Operational Hedging to Foreign Exchange Risk – Case of Kosovo Pension Savings (KPST)

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Abstract - Nowadays, investors face a lot of challenges in the business environment, especially in the investments on stock markets. The challenges and responsibilities are even greater when moneys which have to be invested are public funds, as in the case of Kosovo Pension Savings (KPST). Since investors face multiple risks during investments, the world of money investments would not be developed as it is without proper strategies to hedge. This paper will analyze and study hedging in foreign exchange risk. A broader focus will be given to the operational hedging strategies used from KPST in their investments.

Index Terms - diversification, global market, money market, and portfolio.

I. INTRODUCTION

Nowadays, investors face a lot of challenges in the business environment, especially in the investments on stock markets. The challenges and responsibilities are even greater when moneys which have to be invested are public funds, as in the case of Kosovo Pension Savings (KPST). KPST is an independent not for profit public institution of Republic of Kosovo, which is established as an obligatory plan to manage pension contributions until retirement (KPST, 2019). According to KSPT 2019), the main objective of the organization is to keep, manage and invest pension contributions, saved by the citizens of Kosovo. The investments decisions are made from the Governing Board of KPST. According to Konrad (2015), by the end of 2012 on the global market were over 7238 mutual funds which have offered a lot of investments opportunities. Since investors face multiple risks during investments, the world of money investments would not be developed as it is without proper strategies to hedge. This paper will analyze and study hedging in foreign exchange risk. A broader focus will be given to the operational hedging strategies used from KPST in their investments.

II. HEDGING – AN OVERVIEW

Was mentioned in the introduction part that business environment offers a lot of opportunities to invest. Investments all the time bring risks which need to be managed. The best way to manage risk is to hedge from it. The well-known American author and finance practitioner Aaron C. Brown has pointed out that “Many financial disasters can be traced to people who thought they were hedging”. From this quote it is obviously clear that hedging is a very important part in the world of investments, but how hedging can be defined? In the literature there are numerous definitions about hedging. Prindl (1976), defines hedging as an action taken to protect company’s exposed positions in foreign currencies. Clark et.al (1993), pointed out that hedging represent a strategy created from company to minimize the impact of adverse outcomes in the case of investments on foreign currencies. Bash (2015), defines hedging as an action that protect companies which are exposed to foreign exchange risk from the unexpected changes in exchange rate. We can see that all these definitions are very similar to each other and suggest that hedging is the strategy implemented from companies to protect their investments from the fluctuations in the exchange rate. The way how the company decides to hedge depends to the profile of company, whether the companies are more open to risks or not. Usually companies use two techniques of hedging: Operational Hedging and Financial Hedging. While financial hedging deals with financial assets, operational hedging
III. OPERATIONAL HEDGING

Boyabalti & Toktay (2004), define operational hedging as actions which are taken by the company to hedge from currency risk through the use of non-financial assets, in other words, operational hedging deals the operational side of company. Similar to the authors mentioned above, the author Kaplan (2012), pointed out that operational hedging involves hedging techniques that are also known as internal hedging techniques. Operational hedging is known as internal hedging because it deals with internal environment of hedging and should be considered before using the financial hedging techniques (Kaplan, 2012). According to Bash (2015), the operational hedging techniques include: Lead and Lag, Currency Diversification, Exposure Netting, Currency of Invoicing, Price Variation, Risk Sharing Arrangements, Currency Collars and Hybrid.

Abor (2005), pointed out that a lead strategy involves an aim to collect foreign currency receivables, when a foreign currency is expected to depreciate and to pay foreign currency payables when a currency is expected to appreciate. In the other hand lag strategy according to Hill (2001), represents situations when companies seek to delay collection of foreign currency receivables when currency is expected to appreciate and to delay payables when currency is expected to depreciate.

According to Warwick-Ching (2011), the currency diversification represents the case when companies use more than one currency to invest as a hedging strategy. The author mentioned above shows the benefits of investing on different currencies, mostly of non-facing exchange rate risk.

Abor (2005), explained exposure netting technique as a strategy used in international transactions by companies which involves reducing fund transfers between affiliates to only a netted amount.

