Proposed Hedging Strategy: Combination of Forwards and Futures

Didem Bulut Aykurt
Colorado State University Global
Derivatives and Assets Pricing
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Understanding the Objective

- The CFO wants to lock in future FX rates to achieve a more accurate forecast in 2 days. This means the company aims to mitigate the risk associated with currency fluctuations.
- To achieve this goal, we need to consider various derivative instruments that can serve as the basis for our hedging strategy. The two primary instruments mentioned are forwards and futures.
- The primary objective is to mitigate the risk associated with currency fluctuations. By locking in future exchange rates, we can provide a more accurate financial planning and decision-making forecast.

Advantages of Forward and Futures

Forwards:

➢Customization: Forward contracts are flexible and can be tailored to specific requirements. We can negotiate terms directly with a counterparty.

➢Private Transactions: Forwards are private agreements between two parties, which may be advantageous if confidentiality is a concern.

➢Maturity Date Flexibility: We can choose the maturity date to align with our forecast horizon.

Futures:

➢Standardization: Currency futures contracts are standardized and traded on organized exchanges. This provides liquidity and transparency.

➢Mark-to-Market: Futures contracts are marked to market daily, ensuring that gains or losses are settled promptly.

➢Reduced Credit Risk: Exchange-traded futures reduce credit risk since the exchange acts as the counterparty.

Combining Forwards and Futures

Scenario 1: Using Forwards Alone

Pros:

Customization: We can negotiate specific terms.

Private Transactions: Confidentiality is maintained.

Cons:

Lack of Liquidity: Forwards are less liquid than futures.

Credit Risk: Counterparty risk exists.

Scenario 2: Using Futures Alone

Pros:

Standardization: Transparency and liquidity.

Mark-to-Market: Daily settlement.

Reduced Credit Risk: Exchange acts as the counterparty.

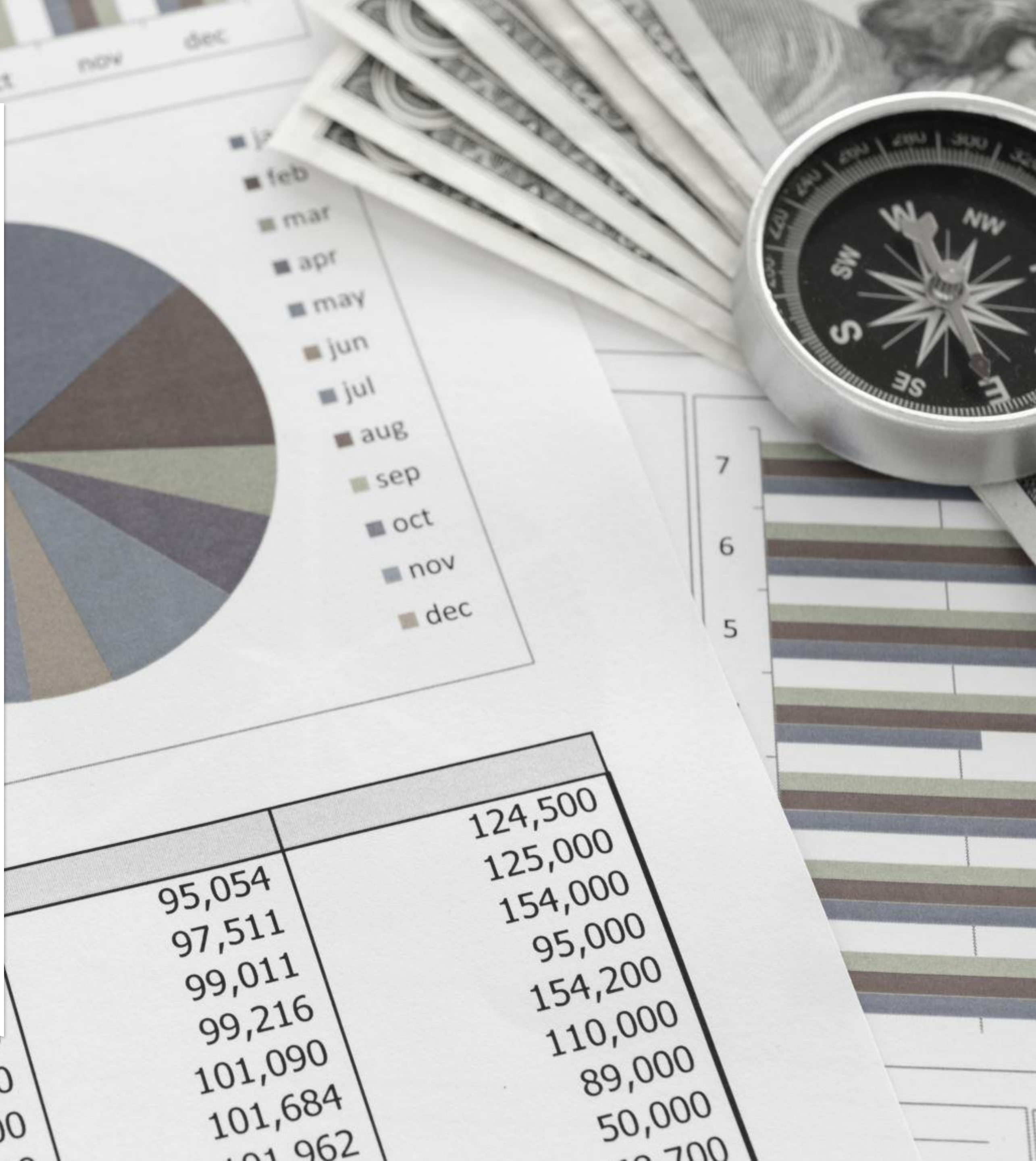
Cons:

Less Customization: Fixed contract terms.

