

**Controlling risk  
when trading in  
overseas currencies**

**Tobias Woodward &  
Guy Phelan, Moneycorp  
30 November 2017**

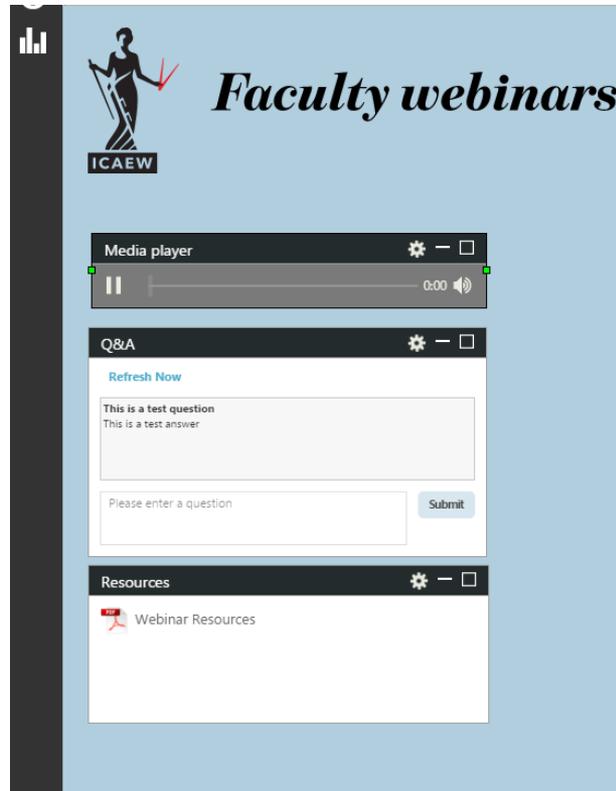
The webinar will begin shortly...

# *Business & Management*



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- Media player:** Shows a play/pause button, a progress bar, and a volume icon. The time is 0:00.
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# Options for risk when dealing with overseas currencies

Tobias Woodward & Guy Phelan - Moneycorp

# Agenda

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- ❖ Introduction to the FX Market
- ❖ Volatility and market movement
- ❖ Different ways of buying currency / hedging risk
- ❖ Practical Examples
- ❖ Options
- ❖ Market Forecasts
- ❖ Questions

# The FX Market

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- ❖ The Foreign Exchange market is the largest financial market globally - \$5.3 trillion traded per day
- ❖ FX Market vs Stock Market
- ❖ Approximately 150 currencies in the world, but not all of them are actively traded.
- ❖ More than **85%** of FX deals involve **US dollar**.
- ❖ Speculators vs transactional foreign exchange



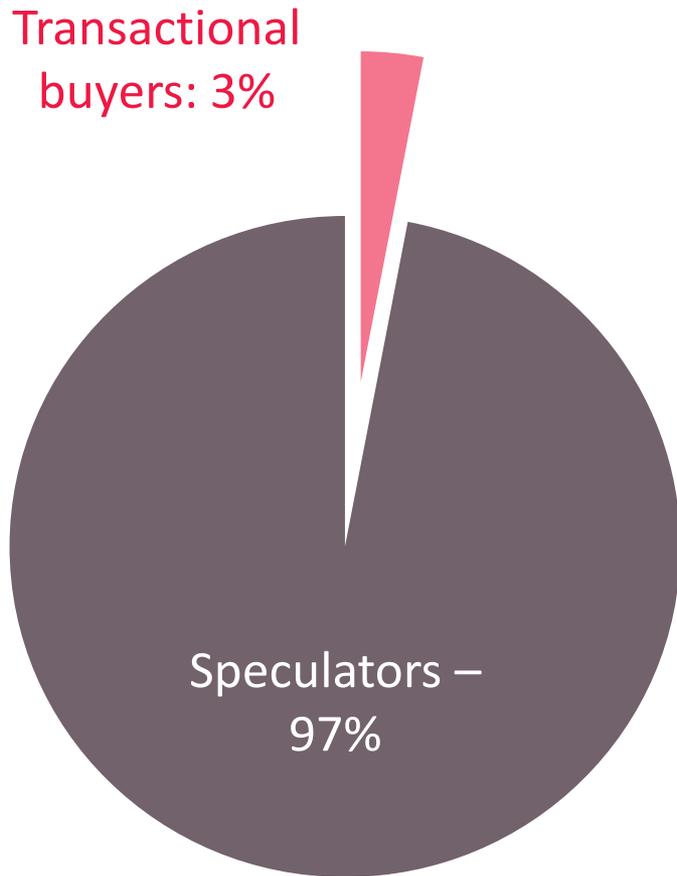
# Poll Question 1

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- ❖ What percentage of the market place are speculators as opposed to transactional buyers?
  
- ❖ Under 10
- ❖ 0 - 20%
- ❖ 21-40%
- ❖ 41-60%
- ❖ 61-80%
- ❖ 81-100%
- ❖ Over 90

# The FX Market

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- ❖ Perception, fear and greed.
- ❖ Markets fluctuate constantly, making it difficult for companies to plan.
- ❖ Fluctuations can significantly add to costs, or erode profitability on projects and deals.



# GBP/EUR - Market Movements 12 Months

- ❖ 11% volatility - High 1.2040; low 1.0744
- ❖ Average rate: 1.1421
- ❖ When buying Euros with £500,000 this translated to a difference of **€64,800** between the year's high and low.





# GBP/USD - Market Movements 12 Months

- 12% volatility - High 1.3654; low 1.1984
- Average rate: 1.2832
- When buying Dollars with £500,000 this translated to a difference of **\$83,500** between the 2017 high and low.





# When Purchasing Currency

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## ❖ Opportunity

- ❖ Exchange rates go in your favour
- ❖ Reducing costs
- ❖ Increasing profit margins
- ❖ Potential to boost revenue

## ❖ Risk

- ❖ Exchange rates go against you
- ❖ Costs increase
- ❖ Profit margins reduced
- ❖ Potential to reduce revenue



# Different Ways To Buy Currency

Online			
Spot	Forward	Market orders	Options
Immediate delivery	Lock in to favourable rates longer term	Target a rate and minimise risk	Fixed rate with potential upside
			
Over the phone			

# Spot Contract

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- ❖ Allows you to trade 'on the spot'
- ❖ Spot contracts are useful if you need to purchase currency and make a payment quickly.
- ❖ Allows you to fix an exchange rate and settle your deal the same day or **up to two working days in advance.**

# Spot Contract

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## ❖ Advantages

- Total market participation (buy when suitable)
- Total flexibility (no risk of over purchasing)

## ❖ Disadvantages

- No protection from negative market volatility



# Forward Contracts

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- ❖ Fix a rate up to three years ahead
- ❖ Complete protection from volatility





