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What do you do about fx volatility?

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WHAT DO YOU DO ABOUT FOREIGN EXCHANGE VOLATILITY?

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Family Offices nowadays generally have policies on most aspects of their affairs. These are normally put in place due to a regulatory or investment imperative, or maybe it is because it assists the family or family office to administer their affairs and ensure the smooth working of the family office, including succession planning, roles and lines of responsibility. However, few families seem to have a protocol about how they deal specifically with Foreign Exchange, despite this being an easy area for them to create efficiencies, control costs and manage currency liabilities.

The foreign exchange market is a 24 hour market, continuously pricing currencies based on what is happening, what is likely to happen and what has happened. Currencies constantly fluctuate as market participants interpret events and adjust their views accordingly. Uncertainty is difficult to manage and adapt to and the foreign exchange market is no exception. Recently we have seen high levels of volatility particularly in £/$ and £/EURO, based more on political turbulence than on underlying economic performance. Now that the Brexit deadline has been delayed until October 31st we are facing another six months on this currency rollercoaster.

In recent key influence on the value of Sterling has been Brexit, since the referendum on 23rd June 2016, and this has been reflected in the £/Euro exchange rate. The week of the Brexit referendum the £/Euro hit a high of 1.3220 but by October 2016 it had fallen to 1.0600 a drop of 19.8%. After rallying back to a high of 1.2040 during December 2016, a rise of 13.5%, over the next 8 months it dropped to 1.0750 by August 2017, a fall of 11%. During 2018 it tended to trade in a tighter range between 1.10 and 1.15 as the negotiation deadlines came closer.

There were similar moves in $/£ in 2018 although these were not all Brexit related as the market reacted to Donald Trump's policies to stimulate the US economy while at the same time threatening trade wars with China. The $/£ rate opened the year around 1.3500 moved up to the year high at 1.4375 on 17th April then over the next four months plummeted to 1.2660, a drop of 12%. After moving back to 1.3300 in September, a rise of 6%, it again dropped by 6% to 1.2480 on 12th December.

How do you protect yourself, your business or your assets against these kinds of currency movements, which often turn out to be unfavourable?

Single and Multi-Family Offices that carry on any form of cross-border activity will have exposure to foreign currency through their underlying business interests, their commercial and residential property portfolios, their financial investment portfolios and their leisure and hobby activities. As we have seen all these have the potential to cause serious headaches that are unlikely to go away anytime soon. Immediate foreign exchange liabilities can easily be covered with an FX transaction in the market at that time, known as a Spot trade so the risk is neutralised. If your foreign exchange liability is for a period of time in the future then it is possible to protect your risk by hedging.

So, what is currency hedging? Simply put - a foreign exchange hedge is a method to eliminate or hedge foreign exchange risk resulting from transactions in foreign currencies.

What should family offices be doing to manage their risk? Below are three easy steps to help reduce your currency risk:

First Step: Develop a Currency Risk Management Plan
Every organization, or individual, should have a currency risk management plan and this requires an understanding of your risk. To start it is essential to calculate your net FX exposure by quantifying all payments and receipts across all your business and investment activity. Quite often currency risks can be “naturally hedged” therefore reducing your overall exposure. This may sound simplistic and obvious, but it is amazing how many family offices, fund structures or financial services institutions that we speak to do not measure their currency exposure accurately and know how much their foreign exchange transactions cost them.
To manage risk effectively it has to be measured.

Second Step: Formulate a Currency Risk Management Policy
Once all your FX risks have been identified it is necessary to formulate your currency risk management policy. The policy instills some discipline as to how you intend to manage movements in exchange rates. Key considerations will include your overall risk appetite, levels of risk you feel comfortable with holding, acceptable levels of currency movements that you are prepared to tolerate and how these affect your various activities, financial reporting and hedge accounting implications – the hedging tools you intend to use.

In our experience many family offices, private clients and investment institutions seek help from an independent FX advisor or consultant to help formulate their policy.

Third Step: Execute Your Plan
This sounds like the easy part. Once you have written and formulated your plan it’s time to implement your policy.

As above, in our experience many family offices, private clients and investment institutions seek help from an independent FX advisor or consultant to help implement their foreign exchange trading strategy.

As a family office you will have exposure to foreign currency in several different ways and you are bound to encounter issues such as currency mismatches, funding international investments and payments, generating international revenue and expenses or repatriating capital.

As we have seen from recent currency fluctuations, currencies can fall and appreciate in value dramatically, sometimes quickly with the result that it can occasionally lead to alarming outcomes. The warnings are out there and the biggest danger is to do nothing. As outlined above there are three steps that will start you on your journey to protect yourself against adverse movements in currency exchange rates and the potential dire circumstances.

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