11.10: Hedging vs. Speculating

Hedging is the process of entering into a forward, future, option, or swap contract to offset a natural risk position (note – there are also ways to hedge risk exposure without the use of derivative contracts). The object is not to make a profit, but to eliminate risk. One example would be a US company that knows it will need to make a payment of 2,000,000 yen six months from now purchasing a forward contract to exchange dollars for yen in six months at forward rate set today. Entering this contract allows the company to eliminate the natural risk arising from their currency situation. While the spot rate of exchange may be more or less favorable in six months when the payment is due, this is not relevant. What is relevant is that the exchange rate fluctuation had no impact on the dollar cost of that payment because it had been hedged away with the use of the forward contract.

Speculation is the process of entering into a forward, future, option, or swap contract in an attempt to generate a profit. This type of transaction creates risk where none previously existed. For instance, if a speculator thought that the US dollar was going to get weaker in the near future relative to the euro (the euro price in dollars would increase), he might enter into a futures contract which would allow him to buy euros at a price set today (the futures price). If he was right and the dollar did indeed get weaker relative to the euro, his futures contract would increase in price and he would make a profit. If he was wrong and the dollar got stronger relative to the euro, his futures contract would decrease in price and he would lose money. Therefore, he has created a situation where he will make or lose money based on the dollar/euro exchange rate — creating a risk position in an attempt to make a profit.

The primary contracts for hedging and speculating in currencies are forward, future, swap, and option contracts. The characteristics of each are quite different. Some (futures and options) are tools for both individual investors and institutions while others (forwards and swaps) are institutional contracts. Also, the risk, complexity, and costs can vary across the contracts. For this class, you will not need to know the differences across these instruments. The following information describing the basics of each contract.

Forward Contracts

Forward contracts are negotiated instruments (size, pricing and expiration date are determined between the parties involved in the contract). They are a legal agreement in that we are bound to carry out our contract regardless of whether it is profitable for us. There are no money flows taking place in forward contracts until the expiration. Also, forward contracts tend to be used primarily by large creditworthy corporations. Individuals do not use forward contracts.

Futures Contracts

Futures contracts are standardized instruments. They have a set expiration date and contract size. Prices are determined in financial markets. They are also a legal agreement that we are bound to carry out (or settle) regardless of whether it is profitable for us. Money flows take place throughout the contract period as gains/losses are settled on a daily basis (referred to as "marked-to-market". Futures contracts can be used both by corporations and individuals and typically involve significant leverage.

Swap Contracts

Swap contracts are negotiated instruments between the parties involved in the contract. In a swap, parties agree to exchange cash flows associated with specific assets. For example, company A in Japan may issue a bond in its home market in yen. Company B in the US may issue a bond in its home market in dollars. Then, they agree to swap the interest payments so that the US firm's interest expense is in yen while the Japanese firm's interest expense is in dollars. This is attractive if the Japanese firm has some revenues in dollars and the US firm has some revenues in yen. By matching their revenues and expenses in the same currency, they reduce their overall currency risk.

Options Contracts

Options contracts are standardized instruments. They have a set expiration date and contract size. Prices are determined in the financial markets. The give the option holder the right to buy (a call) or the right to sell (a put) at the contract expiration if the holder of the option chooses to do so. If the currency fluctuation is in the option holder's favor, the option will be exercised. If the currency fluctuation is against the option holder, the option will expire worthless (costing the option holder the initial price paid to purchase the option).