



Fighting the cave-man instinct: learning to resist the urge to relax in the face of a stronger dollar.

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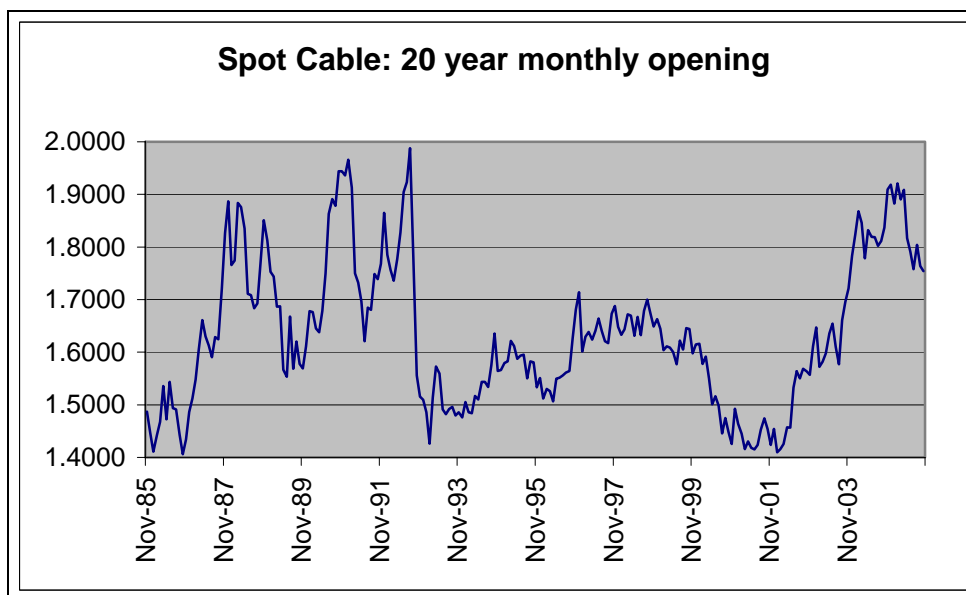
Which worries you more, higher interest rates or a weaker dollar? Banks almost always specify the hedging of interest rate risk as a condition precedent for a loan. However, the same has, historically, not been the case for foreign exchange risk and, despite the fact that it is becoming increasingly common for banks to ask for a strategy paper outlining how companies intend to protect themselves against adverse foreign exchange movements, such a request is still far from universal.

Many firms, therefore, continue to run large and potentially damaging foreign exchange risks, threatening the stability and predictability of returns.

Of those that do hedge, many confuse hedging with ‘fixing’ and operate too rigid a hedging policy which can have the effect of placing them at a competitive disadvantage if the exchange rate moves in favour of more nimble competitors.

The oil and gas sector is, naturally enough, exposed to a rise in the GBP/USD, or ‘Cable’, exchange rate (from the days when foreign exchange deals were ‘cabled’ between London and New York City) since a weak USD reduces the GBP value of USD-denominated revenues.

The chart below provides a flavour of FX movement over the last 20 years.

