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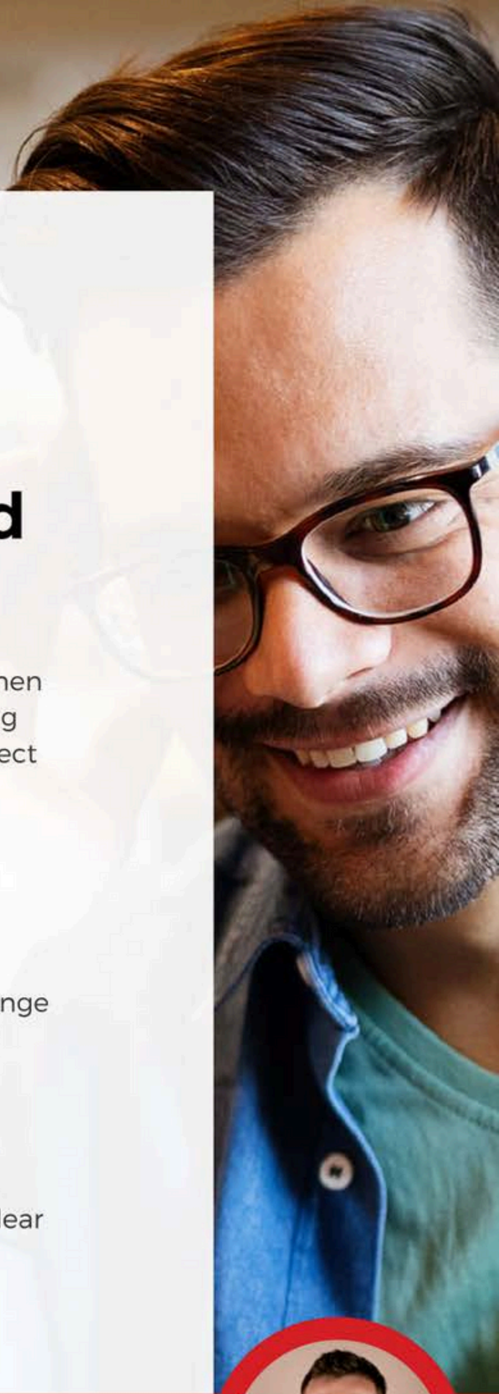
PRACTICAL eGUIDE

# Effective currency hedging

## Detailed strategies and practical guidance for businesses

caxton.io/business/currency-risk-management



# Introduction to hedging and currency risk

Market volatility can significantly impact your bottom line, especially when dealing with foreign exchange (FX) transactions. Understanding hedging and employing effective currency risk management strategies can protect your business from unforeseen losses. In this guide, we explore various hedging strategies, their implementation, and user-case examples.

## Key takeaways

- Currency hedging is a strategy that is used to eliminate foreign exchange currency risk while doing cross-border business.
- Effective currency hedging strategies include spot, forward contracts, market and limit orders, stop-orders, futures and currency swaps.
- General hedging guidelines emphasise understanding risks, setting clear objectives, and regular review for optimal risk management.

## What is currency hedging?

Market volatility can lead to losses in foreign exchange (FX) transactions. When companies conduct business across borders, or they deal in foreign currencies with internally movements between currency accounts. This makes them prone to forex risk when they exchange foreign currencies for home currencies. That's where hedging comes into play.

Currency hedging is a strategy used to mitigate that risk and protect businesses from unfavourable currency market movements, minimising the impact on the bottom line. If you invest or engage in business internationally, exploring currency hedging strategies is a must.

> Currency hedging is an essential strategy for businesses working across borders. For over 20 years, we been helping those at the forefront of international trade, in safeguarding their businesses from market volatility, minimising risk exposure, and protecting their bottom line.
>
> **Matt Downward**
> Head of  - Caxton

## How does currency hedging work?

Hedging currency risk aims to reduce the unpredictability of currency market fluctuations. Companies often enlist the help and support of a risk management expert to deploy a range of hedging tools and strategies to counteract potential losses. Before hedging currency risk, companies need to determine the degree of forex risk they can take and consider the strategies to employ.

## Who should implement a hedging strategy?

Currency hedging strategies are a great idea if you deal with businesses internationally. Currency hedging lowers your chances of risk exposure and makes it easier for you to conduct business and invest across borders, preventing market volatility from hurting your bottom line. It is crucial to choose the right hedging strategy at the right time to see results.

## Key considerations before implementation

The complexities of currency hedging require a thoughtful approach, thorough assessment, and strategic planning. Before diving in, it is crucial to consider several key factors. By evaluating your currency risk exposure, defining clear objectives, and understanding market dynamics, you can develop a practical currency hedging strategy tailored to your business needs. Let's explore some critical considerations to guide your decision-making process:

### Predicting currency movements

Currency movements are challenging to predict, especially in the short term. Market trends can significantly impact investment decisions.

### Volatility and cost

Foreign currency adds volatility and can be costly. Long-term investment horizons help smooth out short-term fluctuations, highlighting the importance of strategic planning.

