World First Whitepaper:

Hedging currency effectively

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A fairer exchange

Currency markets fluctuate by the second, impacted by hundreds of factors; from jobs data in the US, to manufacturing figures in Europe or an election in Asia.

For anyone who is involved in sending or receiving goods from overseas, this kind of movement can have serious implications for their business. This is one of the key reasons why more and more businesses are looking to manage their risk with the right kind of hedging strategy.

When it comes to protecting yourself in the currency markets, especially when importing or exporting is concerned, navigating exchange rate fluctuations can sometimes be a tricky business.

The key to success is not to overcomplicate things. Let's start with what you shouldn't do. Leaving yourself completely 'unhedged' is something you should always try to avoid. Simply put, leaving your business completely exposed to the inevitable ups and downs of the currency markets is highly risky and ill-advised.

While it might work out ok in the end, a bad week for the pound can see it lose 4-6% of its value. This kind of movement can easily put a large dent in your yearly profits if you leave yourself exposed. Fortunately there are products available which will provide all the flexibility you need, but with none of the associated worry.

Really, the key to a good currency strategy is diversity. You should use a variety of products to manage risk and maximise the protection your business can get. Your main product choices are spot contracts, forward contracts and currency options. Each has a valuable role to play.

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Using 'Spot Contracts'

If you've ever converted currency, it's likely that you'll have used a basic spot contract. The spot rate is the exchange rate on any given day. You're quoted a rate, which you accept, and the transaction is done straight away. Easy.

The only issue with spot rates is they can be quite risky, as you're totally reliant on the market rate of the day – no matter what that might be. Currency rates fluctuate dramatically, rising and falling every second. When rates are moving in your favour, it's great. However, using spot rates alone offers you no protection if rates move against you and you can find yourself below the rate that you have budgeted for. This is the 'unhedged' position we talked about above.

If all you need to do is a single transaction, fairly soon (i.e. within a week or two) a spot contract could be the way to go and they certainly play a key part in any currency strategy.

A spot contract is the simplest way to exchange one currency to another. However, as mentioned before, the one thing it cannot do is protect you from the constant movement in exchange rates. There are many products that can help on this front. The most common is called a 'forward contract'.

Fix the rate in advance with a 'Forward Contract'

A forward contract allows you to protect an exchange rate for a date sometime in the future. No matter how much the rate moves against you, you have locked in a 'worst case rate' that you are able to exchange your money at.

This is extremely helpful for managing your finances, as you don't have to worry about nasty surprises. However, a forward contract doesn't let you benefit from any upside if the exchange rates move in your favour; for that you need to look to 'Currency Options'.

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Currency Options

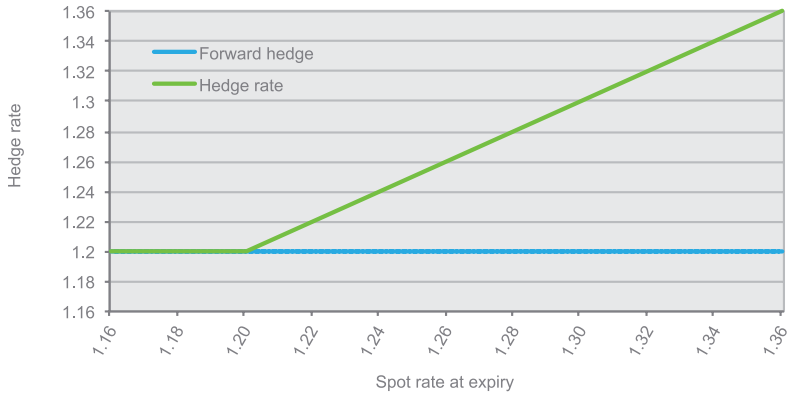
As we've mentioned, a Currency Option allows you to be protected from adverse movements in exchange rates, while also allowing you to benefit if rates were to move in your favour. There are many types of Currency Options available depending on your budget and appetite for risk. Here are a few of the most common ones:

Protection Option

The simplest improvement to a forward we can make is known as a Protection Option. Here, for a fee, the buyer can protect themself at a certain level, known as a 'strike' or worst case rate (WCR), whilst allowing for any upside.

Firstly you can take out a forward contract at 1.20 and be done with it. You have made sure that currency movements will not negatively affect your business.

The alternative is to take out a Protection Option with a strike of 1.20. Come July one of two things will happen, either the sterling / euro exchange rate will be trading below 1.20 or above 1.20. In the case of the former, the option allows you to protect yourself against the move lower. While if the rate has moved higher then you can take the trading rate on the day.