# Forward Contracts

- ❖ Fully flexible (drawdown)
- ❖ Purchase obligatory
- ❖ Credit implication





# Forward Contracts

## Advantages

- Total protection from volatility
- No premium

## Disadvantages

- Purchase obligatory
- No market participation



# Options

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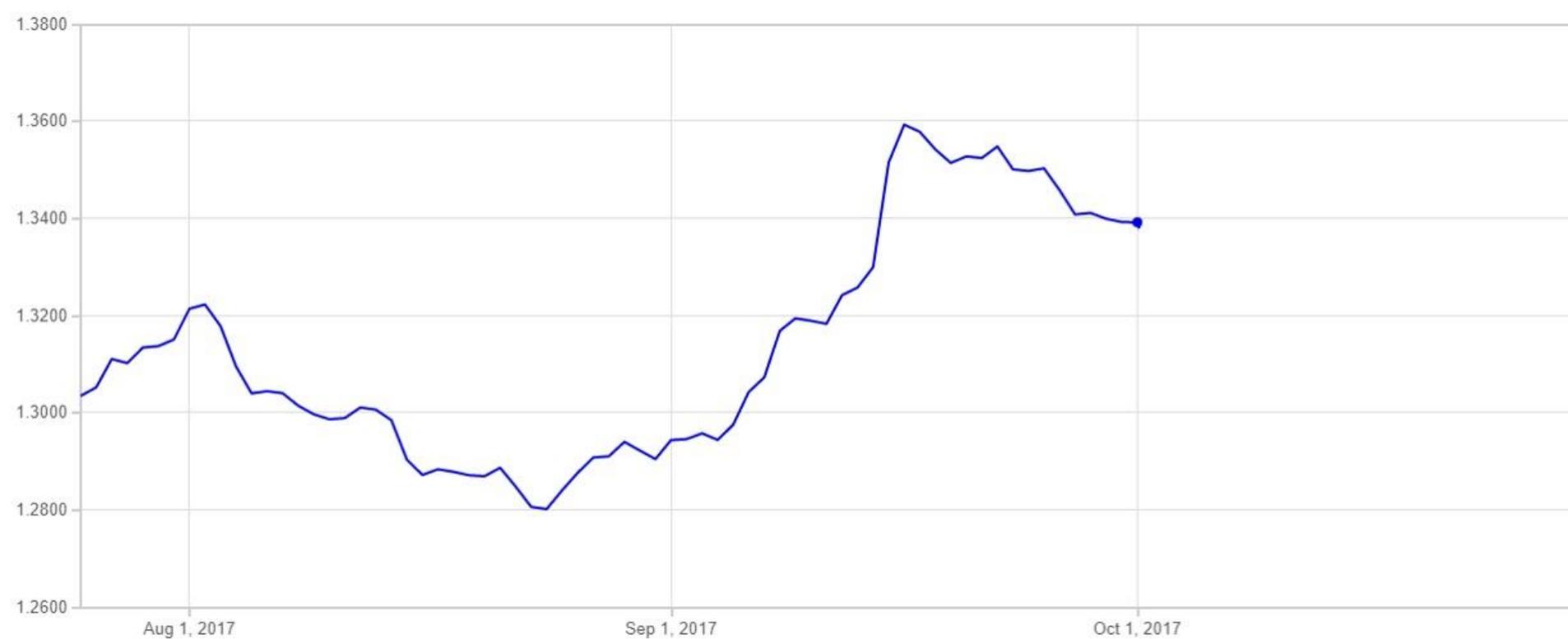
- ❖ A **vanilla option** gives the holder the right *but not the obligation* to exchange one currency for another at a specified rate on a specified date in the future.



# Market Orders

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- ❖ Need to purchase currency but not immediately
- ❖ Target a favourable rate through a market order





# Market Orders

- ❖ A **limit order** allows you to set a target exchange rate
- ❖ Will trigger currency purchase automatically when rate is hit





# Market Orders

- ❖ Conversely, a **stop loss** order allows you to set a 'worst case' exchange rate.
- ❖ Again, triggers automatically when hit.



# Poll Question 2

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Which products do you use the most:

❖ Spot

❖ Forward

❖ Market orders

❖ Options

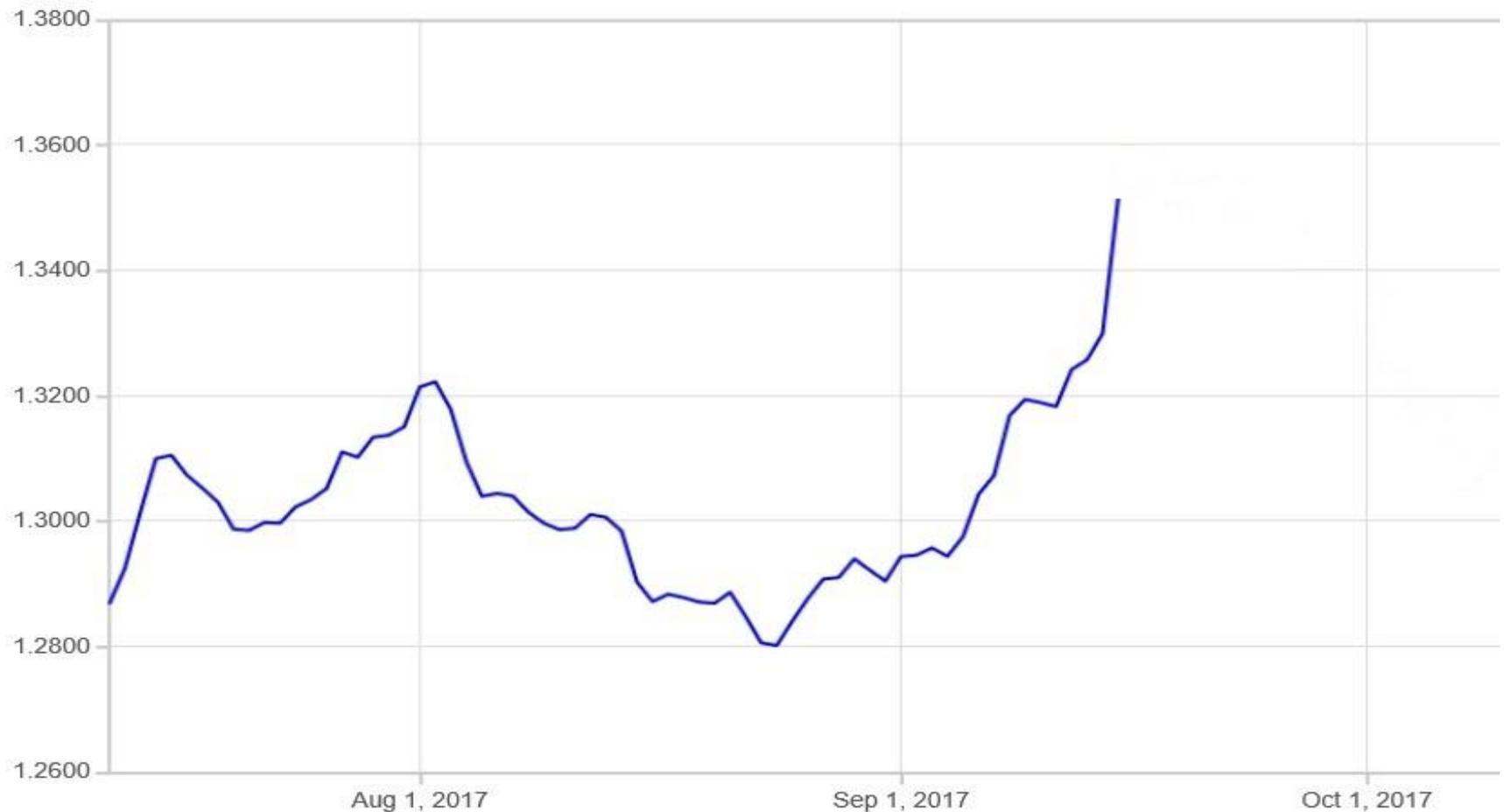
❖ Mixture



# Example of a Business Requirement

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A business agrees a price to buy Steel from the USA at a cost of GBP £500K based on a rate of 1.3514. They have to pay the invoice in Dollars in 3 weeks - the rate is currently on an upward trend.