Public Transactions: Trades are visible on the exchange.

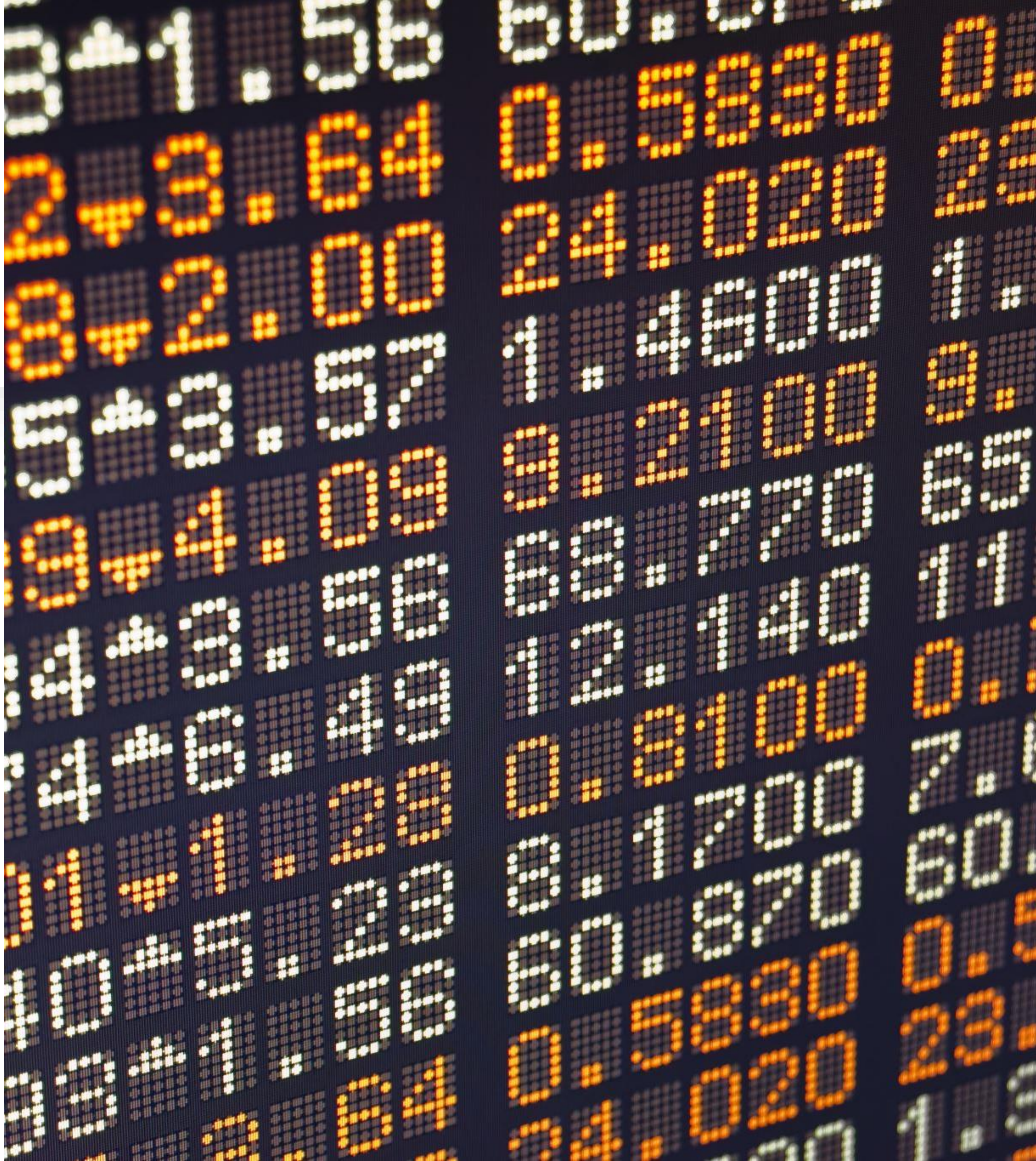
Justification

- Risk Management: The combination strategy balances customization (forwards) with liquidity and transparency (futures).
- Cost Efficiency: Futures typically have lower transaction costs due to standardized terms.
- Market Conditions: Monitor market conditions and adjust the mix as needed.
- Reporting and Compliance: Document all transactions and ensure compliance with accounting standards.



Recommended Approach: Combination

- **Customization:** Use forwards for specific requirements (e.g., longer-term hedges).
- **Liquidity and Transparency:** Utilize futures for liquidity and daily mark-to-market.
- **Risk Diversification:** By combining both instruments, we diversify risk exposure.
- **Execution Strategy:** Determine the proportion of forwards and futures based on our risk tolerance and forecast horizon.



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