# Hedging must add to predictability

## Companies must show investors that hedging will increase the reliability of future earnings predictions

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Special correspondent

Fund managers have a reputation for being against hedging. Mostly, this is because hedging is too frequently a euphemism for companies speculating in commodity and foreign exchange markets in ways that add uncertainty and, in doing so, erode underlying corporate value.

The recent Australian Mines and Money in Melbourne hosted a debate on whether hedging by mining companies was worth the risks. That someone felt a debate on the subject was necessary highlights some tension between companies and investors about the practice.

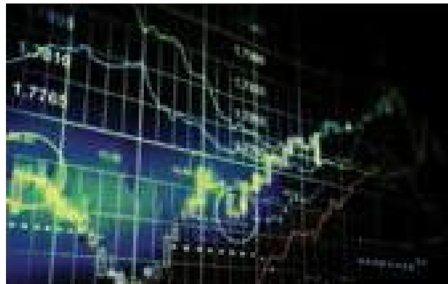
Speaking in favour of hedging was Sean Russo of corporate advisory firm Noah's Rule. Russo is widely regarded as one of the most experienced and adept practitioners of the hedging and risk management craft for the resources industry. I was asked to take the opposite side of the debate, putting the view that the risks were not worthwhile.

As an equity investor, a judgement about hedging rests on whether companies can consistently add value by buying or selling financial derivative products. Doing it occasionally is not good enough. Investors pay a premium for a sustainable and predictable income stream. They are typically put off by transactions that defy prediction. Lumpy or one-off positive effects on earnings will usually be ditched from valuation models.

One of my own early experiences with hedging involved purchasing metal concentrates for smelting in North America. The purchase price of the concentrates was based on daily London Metal Exchange or Comex prices. Simultaneously with the purchase, an offsetting futures sale had to be executed to match the anticipated timing of the eventual refined metal sale, which would also be based on the relevant forward or futures contract. The physical sale would be offset by the closure of the hedge contract.

No matter what happened to the copper price, for example, in the interval between concentrate purchase and metal sale, the smelter would have confidence about its profitability once this classic hedge transaction had been put in place.

Even in this most straightforward of hedging programmes, there were tail risks, such as a smelter malfunction, a shipping delay or a failure of commodity exchange systems. However, in the general course of business, management could rely on well-defined future financial returns.



*Investors often prefer to hedge for themselves*

In other circumstances, as an adviser to mining companies, I have recommended they price anticipated sales on a rolling three-month forward contract so as to take advantage of any contango. Similarly, there have been times when I have recommended that manufacturing companies price foreign exchange purchases or raw material buying contracts regularly so as to achieve average market outcomes rather than be exposed to prices that might prevail at a single point in time.

These sorts of arrangements can add value for investors by improving business predictability and helping analysts' forecast accuracy, if adhered to. Investor doubts about hedging arise when company executives begin to exercise discretions that erode predictability and veer toward more speculative behaviour. There are at least six reasons for investor anxiety about discretionary hedging practices.

Firstly, actual or even potential departures from rules-based hedging programmes create doubt in the minds of investors about pricing decisions that are to be taken in the future.

The investor's ideal is to capitalise a constant stream of earnings so as to determine value. This is true whether the investment is a mining company or a beachside investment property. Uncertainty detracts from value. It reduces the chance that a financial forecast will be accurate and requires any investor to apply a higher discount rate, whether implicitly or explicitly, to a future earnings stream.

If an investor does not know what decisions about pricing are to be taken in the future because executives retain a discretion to respond to market conditions, he is unable to satisfactorily assess the value proposition of the company he is considering as an investment.

Second, geologists and mining engineers are always going to have a hard time trying to persuade those who spend all their time working in financial markets that the former have some special insights into how to make money from commodity-price movements.

In practice, industry executives have proven themselves much like everyone else insofar as they are most bullish near the top of the market and rarely buy near the bottom.

Third, accounting practices do not always line up with economic good sense. Accounting reports can misleadingly describe what is happening at a company level by separating the derivative transactions used for hedging from related physical trading despite the business rationale requiring a holistic view. The resulting confusion and risk of misinterpretation is an added source of uncertainty.

Fourth, hedging normally assumes that production goes to plan and that customers take product when contracts say that must happen despite evidence to the contrary. Ironically, this operational risk is often realised just as market conditions turn and a capacity to insure against these risks would be most valuable.

Fifth, investors can do their own hedging if they want to change the risk characteristics of their portfolios. They can double up or eliminate commodity or exchange-rate risks based on their views of the world. Fund managers are paid to meet defined return objectives.

The achievement of their targets can be upset if companies capriciously or unexpectedly take action based on a view about the future direction of markets.

Sixth, although bankers' funding requirements do not necessarily detract from the certainty craved by equity investors, hedging programmes mandated in finance arrangements can encourage speculative activity on the part of companies.

Finance agreements that offer discretion about the timing of delivery against contracts or discretion to re-price options or buy back derivative contracts invite executives to make judgments about future financial market conditions.

In sizing up whether or not to exercise a discretion to hedge, executives need to make this judgement about their abilities: is the uncertainty accompanying derivative trading going to be offset by an uncanny forecast accuracy, on their part, not replicated anywhere else in financial markets. ▼

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