# Spot Contract

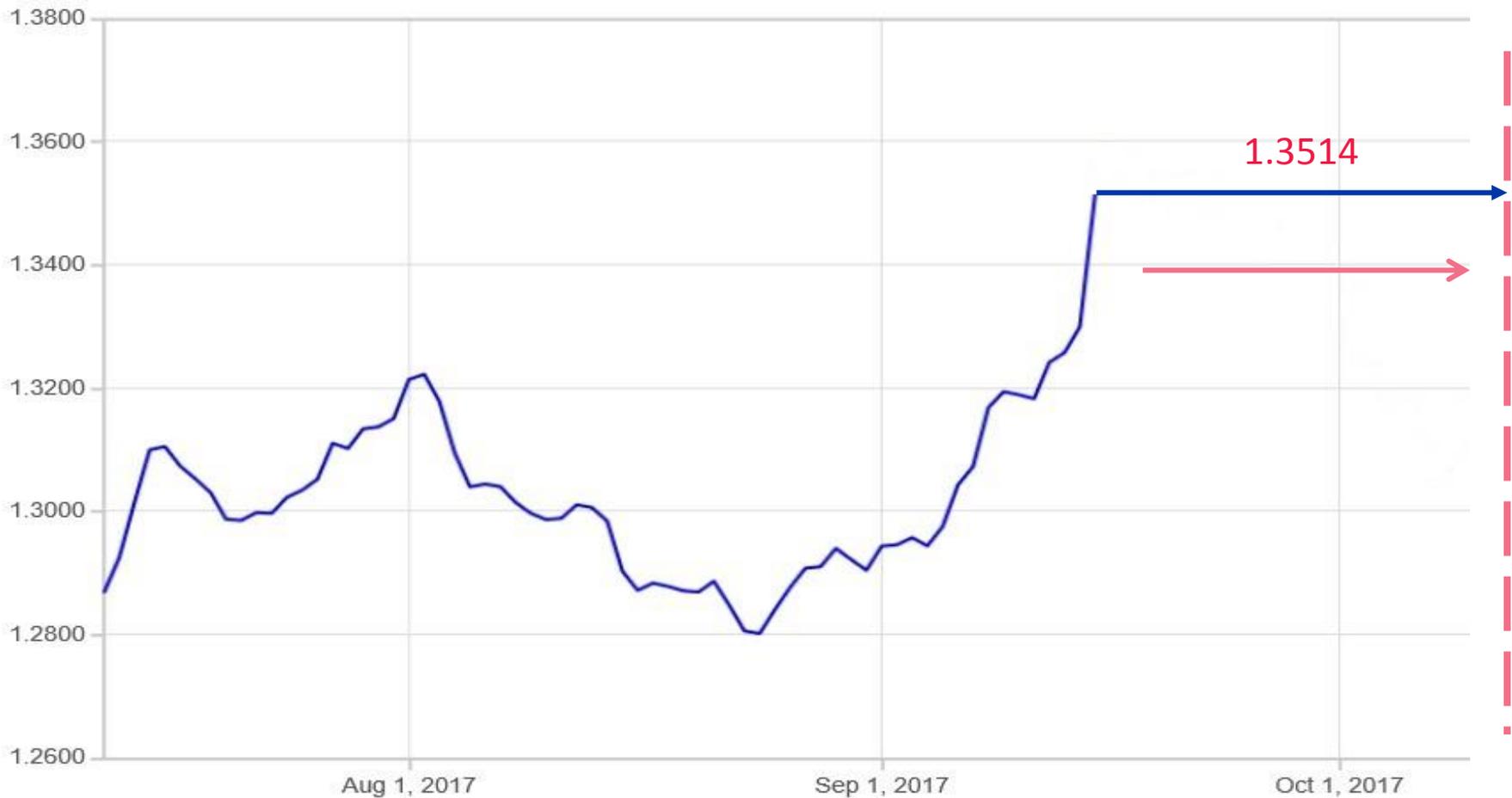
Buy on the day when the invoice is due.





# Fix The Rate – Forward Contract

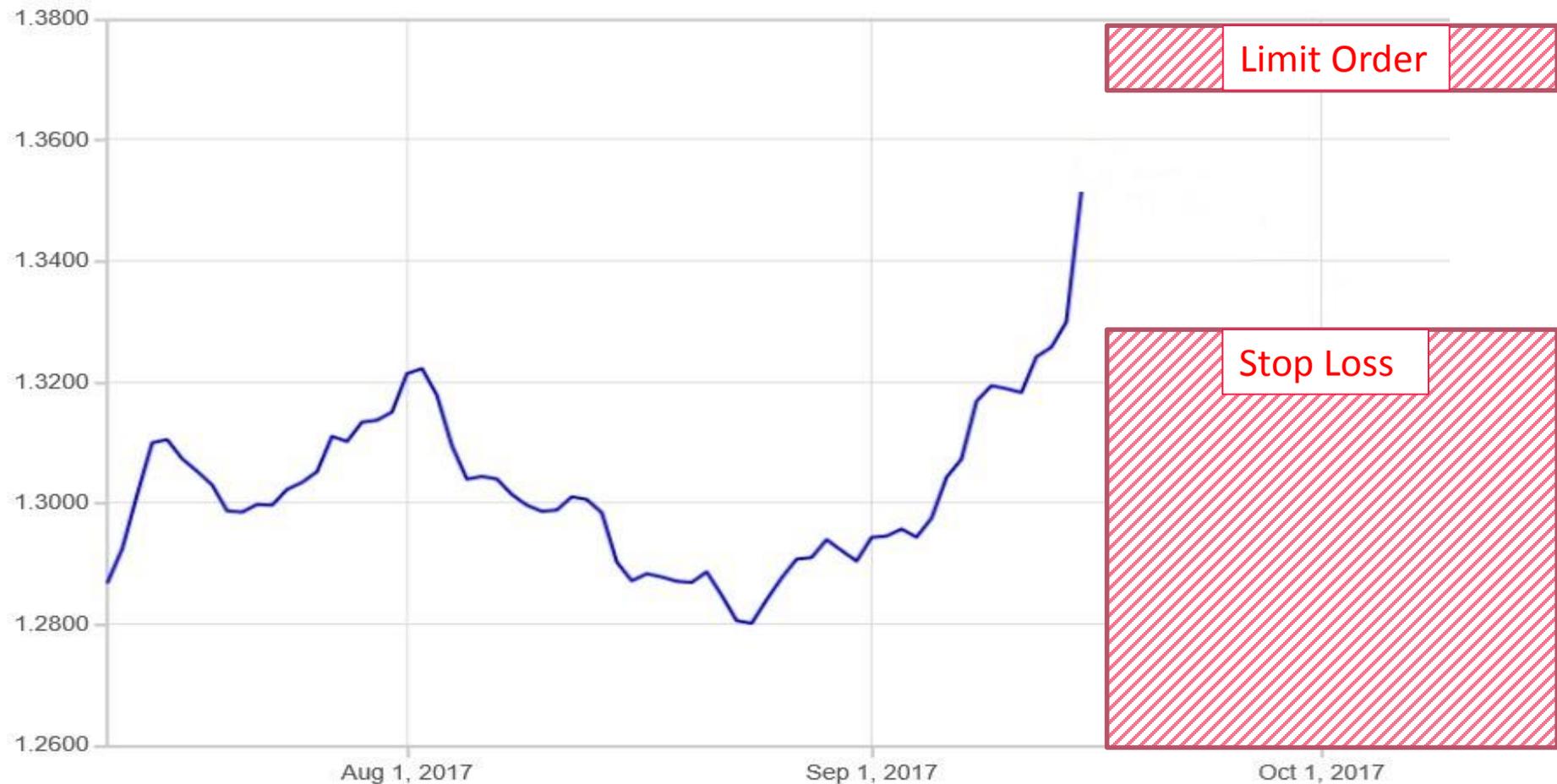
The company can secure the current rate for the three weeks at 1.3514





# Target Rate - Market Order

The company can use market orders to target a rate by creating a limit order and stop loss





# Which Strategy Would You Take?

This could depend on a business' attitude to risk, budgeted rates or preconceptions on the direction of the rate.