# 5 key steps to developing an effective hedging strategy

Creating an effective hedging strategy involves a five-step process which, often carried out alongside a risk management specialist to provide guidance and expertise within the currency markets.

### Gain visibility into your FX exposure

Assess the volume and frequency of foreign currency your business handles annually.

### Understand your risks

Assess the nature and extent of your exposure to currency fluctuations and define your risk tolerance - which can be defines as how much you are willing to lose in exchange for greater potential returns.

### Define your risk management goals

Determine what your business aims to achieve with hedging, such as protecting profits from currency fluctuations or long-term cash flow certainty.

### Formalise your risk management plan

Choose the appropriate hedging tools to formalise your hedging strategy, based on your risk profile and specific needs. Use a mix of techniques to hedge against various types of currency risk.

### Ongoing monitoring

Regularly review and adjust your hedging positions as both market conditions and business requirements evolve.

# Different types of hedging strategies

There are several tools and strategies to employ hedging, each designed to help protect your business's profits from currency fluctuations. Choosing the right strategy can feel overwhelming, which is why specialists like Caxton can help. Our experts can help you create a simple yet effective hedging strategy for your business at no additional cost, so you can stay focussed on growing your business.

Let's take a look at some of the different hedging tools you can choose from at Caxton:

## Spot contracts

A spot contract is the most basic foreign exchange product, involving immediate purchase or sale of currency at the current exchange rate for settlement on the spot date. This transaction type is driven by the urgency of the buyer's or seller's needs, relying on the prevailing market rate at the time of trade and on the transaction day itself. Spot contracts operate on a 'buy now, pay now' basis, making them ideal for urgent international payments

## Forward contracts

You can effectively reduce the effect of foreign exchange risk (FX risk) through the use of forward contracts. This currency hedging strategy involves purchasing a specified foreign currency at a set or pre-agreed exchange rate on a future date.

By picking this option, you can secure the current exchange rate and safeguard yourself against losses and secure your future cash flow, if the value of the foreign currency decreases. The biggest risk associated with forwards is potential losses if the market rates improve.

### *Example of a forward contract in action*

*For example, you can use a forward contract if you're a pharmaceutical supplier based in England but conduct business in the USA. This currency hedging example will only come into play if the value of the US Dollar drops relative to the British Pound (not the other way around).*

## Rate alerts

A rate alert is an automatic notification when a desired market rate can be offered. There is no execution on this product as it is simply an alert function to keep you informed of specific market levels during the time you may be looking to go to market.

## Market orders

Market orders enable businesses to target a specific rate of exchange that is not currently available. If your business dealings mean that you require a specific price, then you can activate a market order that will secure that price when it becomes available. A market order is usually done immediately.

If your business does not need to make international payments immediately, but will likely have to at some indeterminate point in the medium- to long-term, then market orders can be an extremely useful part of your currency risk management toolkit.

## Limit orders

A limit order enables you to set a specific rate of exchange that is above current market levels. Once this rate is reached, you will automatically purchase your currency. Limit orders are particularly useful if you know you need to make a payment in a foreign currency at some point in the future, but are not bound by tight deadlines. If this is the case, then it is worth using a limit order to try and achieve a better exchange rate than the one available at the present moment.

In addition stop loss orders work in a similar fashion to a limit order, but instead of specifying the target rate at which you want to purchase currency, you specify the minimum exchange rate at which you would be willing to trade. It might seem counterintuitive to set a rate below what the market is currently offering, but a stop loss order ensures that if the markets turn against you, you will not lose out.

***Example of a market and limit order in action***

*Let's imagine you know your pharmaceutical company needs to exchange €1.5 million into US dollars at some point in the mid- to long-term future. At the time of contacting one of our traders, the rate is $1.2000. After speaking with one of our dedicated team members, you decide to activate a limit order at $1.2300. However, knowing that you will need to exchange €1.5 million into US dollars regardless of the rate at some point in the future, you bracket the limit order with a stop-loss order at $1.1700.*

*Three months later, the $1.2300 rate is hit and your limit order is triggered. You exchange €1.5 million at $1.2300 and receive $1,845,000. This saves you $45,000 against the rate it was when you activated the limit order and stop-loss order (€1.5 million at $1.2000 = $1,800,000).*

## In summary

Currency hedging is an essential strategy for businesses engaged in international transactions. By understanding and implementing various hedging techniques, you can protect your business from market volatility and reduce risk exposure. Working with experienced professionals like Caxton, can help tailor a hedging strategy that aligns with your specific needs and circumstances, ensuring optimal financial stability and growth

## Why choose Caxton's Currency Risk Management Service?

Choosing to work with Caxton ensures a strategic and informed approach to managing foreign exchange risks. We help you evaluate currency risk, define objectives and understand market dynamics to develop a tailored hedging strategy, designed to protect your bottom line. Our Account Managed Service offers expert guidance and monitoring, while our user-friendly Platform-Only Service provides the tool for independent management. Addressing key considerations like currency volatility, Caxton's strategic planning ensures long-term stability and growth.

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## If you'd like to know how we can support your business, why not book a quick call?

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Shaping the future of payments

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