According to Bash (2015), price variation is a hedging technique that is based on changing the price of exports when the exchange rate changes.

Risk Sharing Arrangements are an operational hedging technique where both importer and exporter deal with the burden of foreign exchange risk when they use domestic currency terms in the invoice part of shipment (Moosa, 2010 & Bash, 2015).

Currency collars determine two exchange rate values, the minimum and the maximum value (Bash, 2015). Bash (2015), clarifies that in the cases when exchange rate exceeds maximum value, both exporter and importer use maximum value. In the other hand according to Bash (2015), in the cases when exchange rate falls below the minimum value, both exporter and importer use the minimum value.

The Hybrid technique is a combination of risk sharing arrangements and currency collars. Bash (2015), pointed out that hybrid technique is based on the weighted average of two exchange rates under a risk sharing arrangements and currency collars.

This part of the paper presented operational hedging and its techniques. Operational hedging is a very important part of decision making in the companies that face foreign exchange risk during their activity.

IV. OPERATIONAL HEDGING - KOSOVO PENSION SAVINGS

In the introduction part was mentioned that Kosovo Pension Savings (KPST) is an independent not for profit public institution of Republic of Kosovo, which is established as an obligatory plan to manage pension contributions until retirement (KPST, 2019). KPST was established in 2001 and started to operate on August 2002. Since then KPST has an ongoing positive performance.

![Figure 1: Cumulative performance of KPST](http://www.trusti.org/wp-content/uploads/2017/12/2017_TM4_shq.pdf)

From the figure we can see, that KPST has faced difficult times just in the years 2007-2008 in the period of global crisis, but we can see that it was a very well managed situation, because share price is increased year by year.
By the end of 2017, share price was 1.4648 € with an increase of 6.5% from 2016 (KPST, 2018). Net assets under the management of KPST at the end of 2017 were 1,634,648,056 €, with an increase of 15.3% from 2016 (KPST, 2018).

![Performance Chart](http://www.trusti.org/wp-content/uploads/2017/12/AR21017_eng.pdf)

<table>
<thead>
<tr>
<th>PERFORMANCE</th>
<th>2017</th>
<th>2016</th>
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<tbody>
<tr>
<td>Share price at the end of the year</td>
<td>€1.4648</td>
<td>€1.3756</td>
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<tr>
<td>Share price increase during the year</td>
<td>6.5%</td>
<td>4.4%</td>
</tr>
<tr>
<td>Gross investment return for the year</td>
<td>€102,172,561</td>
<td>€64,120,264</td>
</tr>
<tr>
<td>Other returns for the year</td>
<td>€385,000</td>
<td>€440,000</td>
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<tr>
<th>ASSETS UNDER MANAGEMENT (AUM)</th>
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<tr>
<td>Net AUM at the end of the year</td>
<td>€1,634,648,056</td>
<td>€1,417,970,874</td>
</tr>
<tr>
<td>Increase in net AUM during the year</td>
<td>216,677,182</td>
<td>€188,637,546</td>
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Figure 2: Performance and AUM of KPST 2016-2017

As was mentioned, investments bring all the time risks and investors need to implement different hedging techniques to hedge from adverse outcomes. KPST has published a document called “Key Investments Information” which provides information about investments portfolio. On the goals of prudent investments mentioned on this document is also diversity of investments. In fact from the reports published from KPST we can see that one of the most applied operational hedging techniques from KPST is diversification of portfolio. The next figure shows the global spread of KPST’s investments.
V. CONCLUSION

This paper showed the importance of hedging to Foreign Exchange Risk with a focus on Kosovo Pension Savings. Investors face a lot of challenges and difficulties in the business environment, especially in the investments in stock markets. Since investors face multiple risks during investments, the world of money investments would not be developed as it is without proper strategies to hedge. The paper had in focus operational hedging and showed the importance of its techniques for investors. A broader focus was given to the KPST operational hedging strategies and from the reports of this institution we can see that a very common strategy used from KPST is diversification. The paper concludes that KPST has chosen appropriate hedging strategies as long as its performance is ongoing positive through the years.

REFERENCES

[4] Brown, A.C. Quotes

AUTHORS

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