Tiffany: futures contract and exchange-rate risk essay

1. In what manner (s) is Tiffany exposed to exchange-rate hazard subsequent to its new distribution understanding with Mitsukoshi? How serious are these hazards?

Answer: Approximately 15 % of (1992) gross revenues of $ 492mln or ~ $ 75mln will now be earned in Yen. but will hold to be reported in $. At a Net Income (1992) of $ 25mln. the hazards caused by this exposure are important. Datas from exhibit 6 shows that in a 6-month period (Apr-Sep) exchange rates fluctuated every bit much as 10 % . (from 133. 30 ?/ $ to 120. 07 ?/ $) . A 10 % downward fluctuation like this would interpret into a 3rd of a bead in net consequences ($ 25mln -/- $ 75mln x 10 %) to $ 16. 67mln. presuming everything else stays the same (e. g. all costs incurred in $. monetary values to consumers remain unchanged) .

2. Should Tiffany actively pull off its yen-dollar exchange-rate hazard? Why or why non?

Answer: Tiffany should actively pull off its ?/ $ exchange rate hazard for the undermentioned grounds: 1. The possible impact on its consequence as described in the reply to inquiry 1 is important ; 2. There are strong indexs (on a PPP-basis the Yen is extremely overvalued) that a rectification will happen. which might intend even larger exchange-rate fluctuations than have occurred in the yesteryear. The manner Tiffany manages its ?/ $ exchange-rate hazard is of class a map of how exchange-rate development scenario’s relate to the cost involved in [the instruments used in] pull offing this riks.

3. If Tiffany were to pull off exchange-rate hazard activity. what should be the aims of such a plan? Specifically. what exposures should be actively managed? How much of these exposures should be covered. and for how long?

Answer: The aims of an exchange-rate hazard direction plan should be to set the value at hazard within a scope that is acceptable for the company. which will depend of the hazard appetency of direction.

The exposure to be actively managed are the stock lists that are denominated in $. but will be sold in ? . as this is where the exchange-rate hazard occurs.

How much of these exposures should be covered and for how long is once more dependent on 1) the hazard appetency of direction and 2) the cost involved in pull offing the hazard. Assuming a risk-averse direction. the full exposure should ideally be covered either through future contracts or through purchasing ? put options. To run no exposed hazards. these places (either in hereafters or in puts) should be rolled over straight upon termination. I would urge the length of the contracts to depend on the stock list rhythms. so to aline the features of the underlying values with the features of the instrument.

4. As instruments for hazard direction. what are the main differences of foreign-exchange options and frontward or hereafters contracts? What are the advantages and disadvantages of each? Which. if either. of these types of instruments would be most appropriate for Tiffany to utilize if it chose to pull off exchange-rate hazard?

Answer: the proprietor of an options contract can exert (to purchase or sell) on or prior to the pre-determined settlement/expiration day of the month. Both parties of a " futures contract" must exert the contract (purchase or sell) on the colony day of the month. Therefore. as a hazard direction instrument. the options buys you the possibility to move on downside hazard. thereby extinguishing it against a monetary value. There is limitless upside to gain from upward monetary value motions in favour of Tiffany. A forward or hereafter contract fundamentally eliminates any upside every bit good as downside hazard as monetary value. exercising day of the month and sum are all pre-determined. Therefore I would urge to utilize the option instrument as it creates the possible to gain from favourable ?/ $ exchange-rate developments while at the same clip extinguishing the hazard from unfavourable exchange-rate developments.

5. How should Tiffany form itself to pull off its exchange-rate hazard? Who should be responsible for put to deathing its hedges? Who should hold oversight duty for this activity? What controls should be put in topographic point?

Answer: Tiffany & A ; Co? s should form itself in geographical units. but the direction of the exchange-rate hazard should be done at a corporate degree. The section that would be best suited to put to death the hedges is the Corporate Finance/Corporate Treasury Department. The Management Board. in peculiar the CFO should hold the inadvertence duty for this activity. as non pull offing this activity adequately can hold a enormous impact on company net incomes. In order to cover with activities in the derivative infinite adequate hazard direction patterns should be put in topographic point. the most of import 1s being the sum of hazard exposure (measured by Mark-to-Market patterns and day-to-day Value-at-Risk ratings) and incorporate direction control.