- SPOT - take risk of rate movement
- Market Order - target a rate
- Eliminate Risk and set rate with forward





## Poll Question 3

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Which strategy would you take?

- 1) Buy on spot, and take risk of rate movement in the meantime
- 2) Put a market order in at a target price
- 3) Eliminate risk and take out a forward contract



# Which Strategy Would You Take?

In this example, GBPEUR falls from 1.3514 to 1.3062.





# Results

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- ❖ In this example a client would have saved \$22,600 if they had fixed the rate with a **Forward Contract** (compared with SPOT).

Action	Amount received	Difference
Forward Contract	\$675,700	+\$22,600
Market Order (stop loss)	\$665,000	+\$11,900
SPOT	\$653,100	0

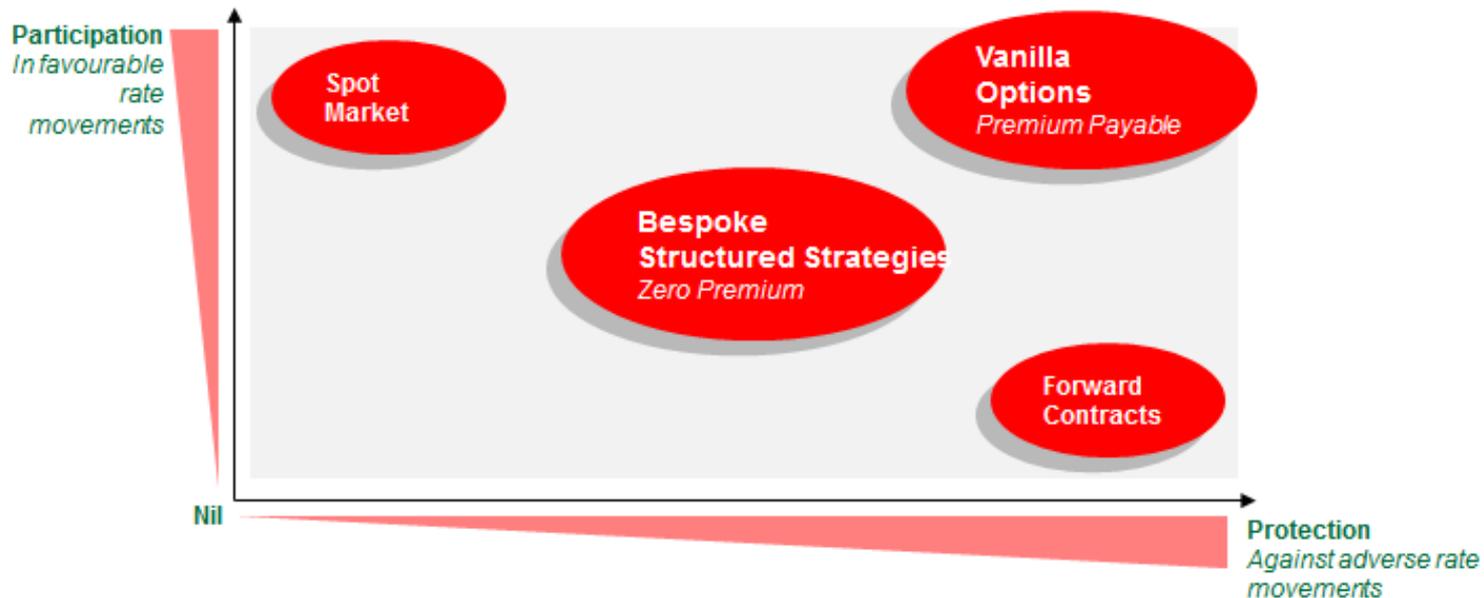
- ❖ Nobody knows where the markets will move – if you have a budgeted rate, it's prudent to protect yourself, depending on your attitude to risk.



# Options

- ❖ Usually offer a level of protection, as well as potential upside market movement
- ❖ Will always pay a premium
- ❖ FX options are regulated investment products that carry a higher level of risk than forward contracts

Risk-Reward Matrix of Alternative Hedging Strategies



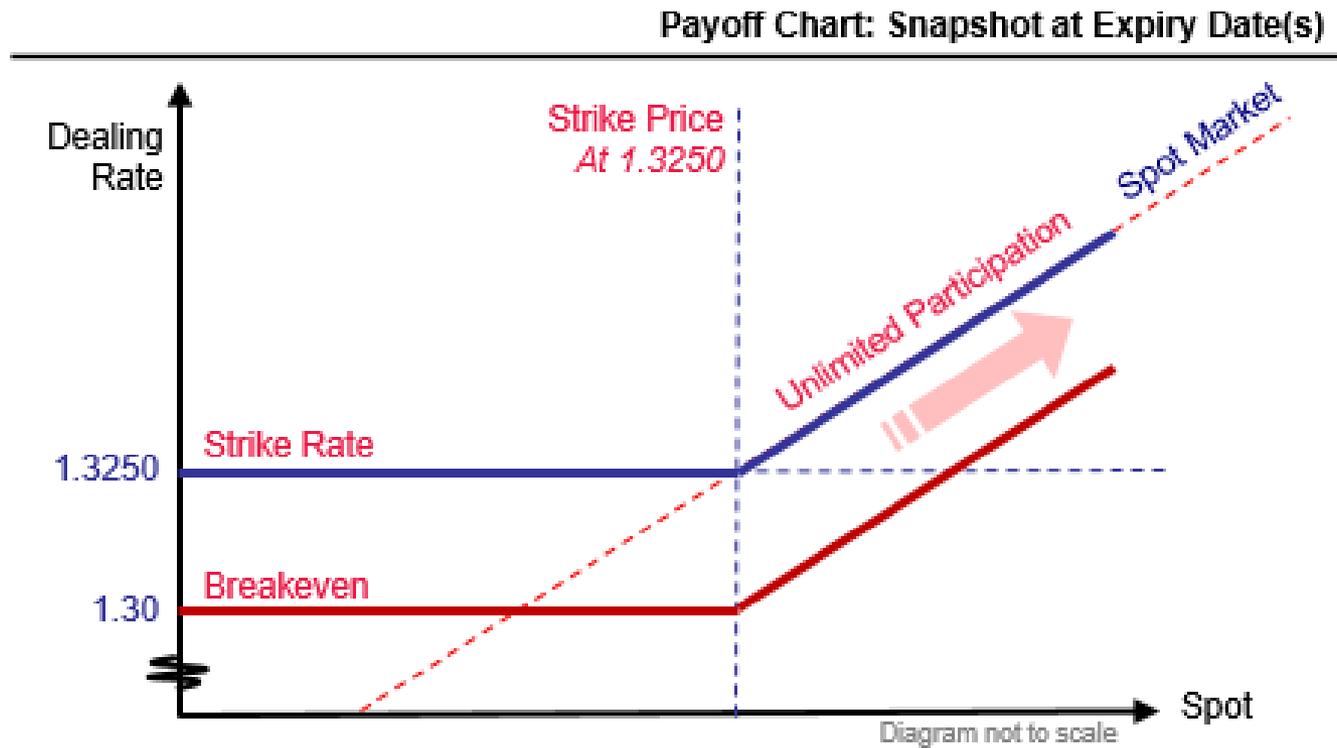


# Options - Vanilla

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- ❖ A **vanilla option** gives the holder the right *but not the obligation* to exchange one currency for another at a specified rate on a specified date in the future.
- ❖ A premium is charged for this option – much the same as an insurance policy.

