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Expect the Unexpected

Managing risk in an era of heightened uncertainty

As Yankee legend Yogi Berra once said, "it's tough to make predictions, especially about the future." The surprising developments of the past year remind us that this old adage is as true as ever. So-called "Black Swan" events, those assumed to have low probability but high impact, appear to be occurring with greater frequency. Britain's decision last June to leave the European Union, Donald Trump's upset win in the U.S. presidential elections last fall, and the Cubs history-defying World Series run are some of the most recent examples of the hazards of relying on expert opinion. Even in the age of big data and instant polling, the experts and the polls still get it wrong.

While economic forecasts and polls are useful tools, academic studies repeatedly have demonstrated the limitations of their predictive power. Making predictions about future economic performance is notoriously difficult, even over relatively-short time horizons. Furthermore, condensing the range of possible future outcomes into a single point forecast fails to reflect the risk that actual outcomes will deviate from the forecast and may lead to overconfidence on the part of management.

Nonetheless, financial managers are often called upon to play the role of financial fortune teller—making assumptions about future exchange rates, interest rates, and commodity prices that get baked into budgets and financial plans. These assumptions may play a critical role in shaping corporate investment decisions.

Confronted with the limitations of traditional forecasting, how can a prudent financial manager successfully navigate this uncertain environment? We believe the answer lies in a three step process of identifying, quantifying, and managing your risks. This disciplined approach can help you better understand and control external factors that may impact the performance of your business. While this simple framework can be applied to any of the financial risks that your business may face, such as commodity prices or exchange rates, we will use an example of managing interest rate risk to illustrate the process.

Step #1: Identifying your risk

Analyzing your company's interest rate exposure begins with understanding the future capital needs of your business. How much capital will your company require to meet your working capital and investment needs as your business grows? What will be the source of that funding (i.e., retained earnings, bank debt, equity, etc.)? Are your present sources of capital adequate to meet those future needs? At a minimum, we recommend maintaining a rolling five year plan that details your expected borrowing levels taking into consideration required debt amortization and potential prepayments while also allowing for contingencies such as strategic investments or acquisitions.

Step #2: Quantifying your risk

Once you have identified your anticipated debt levels, the next step is to understand how changes in market conditions may affect the availability and the cost of your funding. We recommended using sensitivity analysis or value-at-risk analysis to determine how potential interest rate movements may affect your business' free cash flow. This type of analysis can help you uncover those scenarios where your liquidity, debt coverage, credit rating, or investment opportunities may be impaired. Quantifying the bottom-line impact of these adverse scenarios can help you put your risks in perspective as you communicate with key stakeholders in your company such as management, the board, lenders, and equity investors.

Step #3: Managing your risk

If your stakeholders conclude that some of these potential scenarios are unacceptable, you may elect to undertake strategies to manage your financial risk such as adjusting your capital structure or implementing financial hedging strategies. Table 1 illustrates some of the factors that corporate borrowers often take into consideration in determining the appropriate mix of fixed and floating rate debt for their businesses.

Faced with the prospect of rising interest rates in the years ahead, floating rate borrowers may consider increasing the proportion of their debt portfolio that is indexed to fixed rates and/or extending their repricing maturity of their debt. Borrowers also can protect against unexpected rate increases by utilizing simple hedging tools such as swaps, collars, and caps. These strategies can overlay existing debt, allowing borrowers to protect as much as of their debt as they wish for as long as they wish without refinancing or restructuring their underlying debt.

Weatherproofing your business

Following this three step process of identifying, quantifying, and managing your financial risk may not make you a better forecaster, but it will ensure that your company is well-prepared to weather those inevitable situations when reality inconveniently diverges from our forecasts.

The PrivateBank offers a full suite of tools to help you analyze and manage the financial risks that your business may face. For more information, contact your PrivateBank representative or e-mail swaps@theprivatebank.com.

Figure 1. Considerations in determing optimal debt mix for your business.

	More fixed	More floating
Duration of assets financed	Longer-term (e.g. real estate)	Shorter-term(e.g. working capital)
Leverage	High	Low
Business correlation with rate cycle	Non-cyclical/uncorrelated	Cyclical/positive correlation
Investment horizon	Long-term	Short-term
Absolute level of rates	Low	High
Steepness of yield curve	Flat or inverted	Steep