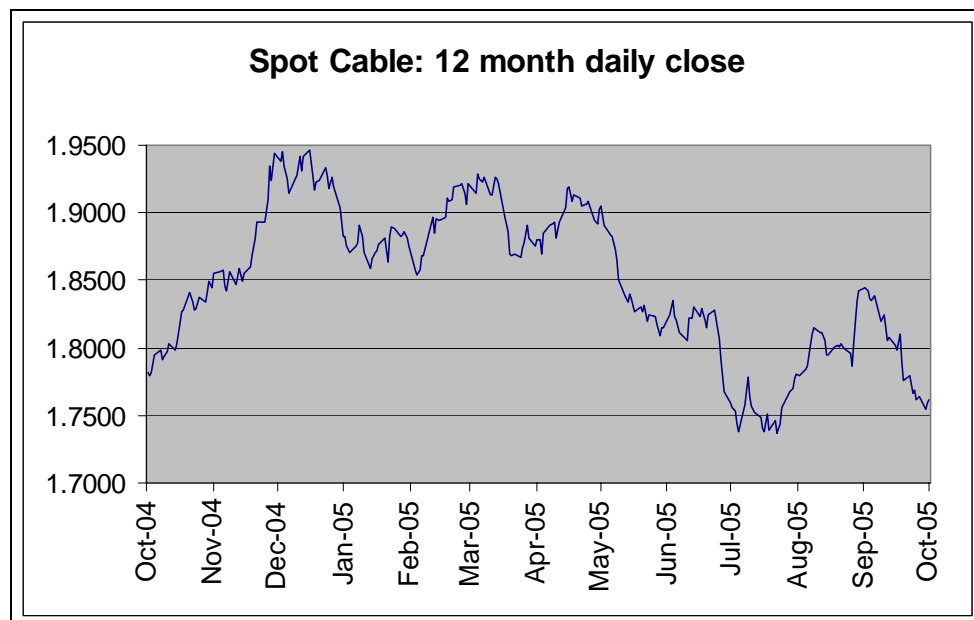


Perhaps most notable was the year 1992 when the GBP/USD rate fell from 1.9880 at the beginning of August to 1.5095 at the beginning of December, following the GBP's expulsion from the ERM in September.

Such a collapse nowadays would have many oil and gas sector executives singing in the bath, as ex-Chancellor Norman Lamont famously admitted to doing at the time. However, despite the recent recovery in the USD, caused by American interest rates moving apparently relentlessly upwards and economic activity on the UK high street contracting, at some point the USD may well weaken again as the market's focus returns to America's giant trade and public sector deficits.

There is a theory that the brain of *homo sapiens* has been 'hard-wired' over millennia to promote frantic activity in times of hardship (when confronted by a cave bear, for example!) and relative idleness (presumably to conserve energy) when times are easier. This has been put forward as an explanation as to why people instinctively run, or even add to, loss-making positions and cut out profit-making ones too soon. The ability to 'unlearn' this innate behaviour, it is argued, is part of what defines the successful trader. Certainly anyone who can remember the first time they 'shorted' a rising market, or bought into a falling one, will be familiar with the sense of unease that bucking the trend can induce.

However, in hedging, as in trading, bucking the trend can be crucial. As the USD strengthens (see the 12 month chart, below), the natural tendency of those exposed to a weaker USD is to breathe a sigh of relief that the exchange rate has finally turned and concentrate on other things. But the correct response is to use the improved position to focus on formulating hedging strategies which will reap rewards if, and when, the USD weakens again. Indeed, some strategies to provide flexible protection above a level of, say, 1.8000, which might have been prohibitively expensive 6 months ago, will now, in all likelihood, be affordable.



Furthermore, as the market approaches levels that are less historically high and at which many firms are happy to exchange USD for GBP, opportunities arise to enter into more sophisticated hedging strategies. For example, the selling of USD call options in the 1.6000s (where many firms are more than happy to convert USD to GBP) can, once again, generate sufficient premium to fully offset the cost of protective USD puts in the 1.8000s, above which most firms would be much less happy to convert.

Care must be taken, however, to avoid unduly complex or opaque structures. Customers' natural and understandable reluctance to pay upfront premiums to buy fully flexible protection through options has led banks' treasury teams to devise myriad different zero cost structures where no premium is payable. Unfortunately, the temptation to embed wide spreads within these structures often proves impossible to resist and many, consequently, do not represent good value.

As a rule of thumb, if it is very difficult to understand, or the person advising on it has difficulty explaining it, then the structure is probably best avoided! Particular caution must be reserved for structures where protection is 'knocked-out' and lost just at the point at which it is needed most.

The increased volatility in the Cable rate of late has led some companies to adopt less conventional strategies. Borrowing in foreign currencies has been standard practice for offsetting translation risk on assets held overseas, but we have seen a considerable increase in foreign currency borrowing against expected foreign currency receipts. While this actually creates translation risk where the company has no offsetting assets, this can be a relatively minor concern in most cases in comparison with the advantages, firstly, of protection from the danger of reduced income in sterling terms and, secondly, until very recently, the considerable interest savings that have been achievable.

The optimum foreign exchange hedging strategy combines protection from adverse foreign exchange movements with the ability to benefit from advantageous ones. Such flexibility comes at a price and if a hedging strategy is to be effected at zero cost, some upside potential will have to be foregone. However, as the Cable rate slides, the market continues to offer firms dependent on USD revenues the opportunity to protect themselves at more comfortable levels against a return to a much higher rate. The cave bear will return: it is not a question of 'if' but 'when'.