# Options - Vanilla





# Options - Vanilla

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## Benefits

- ❖ Full protection
- ❖ Full participation
- ❖ Not subject to margin calls
- ❖ If the Client wishes to terminate the trade early, there would be no cost to do so

## Risks

- ❖ Upfront premium payable to enter the trade will be lost if the Vanilla
- ❖ Option expires
- ❖ The true rate of protection *out of the money* is not the strike rate, but the breakeven rate, which takes the upfront premium paid into consideration

# Zero Cost Options:

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- ❖ Options strategies can offer you protection as well as the opportunity to benefit if the market moves in your favour, however there is usually no upfront cost.
- ❖ Upside limited
- ❖ May or may not leave an obligation
- ❖ Credit implications



# Participating Forward

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- ❖ **What is it?** A participating forward provides a guaranteed 'worst case rate' and also allows you to benefit from favorable exchange rate movements on a proportion of your contract amount e.g. **50%**
- ❖ No premium payable
- ❖ Full protection against adverse exchange rate movements
- ❖ Ability to partially benefit from favourable exchange rate move
- ❖ You need to accept a slightly worse rate than the prevailing forward rate movements



# Participating Forward – Example 1

- ❖ GBP/EURO SPOT at **1.16**
- ❖ Protection rate of **1.14**
- ❖ Market will rise or fall..





# Participating Forward – Example 1

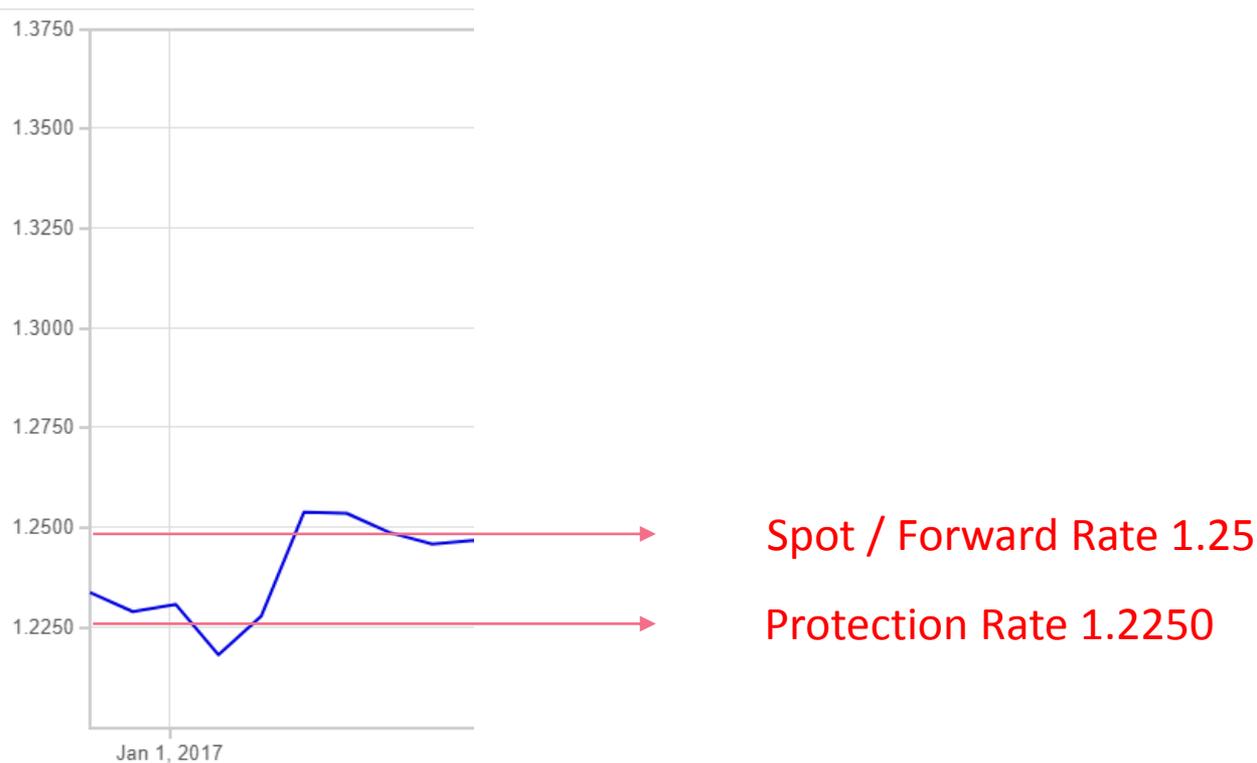
- ❖ Market falls below worst case rate of 1.14 (to 1.08)
- ❖ Have the right but not the obligation to buy at **1.14**





# Participating Forward – Example 2

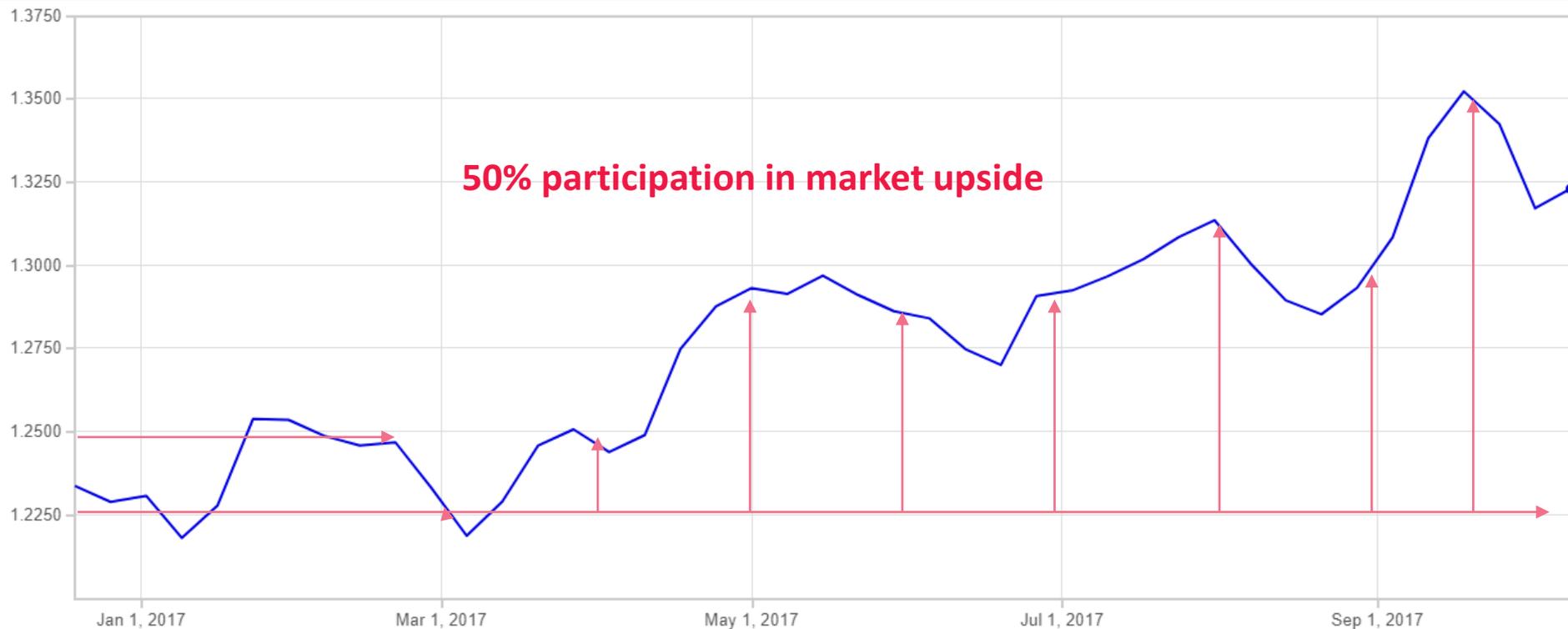
- ❖ GBP/USD SPOT at 1.25
- ❖ Protection rate of 1.2250
- ❖ Market will rise or fall





# Participating Forward – Example 2

- ❖ Market rises to **1.35**
- ❖ Obligation to buy 50% at **1.2250**
- ❖ Option to Purchase rest at **SPOT**