As an example, let's say you are paying suppliers in Italy and have budgeted at a sterling/euro rate of 1.20 and you're due to pay in July, the figures are as follows:

At expiry, spot rate is 1.15	You buy euros at the protected rate of 1.20
At expiry, spot rate is 1.22	You buy euros at better rate 1.22

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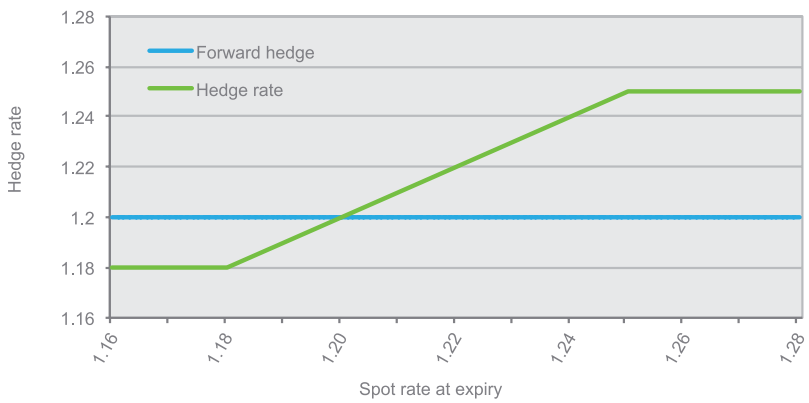
Risk Reversal

A Risk Reversal is very similar to the Protection Option but, for a reduced cost, it limits the amount of upside that you may benefit from. Because of this limit, the premium (fee) is reduced or eliminated. So, continuing the example above, you would be protected at a rate of 1.18 but only able to benefit up to a capped level of maybe 1.25. That level (e.g. 1.25) is up to you to determine, and depending on what level you choose, the savings will differ: less upside, more savings and vice versa.

Should you wish to see the cost reduced to nothing there are modifications that will allow you to do that too. However, in all of these instances you are protected if the rate moves against you.



If we look at some comparisons, at expiry the figures would be as follows:

At expiry, spot rate is 1.17	You buy euros at the protected rate of 1.18
At expiry, spot rate is 1.20	You buy euros at euros at 1.20
At expiry, spot rate is 1.27	You buy euros at the capped rate of 1.25

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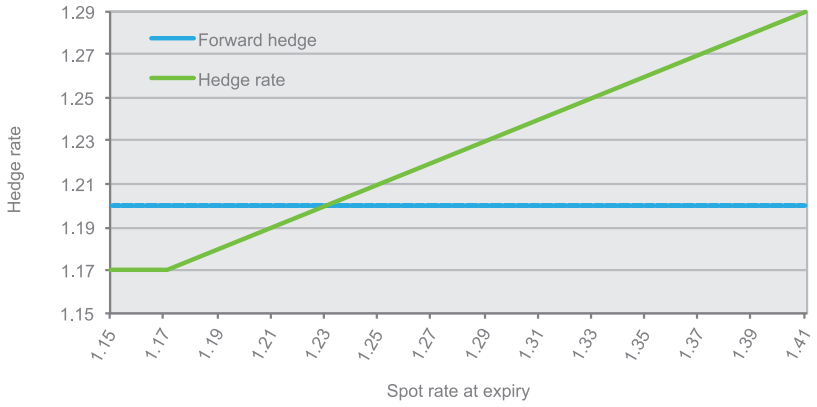
Participating Forward

A 50% Participating Forward differs from the two previous options by being premium free, but still allowing you to benefit from 50% of all upward movement. The absence of the fee limits the amount of freedom you have but still gives you protection.

With the Participating Forward you have to take a lower worst case rate to compensate for the lack of an upfront cost and in this case you are protected at 1.17. If at the end of your hedge the rate is below 1.17, you are completely protected. However, if it is above then for every two cents above 1.17 you receive one, i.e. if the rate was 1.21, you would collect 1.19.



