price move; or b) the prevailing pricing

of derivative contracts allows for locking in an attractive—or at least acceptable—price. In my experience, too few companies give sufficient consideration to this second consideration.

The current interest rate environment offers a good example relating to this point. Short-term interest rates have been remarkably stable over the last several years, and conventional wisdom (as reflected by consensus forecasts reflected in forward interest rate pricing) calls for only modestly rising interest rates in the next couple of years. This mild interest rate forecast has provided justification for many companies to allow their hedges of short-term borrowing exposures simply to run their course, without extending or replacing them as their expirations approach. The relatively modest forecasted increases in interest rates may very well allow these firms to secure historically low interest costs. Failure to extend hedging now could be a costly error. Ultimately, when the prospect of more substantial rate increases becomes more pressing, the opportunity to hedge at seemingly attractive prices may well have passed.

Setting an explicit hedge horizon and revisiting the issue of hedge coverage on a recurring basis imposes a useful discipline—a discipline that forces a transcendence of hedging from a trade to a process. Unless hedge horizons are adjusted as time passes, many opportunities available from derivative instruments will necessarily go unrealized. You will only find them, however, if you are looking.

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