



Hedging in an Inflationary World

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These days, given the complex web of global financial transactions in which companies are enmeshed, it is unrealistic to expect management to avoid hedging. When I invest, however, I search for companies that follow simple, consistent, and short-term hedging policies – and whose business models are strong enough to adapt to the inherent volatility and uncertainty of the marketplace.

Let's look at the dangers posed by inappropriate hedging and how adept managers deal with volatile prices in an inflationary environment.

Good in theory, bad in practice

My library contains a classic textbook on corporate finance, and its chapter on the practice of hedging risk concludes as follows:

As a [company] manager, you are paid to take risks, but you are not paid to take any risks. Some are simply bad bets and others could jeopardize the success of the firm. In these cases you should look for ways to hedge.¹

As the text suggests, theory tends to favor hedging techniques, although there is disagreement over what constitutes best practice. Among the potential benefits research papers cite are mitigating catastrophic risk, reducing financing costs, and smoothing fluctuations in cash flow, the last of which results in a discernible and positive impact on share prices.² With benefits such as these, why wouldn't all companies hedge?

Present inflationary conditions might further favor hedging. Imagine you are a manager in Brazil, where loose monetary policies at home and abroad are feeding inflationary pressures. You face persistent price increases on inputs essential to your company's manufacturing process. Lost competitiveness and lower profits loom. The temptation to hedge such risks is overwhelming. After all, it's not your fault that commodity prices are rising; why not have an investment bank create a customized derivative for you that locks

¹ Brealy and Myers, *Principles of Corporate Finance*, 4th Edition, 1991, page 644.

² Lin, Pantzalis and Park, "Corporate Hedging Policy and Equity Mispricing," 2005, page 4.



in prices for 18 months? Why not smooth out the potential shock to your profits? Prices are moving in only one direction – why not even profit from the trend?

This may seem reasonable enough, in theory. The problem is that in my experience, it doesn't work. I have seen hedging programs bring on several large-scale implosions. To name two: Citic Pacific, a well-connected Chinese conglomerate, [lost billions](#) in a foreign exchange contract gone awry; numerous small companies in Korea [were knocked flat](#) by their aptly-named "knock-in / knock out" currency derivatives.

Admittedly, those two cases are atypical, as they are examples of hedging gone very wrong. They illustrate a common characteristic, however: managers wished to insulate their firms from small price fluctuations, but they also wished to be clever, so they simultaneously bet against extreme and seemingly unlikely price movements. Basically, they eliminated one kind of risk, but they amplified another in exchange, and these new risks were harder to evaluate and potentially damaging. Their counterparties in these transactions were savvy banks, better-equipped to evaluate the underlying probabilities.

Guess who won the bet?

Keep it simple

Companies can hedge prices in myriad ways, but three techniques are most common:

1. A company can hedge interest rate risk by buying contracts, swaps or related derivatives
2. A company can hedge currency risks by borrowing (or lending) in a foreign currency, by purchasing (or selling) foreign currency, or by purchasing forwards, swaps or other derivative contracts that mimic such exposure
3. A company can hedge input prices by purchasing commodity futures or forwards, or by stockpiling large quantities of raw materials, such as non-perishable commodities

All three techniques have useful applications, but I have seen all three abused. In my experience, the most useful corporate hedging programs keep it simple. They do not attempt to hedge over long time horizons; instead, they focus on hedging over the next quarter or two. Management has an operating plan and a budget to match; they hedge in order to set their costs within the constraints of that quarter's budget. By smoothing excessive short-term volatility, they can execute effectively (e.g., order the appropriate quantity of raw material) and complete a productive business cycle. Beyond that relatively short horizon, good managers let prices float freely.

Savvy managers don't attempt to hedge long-term price fluctuations, no matter how tempting, for various reasons. First, it is expensive – the longer you seek to fix a price, the more the hedge will cost you. Derivatives are not free, and the added cost of a longer-term hedging program is a permanent drag on profits. Second, long-term hedging creates



deeper exposure to counterparties, which for these transactions are typically commercial and investment banks. Counterparty risk is nearly imperceptible, and therefore often ignored – that is, until it blows up, as it did in 2008, at which point it is usually too late to avoid losses. The most prudent hedging policies recognize that counterparty risk is material, increases over longer horizons, and should be minimized whenever possible.

The third reason that management teams do not engage in extensive hedging is the most important. They understand that when markets are constantly changing, flexibility and adaptability are essential to long-term survival. What happens to the Brazilian manager who stockpiles two years of materials in advance? If her bet pays off because she guessed correctly about future prices (she'll be fired otherwise), her hedge will insulate the company's profit margin. Ironically, though, this cushion will make her company slow to adapt to the new, higher costs that prevail in the marketplace. She may not adequately prepare for the day when her inventory runs out or her derivative contract expires. Instead, she will probably attempt to repeat her prior feat, at which point the ensuing hedging trades usually become indistinguishable from outright speculation.

Hedging policies do not foster sustainable growth or create a permanent competitive advantage, and rarely do they contribute to intrinsic value. More often they delay the inevitable, masking the need to change. On this point, I agree with Warren Buffett, who has stated that when a problem exists in a business, "the time to act is *now*."³ A successful hedge may stave off adverse pricing conditions, but if the company fails to adapt its business model in the present, it may experience a dislocation that is more painful and costly in the future.

When I evaluate companies, I avoid those that defer difficult adjustments, and favor those that meet challenges head on by adjusting their business models in the present. They do so by adopting more efficient technologies, by switching to substitute inputs, and by driving down operating costs. They construct "natural hedges," perhaps by borrowing in the same foreign currency in which they have an existing revenue stream. Most importantly, they focus on building a reputation for quality and an effective brand that allows them to raise prices when necessary – like right now, amid persistent inflation. Companies that have the resources and wherewithal to adapt in this fashion – rather than defer change with excessive and possibly reckless hedging – are more likely to survive over the longest run.

³ Buffett, *2005 Chairman's Letter to the Shareholders of Berkshire Hathaway Inc.*, page 11.



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