CORNERSTONE **Topics** *Insight For Management*

Spring 2005

Hedging

Protection from Market Price Volatility

Hedging is an excellent way to limit supply chain risk. It is a form of price insurance, in which you transfer some of the market risk associated with price movements to another party willing to assume that risk. Supply chain professionals use hedges most often in the areas of raw materials (metals, foodstuffs, fibers), energy (petroleum products), and currencies.

Hedge transactions are executed using the services of a regulated commodities exchange like the Chicago Mercantile Exchange or the London Metals Exchange. Regulated exchanges provide a reasonably fluid and transparent market for the transference of the particular risk.

How does hedging work? In short, a hedger buys and sells positions in a futures market for an item to partially smooth the effect of price activity in the cash or "spot" market for the same item. Think of parallel markets here. The cash market rationalizes prices for transactions involving actual day-to-day requirements, like natural gas needed for the operation of a facility right now. Alongside the cash market there exists a futures market for the same item where participants trade on the basis of where they think the price of the item will be a month, six months, or even a year from now.

Imagine that you are a regional coffee roaster. It is early May and you know that you will need 10,000 lbs. of green (unroasted) coffee in September for your firm's fall roasting requirements. Unfortunately, you fear that green coffee prices will rise over the summer months, perhaps due to bad weather or political unrest in the coffee's country of origin. Further, you do not see any great likelihood of a price decline during this same period. You decide upon a hedging strategy to better control your cost of green coffee.

To execute this strategy, you buy coffee futures in May, for September delivery. That is to say, you buy coffee at the price the futures market in May expects will be the going price come September. You then plan to sell these futures in September when you believe the futures market price for them will be even higher, thus generating a profit on the futures transaction. Concurrently, you defer any actual cash purchase of your green coffee until September, at which time you enter the cash market and buy your green at the then-market price. In summary, you are buying your coffee futures " low" and selling them "high," and using the net gain on the transaction to offset some of the purchase cost of your actual needs.

Here is a dollar summary of the above:

Futures Market. In May you buy one contract (37,500 lbs.) of September coffee for $1.45 / lb. for a cost of $54,375 ($1.45 X 37,500). By September, coffee prices have risen as you suspected and September coffee is now trading at $1.57 / lb. on the futures market. You sell your September futures contract for that price and realize $58,875 ($1.57 X 37,500), a gain of $4,500 ($58,875 - $54,375).

Cash Market. In May you do nothing. You wait until September, when cash coffee is selling for $1.55 / lb. You buy 10,000 lbs, costing you $15,500 ($1.55 X 10,000).

Result. Your net expenses are $11,000 (($54,375 + $15,500) - $58,875). This equates to a purchase cost for your coffee of $1.10 / lb. ($11,000 / 10,000 lbs.).

Another wise use of hedging is to limit foreign exchange costs. For example, assume that you have "offshored" some of your services to Ireland and your Irish services provider accepts payment only in euros. You can smooth your cost of euros in the same manner as for coffee by hedging in the euro futures market, and then applying the gain on your futures trades to soften the cash price you later pay for your euros.

Hedging also helps you to protect against price declines as well as price increases. In the euro situation immediately above, assume that you believe there is a good chance that the euro will drop in relation to the U.S. dollar. In this case, you follow the same

rule about buying low and selling high, but you reverse the order of events. You sell euro futures first ("short-sell") then buy them back later after the euro futures prices have dropped. As before, you apply the gain from your futures transaction against your cash cost of euros, lessening your total cost of euros.

You should use hedging only for items you consider strategic and whose supply chains you know most intimately. If you consider knowledge about the item important enough, consider doing required analyses in house rather than relying exclusively on the work of others.

There is considerably more about hedging to be learned than the space available in this newsletter allows. Good places to start are the web sites of the New York Mercantile Exchange (http://www.nymex.com/), the Chicago Mercantile Exchange (http://www.cme.com/), or your firm's brokerage services provider.

Disclaimer: Cornerstone Services, Inc. is not a commodities broker, a member of any futures exchange, or a market maker for any futures transactions. There are risks inherent to hedging, such as a futures market moving in the direction opposite your strategy. You should thoroughly consider and discuss further with competent advisors beforehand any decision to hedge.

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Do any of the questions below apply to YOUR business?

How effective is our firm's supply chain management?
What kinds of savings should our firm expect from our supply function and how much should they be?
Do our supply management skills meet our needs?
When should we negotiate, conduct a formal request for bids, or just order what we need?

Call CORNERSTONE during normal Pacific Time business hours, or email us for more information.

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