**The business of hedging**

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**We've all heard the phrase hedging your bets - but do you know what it actually means?**

"Hedge" has been used as a verb meaning to "avoid commitment" since at least the 16th century; it's used in Shakespeare's Merry Wives of Windsor, for example. It started being used in relation to financial transactions in the early 17th century.

Technically it is a way of managing a financial price risk. But let's take it back to basics.

What is a hedge?

If you've ever packed an umbrella so you aren't caught out by the weather, you've adopted a hedge position. Chances are you have also taken out a financial hedge in the form of health or life insurance. You pay the premiums to cover yourself if something bad happens - it's a hedge on your health.

Businesses do the same thing. They will take steps to try to offset the possible losses that may be incurred by investments or by changes to financial markets.

Why do companies hedge?

Hedging is an important part of doing business. When investing in a company you expose your money to risks of fluctuations in many financial prices - foreign exchange rates, interest rates, commodity prices (oil and so on) and equity prices.

If a company makes sweet treats, the price of sugar is going to be watched closely. If a business relies on a fleet of lorries to move goods, then the price of petrol is key. More often than not, though, in today's global business world, the killer movers are currencies.

Foreign Exchange (FX) is by far the largest market in the world, dwarfing the size of stock and bond markets. The daily trading volume in FX markets is about $5 trillion (£4 trillion) - that's about four times more than all the trading in companies listed on the FTSE 100 for a whole year.

"It is often a good idea for companies to use hedging to protect themselves from swings in the exchange rate of a foreign country they are investing in," says Jasper Lawler, a markets analyst at CMC Markets.

The impact of changes to market prices can have a devastating effect on profits, so companies will seek to shield the sensitivities of their core business.

"Companies hedge for a variety of reasons, but they all come down the same thing," says Karlien Porré, a partner in Deloitte's global treasury advisory services practice. "They want to protect their financial results - for example cash or profits."

How is it done?

Focusing on the foreign exchange markets. Let's take as an example a Canadian company that makes skiwear. Selling locally they will earn in Canadian dollars. But what about if they signed a big contract to sell their products in bulk to a company in the US?

That would mean they are open to losses or gains depending on how the exchange rate between the Canadian and US currencies fluctuate before they can exchange their American cash for Canadian dollars.

f the company does not hedge the transaction, it will have no idea what exchange rate it will get when changing the US dollars into Canadian ones.

The challenge for the company's treasurer is to find the best way to protect the company from this risk.

They might decide to fix the price in advance, signing what is called a "forward contract". The alternative is to purchase a sort of insurance policy, an option such as a "call", which allows a little more movement in the hope that the exchange rate will improve before changing the dollars, but at the same time, limits the worst case scenario.

The decision will ultimately come down to the level of risk the company - and crucially, its investors - are willing to take.

A recent example of this going badly wrong was **Sports Direct's £15m hit** it suffered when a hedge position was triggered during the "flash crash" of the pound late last week. The simple explanation is they had to pay out on a bet they had placed.

What does it cost?

There is no simple answer to this one. There are just too many variables.

Setting a fixed price with a bank at which to exchange currency does not generally have an upfront cost. However, you will need to have an account with the bank already to avoid having to put up collateral (such as a deposit) to be able to receive the deal in the first place. The bank needs to know you can pay.

With options there are many variables that will influence the deal you get, but there will be a cost involved.

How long the option is, the so-called "strike" price (the difference between the  currency exchange rate and the one at which you wish to exchange), and the  volatility (amount of movement) in the market concerned will all play a part in the  bank's decision on what to charge.

Another cost to consider when putting these deals in place is the need for in-house expertise. Companies will need suitably qualified staff to be able to negotiate and manage the hedges.

What are the key risks?

The main risk is getting it wrong. Companies need to be in tune with their wider supply chain so as not to hedge at the wrong time or for too long.

A London shop selling goods bought from Europe may fix an exchange price for a long time if using a consistent supplier over the course of a year. But if the company switches suppliers regularly in search of the best prices, it will also need to keep a close eye on the rate at which they are exchanging money.

Failing to keep all sections of the business as well as senior management and shareholders informed on hedges is another potential pitfall.

"Lack of communication around the possible results and outcomes of hedging activities could cause significant problems," says Ms Porré.

Everyone needs to understand that you stand to lose as well as gain.

Competition crucial

Hedging is critically important for remaining competitive. Firms that demonstrate good risk management can find it easier to get investment or a loan.

If done correctly they will also be able to quickly adjust their pricing to accommodate changes. Take the aviation industry: airlines all hedge fuel costs.

Imagine one airline fixes a price for 12 months and another for only three months. If fuel costs unexpectedly fall, the company with the longer fix is locked into paying more. Meanwhile, the other company would be able to lower ticket prices with the saving they will make on fuel.

Which ticket would you buy? Hedging, well, matters.