# Participating Forward Risks vs Reward

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## ❖ Reward

- ❖ Guaranteed worst case rate
- ❖ No premium
- ❖ 50% Upside in positive market movements

## ❖ Risks

- ❖ Obligated to buy 50% at worst case rate
- ❖ Accept a slightly worse rate than the prevailing forward rate
- ❖ Fixed dated. Cannot 'draw-down'



# Window Forward Extra

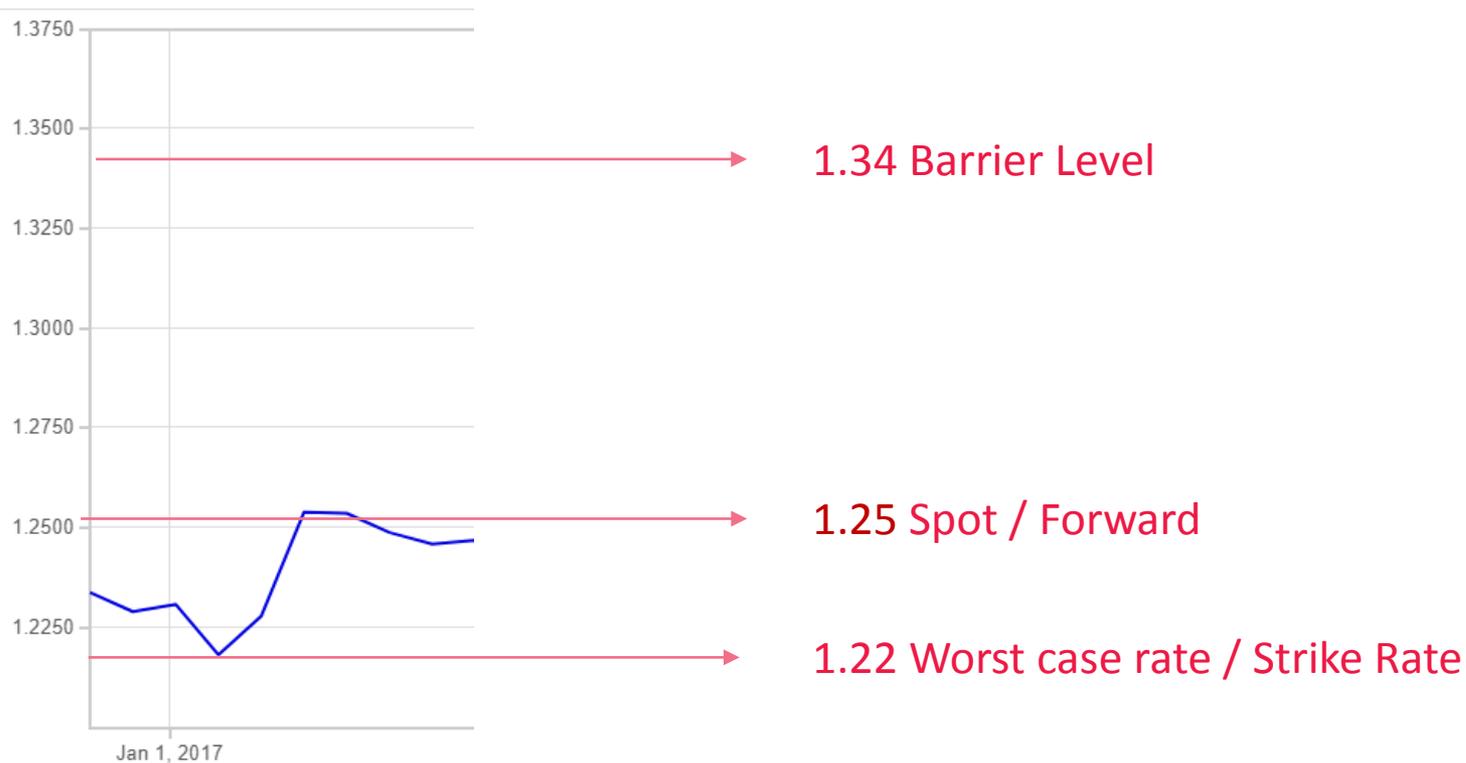
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- ❖ **What is it?**
- ❖ A forward extra contract provides a guaranteed 'worst case rate' of exchange
- ❖ Allows the opportunity for you to fully participate in positive exchange rate movements, up to a pre-determined 'barrier level' If this barrier is breached during however, you are obliged to deal at your worst case rate
- ❖ You need to accept a slightly worse rate than the prevailing forward rate movements



# Window Forward Extra – Example

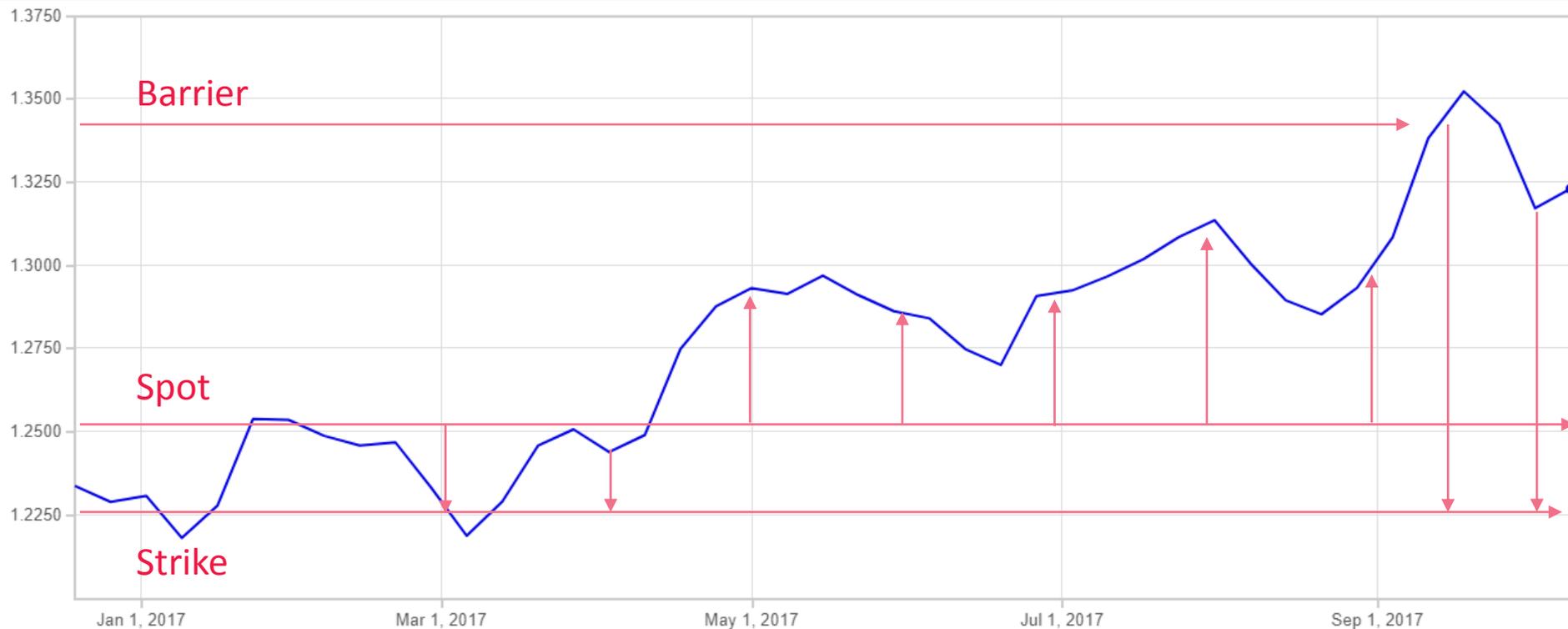
- ❖ Spot at **1.25**
- ❖ Worst case rate / Strike Rate **1.22**
- ❖ Enjoy full participation until Barrier Level reached at **1.34**





