Case Study

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## Small Business Dilemma

1. Unavoidable risk in investing in foreign countries known as exchange rate risk or foreign exchange (forex) risk. Hedging techniques are used throughout the world to mitigate this unavoidable risk.

Currency futures as a technique of hedging, are dealt on an exchange and are extensively used by foreign investors to hedge the exposure to the exchange risk. Sports Exports Company should sell futures contracts on pounds (while taking a short position), to make itself safe from the depreciation in the value of Pounds. These currency futures sold should be equal in value to the number of receivables in Pounds, and the settlement dates should be such that they match up with the dates the amount is to be received. An advantage of currency futures is that they require a minimal amount of upfront margin. And the disadvantage is that their dates are fixed and due to their standardized nature they cannot be customized to meet the requirements of the Companies. Prices at the beginning of the futures contracts are locked-in, thus the company entering into the contract loses if the movements in the exchange rates are favorable. Moreover, mark-to-market adjustments is also a requirement of these contracts, and at the close of every trading day, the companies entering into the contracts are required to maintain their position in futures contracts.

1. The firm should buy put options on British Pounds to eliminate exchange rate risk thus fixing the least exchange rate to sell the pounds at a predetermined future date.
2. The restraint in case of using currency options is that these use standardized units and therefore, there would be no exact match of currency option for the number of £ that the Firm would need to sell at the end of each period.
3. The owner of the Firm should consider purchasing put options, due to their nature of offering greater flexibility. The owner of the company would have an option to exercise the options if in case the pound falls in value against the U.S. dollar. While on the other hand if the pound’s value gets appreciated then there would be no liability in case of non-exercise of the options.

The disadvantage concerned with buying put options is that these require a premium to be paid when purchasing them. While in case of futures contracts used to hedge against currency rate fluctuations no such condition exists (i.e. no premium is to be paid), but the contracts are to be exercised at the end of the term.

## Internet/Excel Exercises

1. The currency futures with closest settlement dates are Brazilian Real Futures (Jul 2019), Indian Rupee/USD Futures (Jun 2019), and the remaining due to be settled in Sep 2019. All these contracts reflect changes (i.e. increases) from the day before. And the increases are as follows:

Brazilian Real Futures (Jul 2019)

Last 0.2618

Change +0.00075

Open 0.2615

Indian Rupee/USD Futures (Jun 2019)

Last 144.35

Change +0.73

Open 143.60

News release dated June 20, 2019, states that “LONDON and SINGAPORE and CHICAGO, June 20, 2019/PRNewswire/ -- CME Group, announced today that Shanghai Gold Exchange (SGE), will grant CME Group a license to use, create and list futures contracts based on SGE's Shanghai Gold Benchmark PM Price..”

1. There is a total of ten futures that are due to be settled till September 2019. One of them is due to be settled in June 2019, and another is due in July 2019. While the remaining eight are due by September 2019. Prices among all of these are moving in the same direction i.e. an upward trend can be seen in the prices of all of these. While in the case of two of them, the prices are decreasing. One of them is British Pound Futures and another is Mexican Peso Futures. The movements in prices are as follows:

British Pound Futures

Last 1.2781

Change -0.0004

Open 1.2787

Mexican Peso Futures

Last 0.051460

Change -0.000100

Open 0.051590

1. If I buy the British pound futures contract that is the nearest to their reimbursement date, then that would be due by September 2019, and the future price would be:

As per the website (cmegroup.com) data GBP/USD futures information the future price is $1.2787. So, the contract value would be

Value = 62,500 Pounds

To buy = $1.2781 x 62,500 pounds = $79,881.25

To sell = $1.2787 x 62,500 pounds = $79,918.75

Thus, the settlement of the contract = $79,881.25 - $79,918.75

= $37.5 Gain

Because the selling value of the contract is more than the buy value. Therefore, I will make a gain at settlement.