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Diversifying internationally: disentangling hedging, valuation and capital cost effects

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Abstract

This introduction highlights the six papers competitively selected from papers presented at the 2003 Annual Conference of the Midwest Finance Association. This special issue deals broadly with the issues of diversification in an international setting. All the papers have a common thread. The firms that are analyzed are diversified along geographic (international) and/or industrial lines. They are involved in international business either through international acquisitions or (i) they have existing foreign currency debt or (ii) they align their foreign asset base with that of their foreign sales. Some of the firms in the studies covered cross-list their stock internationally to increase firm value. Others use international debt to reduce their cost of capital.
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1. Introduction

Regardless of the specific form in which diversification occurs, significant and important issues are addressed. The papers in this special issue tackle some leading edge problems that arise from the choices made by international managers. These problems range from (i) the effectiveness of currency derivatives at hedging the residual risk arising from natural hedges, (ii) the role of maturity in determining the optimal choice of hedging strategy when exposures at different maturities are not known with certainty, (iii) which hedging strategies

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aimed at reducing exposures are value-increasing, (iv) what is the impact of corporate diversification on technical efficiency, (v) what is the impact of internationalization on cost of capital, to (vi) are the markets for stocks that are cross-listed internationally integrated, and many other important issues.

2. Discussion

In the first paper by Huffman and Makar, "The Effectiveness of Currency-Hedging Techniques over Multiple Return Horizons For Foreign-Denominated Debt Issuers," the authors address an issue of primary relevance for corporate financial managers and international managers: how does the effectiveness of hedging change over multiple periods, if the hedger has foreign-denominated debt outstanding? For multinational corporations (MNCs), it is clear that the time-horizons for which risk must be managed and the exposures associated with each time horizon are not known with certainty a priori. Hence, the use of currency derivatives, which works in the Adler and Dumas (1984) framework, has to be modified.

The authors could have proceeded along several different possible paths. They choose to evaluate from an empirical perspective, the efficacy of the use of some natural hedging techniques. This tack is justified by work from Geczy et al. (1997), Nance et al. (1993) and Chowdhry (1995), who show that (i) MNCs that issue foreign denominated debt may be naturally hedged, (ii) natural hedges are more effective in the longer-term than in the short-term, and (iii) natural hedges may be more cost-effective than short term hedges using currency derivatives.

The authors' approach thus differs fundamentally from the analysis of unconditional techniques aimed at improving hedging effectiveness by rolling over hedges for long dated commitments or using multiple short contracts simultaneously as in Neuberger (1999). Neither does the paper address the problem of whether it is in some sense optimal to hedge cash flows from operations and to hedge sales revenues as in Mello and Parsons (2000).

What this study provides is evidence from a layered hedging approach. It is clear that the authors are dealing with the issues of residual foreign exchange risk and exposures not resolved by the primary debt issuing strategy. Given that the firm has already done some long-term hedging, how should it best hedge residual risks at different maturities? This question has not been previously addressed in the literature and the authors make a contribution here. They address a practical problem faced by international financial managers who may have inherited an existing debt management policy and need to know how to best deal with its repercussions. Should residual risks be hedged by the use of foreign exchange derivatives or by altering the firm's geographic sales-to-asset alignment? To what extent is the choice of technique influenced by the hedging horizon contemplated?

Using firm data culled from annual reports, the authors investigate results for multiple return horizons ranging from as little as 3 months to 5 years. For the time period analyzed, 1994–1999, risk from foreign exposure increases as the return horizon increases. This is consistent with previous work covering a similar time period. The authors show that (i) hedging foreign exposure at the intermediate and longer-term periods is effective, if debt issuance is combined with aligning geographic sales and foreign assets, and (ii) the use of foreign exchange derivatives is effective in the short-term horizon.

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