# Window Forward Extra – Example 1

- ❖ Spot below forward rate for 2 months
- ❖ 100% 5 month upside from May until Sept
- ❖ Knocked down to Strike in Sept





# Window Forward Extra Risk vs Reward

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## ❖ Reward

- ❖ Guaranteed worst case rate
- ❖ No premium
- ❖ 100% Upside in positive market movements until 'upper barrier' breached

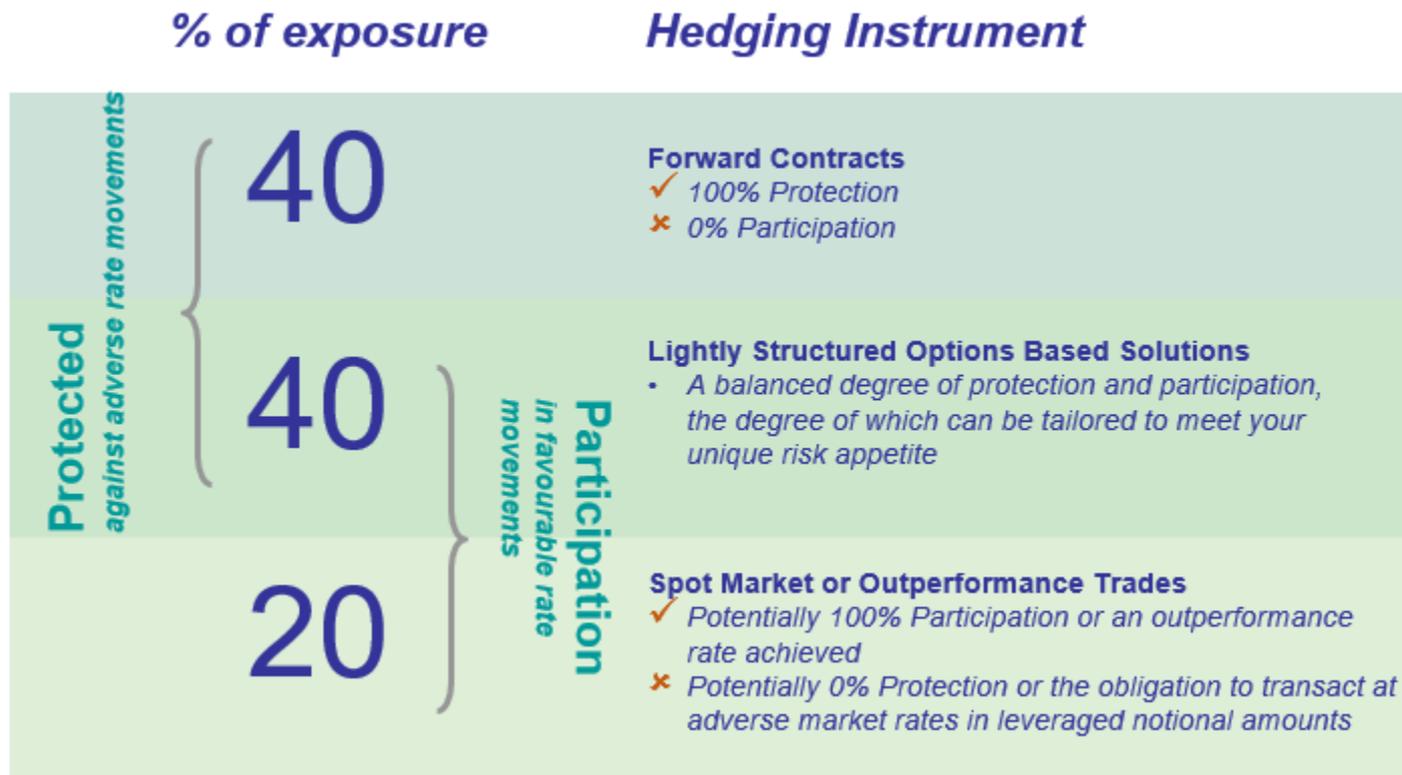
## ❖ Risks

- ❖ If the barrier level has been breached, you will be obliged to trade the full notional amount at the worst case rate.
- ❖ Accept a slightly worse rate than the prevailing forward rate
- ❖ Fixed dated. Cannot 'draw-down'



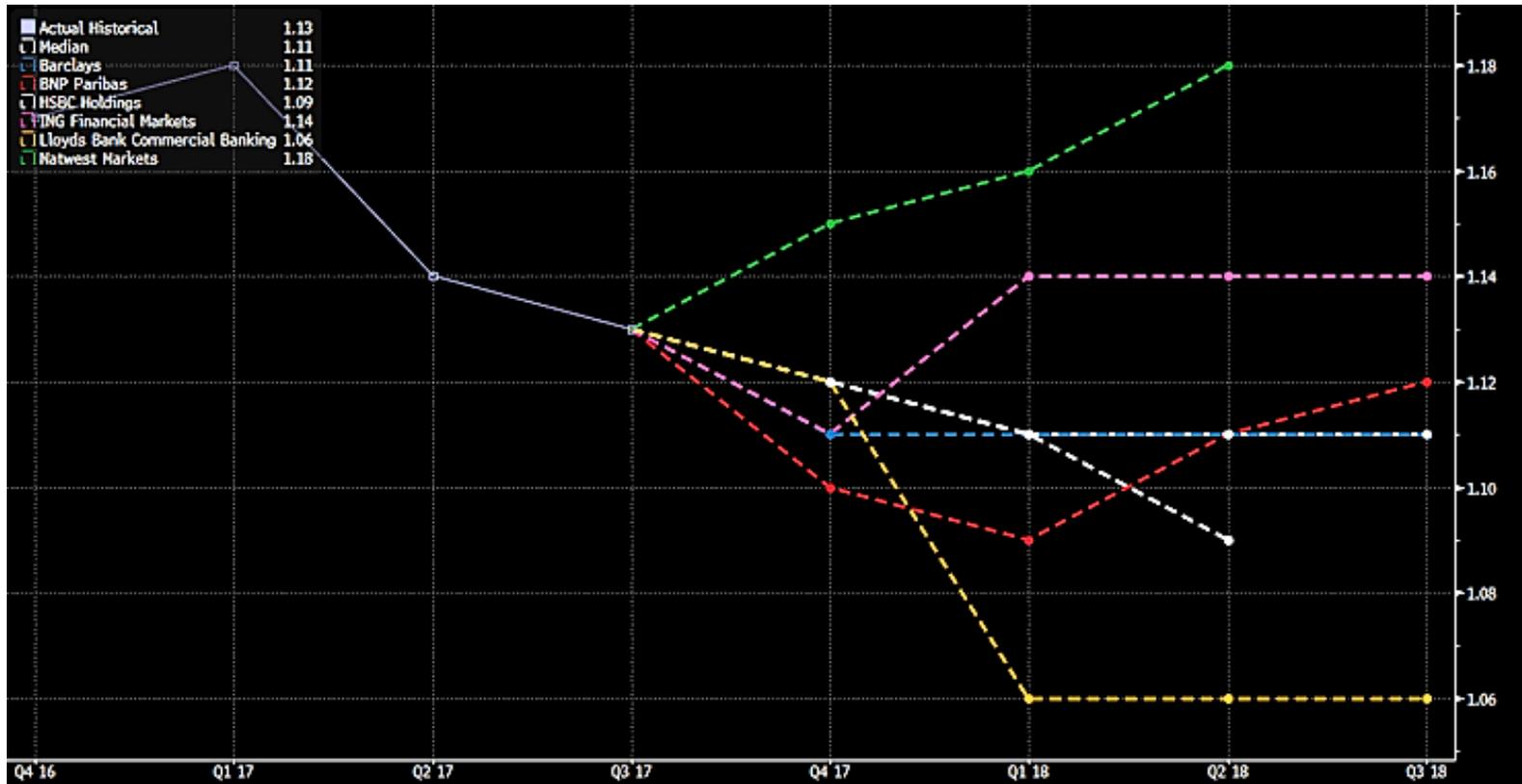
# Hedging Strategy – Blended Approach

- ❖ The markets are unpredictable – not necessarily a right or wrong answer to which hedging tools to use
- ❖ Match your hedging strategy to your risk appetite / profile





