




HEDGING WITH OPTIONS: AN OPTION STRATEGY CAN CONTRIBUTE TO A COMPANY'S EFFICIENCY IN MORE WAYS THAN ONE

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The fundamental attraction to going long an option is having the right, but not the obligation, to buy or to sell an underlying commodity or currency at a predetermined price. Compared to forward contracts, which fix an obligation to buy or sell the underlying at a predetermined price, options offer the additional flexibility to take no action if caught on the wrong side of a trade at or before option expiry. This cuts potential losses to the premium paid to enter an options position.

Some practitioners have been reluctant to use commodity or FX options because of required cash outlays for buying them and perceived challenges in valuing and reporting option positions once traded. Justifying sustained funding to maintain an options program can be especially tough when cash is dear. However, recent volatility in both commodity prices and major currencies has strengthened the business case for using options if they are well understood and if the facilities are in place for a company to maintain, adjust and report on its options portfolios.

Many companies have reconsidered their reluctance to use options as they review their hedging programs or consider initiating new hedging initiatives. Option strategies may take on new appeal as practitioners consider the protection offered by options compared to the commitment involved in using forward contracts to hedge cost or price risk.

For example, a U.S.-reporting corporation earning British pounds (GBP) from a subsidiary anticipates receiving GBP cash in settlement of its accounts receivable from its customers, one month hence. If management feels that GBP will continue to decline relative to USD, it might sell the anticipated GBP inflows forward at a rate close to the current prevailing rate (ignoring interest rate differentials that would change the agreeable rate of exchange for the moment) to lock in an acceptable rate of exchange. The risks in using a forward contract in this case are:

1. If GBP strengthens relative to USD before next month, the company is still obligated to perform on the forward at the predetermined rate, resulting in an opportunity loss if the spot rate at the time would have provided a better exchange rate (more USD for each GBP). Recall that the forward contract is to sell GBP in exchange for receiving USD.
2. The company will have to perform on the forward obligation anyway, to the volume agreed, even if the forecast GBP inflows do not fully materialize.



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An options position has much different implications. To address the same anticipated GBP scenario, the company could instead go long a USD call option against GBP. This gives it the right but not the obligation to buy USD in exchange for GBP at a predetermined rate of exchange. Alternatively, the equivalent position can be stated as going long a GBP put option against USD – the right but not the obligation to sell GBP in exchange for USD at a predetermined rate of exchange. Either interpretation results in an initial cash outlay to put the position on. However, the position holder has no obligation to perform on an option beyond paying the initial premium. One would presume that an in-the-money option position would be cashed in if the GBP cash inflows materialize (thus closing out the hedge). An out-of-the-money option position would simply be left to expire, in the knowledge that the premium paid to put it on is lost. So the advantages in using options as described are:

1. If the option can be traded, the hedge position (the option) could be closed out to coincide with the forecast inflows, presuming the tenure of the option position lasts at least as long as it takes to realize the GBP inflows.
2. The option represents buying a level of certainty for an exchange rate, locking it in without selling the upside in exchange for an up-front premium. In the example, if the GBP strengthens against expectations, the company can simply exchange the realized GBP at an advantageous rate for USD (relative to the rate locked into the option) and let the option expire.

Whether for protection against rising input costs (say, hedging natural gas for plastic producers) or protection against falling prices (say, the selling price of copper for a mining company) or profit margins on outputs, options represent contingency protection against unplanned price movements, whereas forwards are clear commitments to buy or sell at a predetermined price or rate. Many argue that contingency risks should be mitigated using contingency instruments, while others say forwards basically, give up the upside in exchange for more certainty.

Today's greater willingness to use options strategies recognizes the need to analyze potential strategies up front and to track their valuations on an ongoing basis once implemented.

Under increased scrutiny, corporate treasuries now have greater responsibility for monitoring and analysing risk than they did before the credit crisis. Even in organizations with an independent, focused and separate risk-management function, treasury's attention is trending toward liquidity and working-capital management. The liquidity penalty for not monitoring the impact of derivatives on one's funding and collateralization requirements, and therefore cash forecast, is arguably higher today than it was pre-crisis. Likewise, the responsibility for monitoring derivatives is falling increasingly on treasury.

Perhaps more than other instruments, derivatives involve counterparty risks whose measurement can become very complex. The solvency of counterparties was once taken for granted, but practitioners are now questioning how to measure, monitor and prove the suitability or tolerance for exposures. To mitigate counterparty credit risk, some corporations are diversifying their banking relationships. In the case of commodity and FX exposures warranting hedges, companies are adding options to their forward positions to provide a closer or more flexible match to their exposures.

Meanwhile, the position reporting and maintenance burdens that once precluded the use of sophisticated options strategies no longer apply. Once the benefits of using these instruments are acknowledged, then lack of processes or technologies to enable their use becomes the only obstacle.

Technology as a strategic enabler

Corporations with FX exposures previously left unhedged must carefully assess a new program or a renewed effort to better protect better against unforeseen FX changes. This will prevent such problems as over-hedging – an unwanted exposure within itself. Companies should conduct this analysis, before executing a hedging transaction, as part of either a strategic initiative or the ongoing maintenance of financial strategies. Either way, appropriate technology is required to evaluate portfolio behaviour at the start and to detect deviations from intended outcomes once a strategy is implemented.

The translation and transaction exposures of hedging portfolios depend on position valuations to alert treasury and risk management to daily standing (FX and otherwise) and cash flow expectations. For some corporations, derivative position valuations and risk reporting are new metrics of sustainable value reported at the board level. Commonly at quarter's end, compliance with reporting requirements must be met. Therefore, technology solutions required to benefit from hedging include regular and on-demand valuations.

Enabling technologies must combine the required market data and analytics to generate theoretical and historical valuations for portfolios, both in planning and on the books. Affordable systems are of paramount importance when handling complexity. They must be simple, easy to understand and accessible. Valuations will be required on demand or at intervals dictated by their reporting purpose. Treasury will have time to analyse detailed valuation issues but must produce these details when required. Systems must be right the first time. They must combine position and market data inputs and show clearly how the data were determined.

Once valuations are available on demand, the opportunity arises for scenario analysis and strategic planning using timely and recent valuations. This creates higher value and more current and informative reports, especially for companies whose exposures are large and actively managed.

Markets are now calling for quality of growth, echoing the call for quality of earnings in previous years. The additional transparency achieved through reliable, systematic and regular valuations of derivatives will create sustainable value in sectors where interest rate, commodity and FX derivatives have a pronounced influence on the corporate bottom line. As much as volatility has revealed derivatives to be lurking risks in many cases, informed usage supported by timely valuations can guard against negative surprises while creating an information base to devise and maintain financial strategies.

A hedging strategy must define boundaries and the degree to which a hedging program should reflect varying levels of confidence in, say, FX inflow or outflow forecasts. Valuation information is equally useful for total picture forecasting and for reporting derivatives properly.

If yesteryear's problem was optimizing inter-company cash by gaining access to latent pools of liquidity held internationally, the current trend is acceptance of the operational burdens that come with introducing hedging, electing to do hedge accounting, or using instruments not used before to achieve strategic financial management goals.

Affordable valuation technologies make option strategies possible, easily monitored and efficiently assessed on the fly. The strategic value of building a fundamental valuation capability should not be underestimated. It can provide an effective barometer to potential strategies and tactical indications of slippage from plan.

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