Here is how various scenarios would play out on expiry:

At expiry, spot rate is at 1.14	You buy euros at protected rate of 1.17
At expiry, spot rate is 1.20	You buy half your euros at protected rate of 1.17 and the other half at 1.20, giving you an average rate of 1.1850

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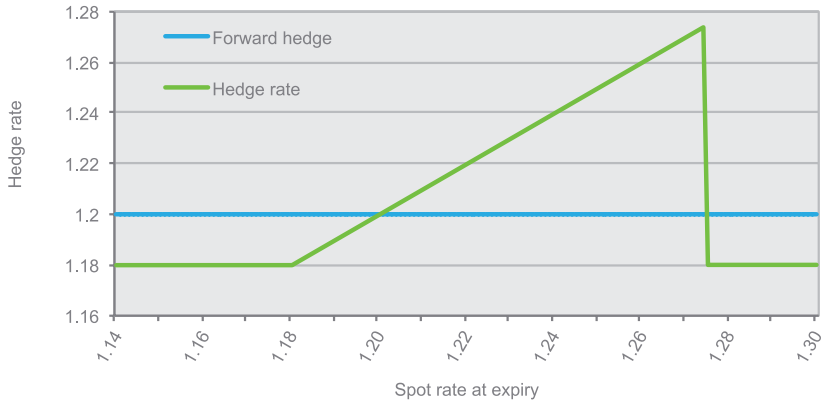
Convertible forward

A similar option is called a Convertible Forward. It is also a premium free option in that you have a protected level and a maximum level up to which you can benefit.

However, a Convertible Forward's upper barrier is known as a 'knock-in', let's say 1.27 in this example. Should the rate touch the barrier level, you are 'knocked-in' and you must trade at your protected level of, in this case, 1.18. Should you not be "knocked-in" and the rate is above 1.18 you will receive 100% at the trading rate.



Here is how various scenarios would play out on expiry:

At expiry, spot rate is at 1.16	You buy euros at protected rate of 1.18
At expiry, spot rate is at 1.24	You buy euros at spot rate of 1.24
At any point, in the month before expiry, spot trades above 1.27	You buy euros at protected rate of 1.18

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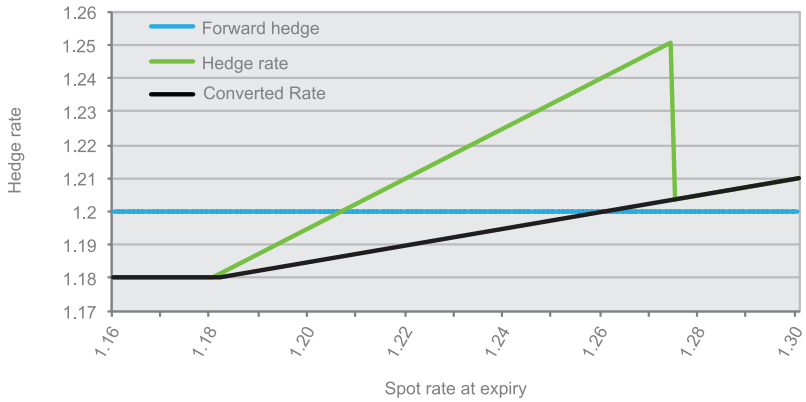
Ratio Forward

Another similar strategy is called a Ratio Forward. A Ratio Forward works like a Convertible Forward, however should the rate touch your upper barrier, you still stand to benefit.

Continuing from the example above, this strategy guarantees protection at 1.18 and gives you the benefit of 75% up to the barrier of 1.2750. If the barrier is hit, however, you do not automatically have to trade at your worst case rate and instead continue to benefit for 25% of any upward movement.



At expiry, spot rate is at 1.16	You buy euros at protected rate of 1.18
At expiry, spot rate is at 1.24	You buy 75% of your euros at rate of 1.24. And 25% of your euros at 1.18. giving you a blended rate of 1.225
At any point, in the month before expiry, spot trades above 1.25	You buy 75% of your euros at rate of 1.18. And 25% of your euros at spot

1. Below 1.18

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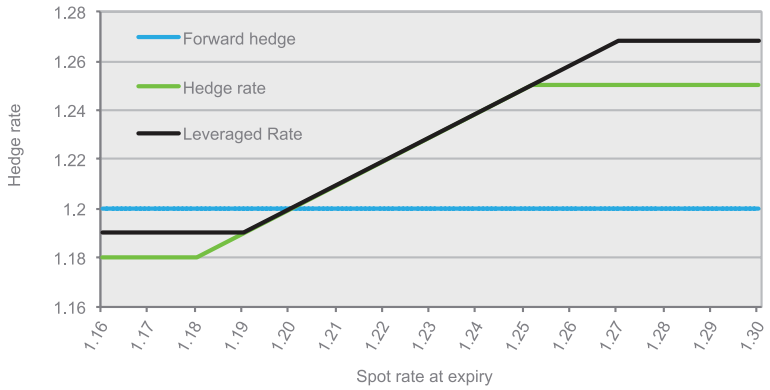
Leveraged Risk Reversal