# GBP/EUR Multi-Bank Forecasts

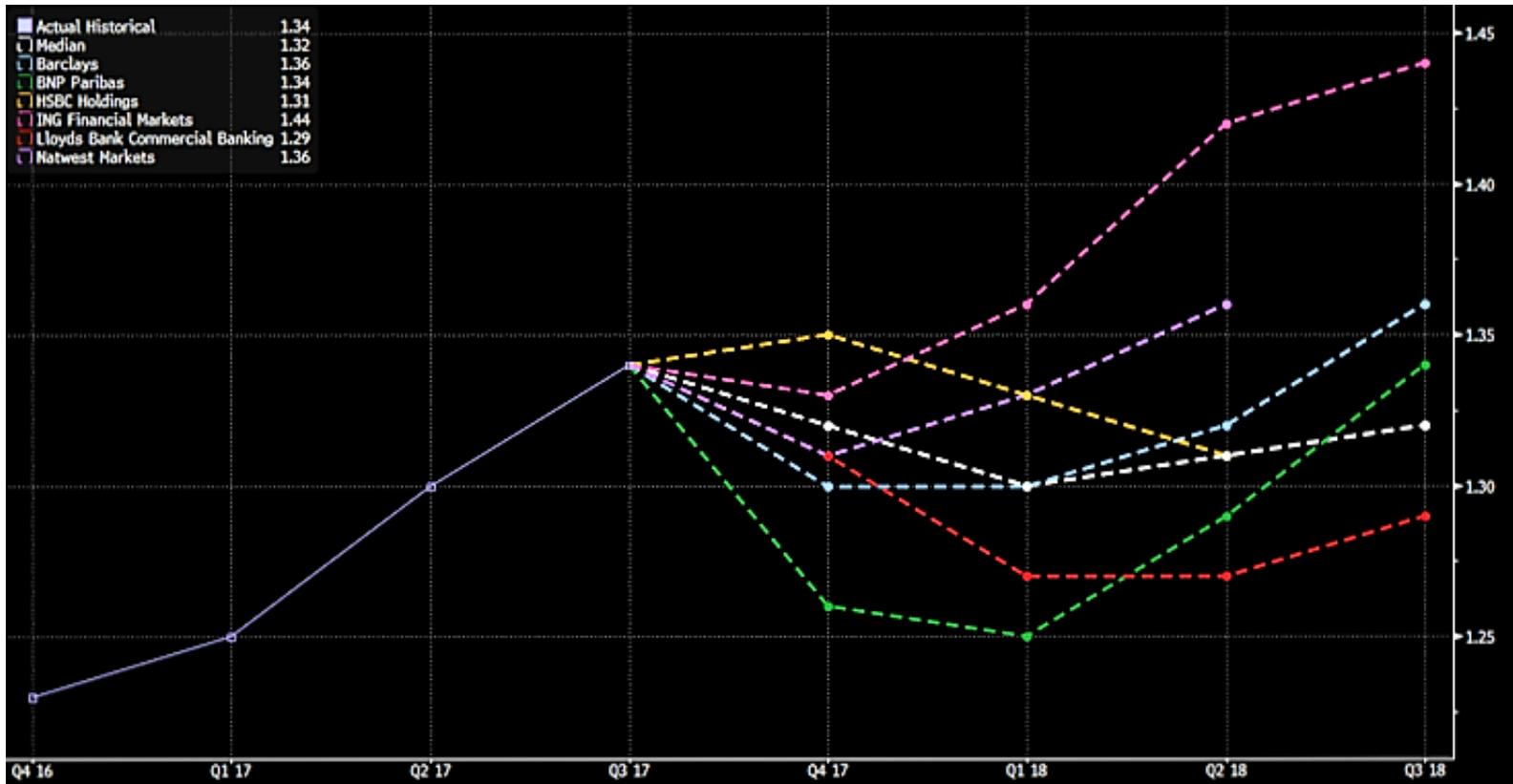


Currently: 1.13. In Q3:

- ❖ High – Natwest at 1.18
- ❖ Low – Lloyds at 1.06
- ❖ Average – 1.11



# GBP/USD Multi-Bank Forecasts



Currently: 1.34. In Q3:

- ❖ High – ING 1.44
- ❖ Low – Lloyds at 1.29
- ❖ Average – 1.32

# Current FX situation in UK

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- ❖ Approximately 75% of UK companies still use their bank
- ❖ Remaining 25% use a foreign exchange specialist - more competitive rates of exchange and guidance
- ❖ Banks offering exchange rates that can be up to 1%+ worse
- ❖ Fees typically £20-£40



# Benefits of using Moneycorp

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Bank beating  
exchange rates

Expert market  
guidance at the  
end of the  
phone

Fast online  
money transfers  
24/7



Safeguarded  
client funds

Free account  
opening and  
access to  
moneycorp's  
currency holding  
accounts

Low transfer  
fees

# About Moneycorp

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**1962**

Company incorporated

## **FCA Authorised and Regulated**

TTT Moneycorp Limited is authorised and regulated by the Financial Conduct Authority for the provision of payment services.

**1979**

Started dealing in foreign exchange

**5A 1**

Strongest security rating in the industry with D&B

## **One stop shop**

Corporate, Private, Wholesale, Retail

**7.1m+**

Customers transactions last year

## **Preferred partner**

ICAEW, Telegraph, The Guardian, BCC, CNN, The Post Office, The City AM, UKTI, The FT,

**£24.5bn**

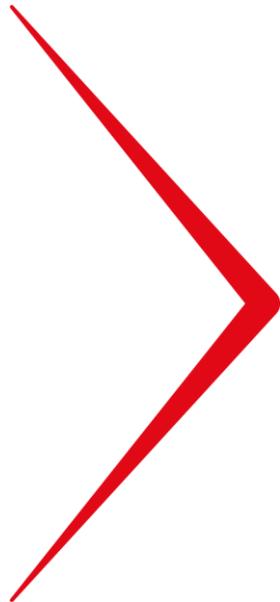
Traded in currencies last year

# Final Thoughts

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- ❖ If you have budgeted for a certain rate of exchange, your profit margins can be seriously affected by a negative turn in exchange rate.
- ❖ Create a hedging policy for your Foreign Exchange
- ❖ Review policy regularly
- ❖ Get the best rates and service
- ❖ Free rate comparisons available



*Any  
questions?*

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## **Free webinars**

*Excel skills*

5 December **10.00am**

**[lcaew.com/bamdecwebinar](http://lcaew.com/bamdecwebinar)**

*Stats skills for Excel – the basics*

24 January **12.30pm**

**[lcaew.com/lunchjan](http://lcaew.com/lunchjan)**

*Practical password policies*

8 February **12.30pm**

**[lcaew.com/lunchfeb](http://lcaew.com/lunchfeb)**

*Forecasting without fear*

20 February **10.00am**

**[lcaew.com/bamfebwebinar](http://lcaew.com/bamfebwebinar)**

## **Free event**

*Presenting with confidence*

7 March

**[lcaew.com/bammarevent](http://lcaew.com/bammarevent)**

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