The Leveraged Risk Reversal is exactly the same as its non-leveraged cousin but you have more things to play with. The non-leverage gave you protection at a level of 1.18 and a benefit of up to 1.25 for a cost. The use of leverage can increase this protection to, say, 1.19. The cap could rise to 1.27 or it could just make the whole thing completely free. Clever eh? The disadvantage of the leverage is that should the rate be trading above your cap then you will have to buy an increased amount of euros at the higher level.



At expiry, spot rate is at 1.17	You buy euros at protected rate of 1.19
At expiry, spot rate is at 1.24	You buy euros at spot rate of 1.24
At expiry, spot rate is above 1.27	You buy the leveraged amount of euros at the capped rate of 1.27

1. Below 1.18

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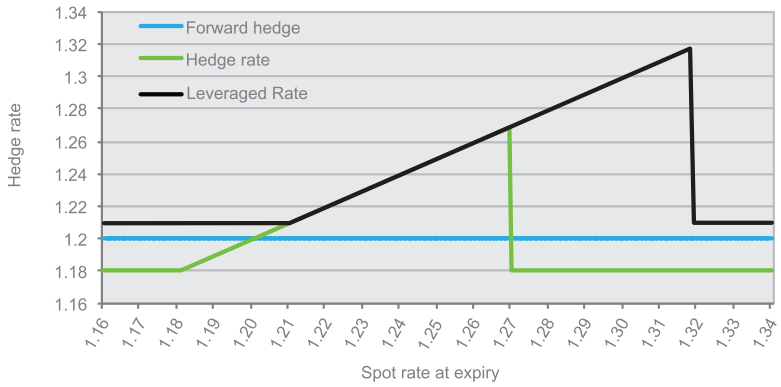
Leveraged Convertible Forward

Similar benefits can be seen by leveraging the Convertible Forward. Most buyers will go for a higher strike to give a better worst case rate, but giving yourself more headroom by raising the barrier is also possible. The previous non-leveraged example gave you a strike at 1.18 and a barrier of 1.27. However by leveraging you have been able to improve the strike to 1.21 and increase the barrier to 1.32.

Much like in the Leveraged Risk Reversal example the only disadvantage of leveraging this option is that, should the barrier be hit, then you will have to buy more euros at your worst case rate. However, this is still well above the forward rate that you could have got on the day.



At expiry, spot rate is at 1.19	You buy euros at protected rate of 1.21
At expiry, spot rate is at 1.26	You buy at spot rate of 1.26
At any point, in the month before expiry, spot trades Above 1.32	You buy the leveraged amount of euros at the protected rate of 1.21

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Conclusion

When you're looking to manage your currency risk, you have many products to choose from to protect yourself from currency fluctuations, and a lot will depend on your individual situation and your appetite for risk.

Don't be afraid to mix and match, as the best strategies often include a variety of products. The currency markets are highly unpredictable and anyone who is involved in international payments of any kind needs to take exchange rate fluctuations seriously before planning a budget.

As we have seen, market moves can make a massive impact on your bottom line. Fortunately, regardless of your appetite for taking a risk there will be something that works for you.

About World First

World First is a currency exchange broker, serving both private and corporate clients. Set up in 2004 by directors Jonathan Quin and Nick Robinson, the company is experiencing very fast growth and now employs over 100 people in two offices (London, UK and Sydney, Australia). World First won 'Service Business of the Year' at the Fast Growth Business Awards 2010 and was named on the Sunday Times Fast Track 100 for both 2009 and 2010.. With over 26,000 private clients and 7,000 corporate clients, World First transacted over £2.5 billion in 2011.

World First's corporate clients are generally import or export companies, making regular transfers. World First helps them minimise their exchange rate risk and manage their currency exposure.

World First offers currency options to SMEs and private clients through World First Markets Ltd. World First is the first broker to offer currency options which have, until now, been the preserve of very large corporate organisations through their banks.

World First UK Ltd is authorised and regulated by the FCA as an Authorised Payment Institution and is registered with HMRC. World First Markets Ltd is authorised and regulated by the FCA.

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Comments or queries about this whitepaper are very welcome.

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