FOREX HEDGING

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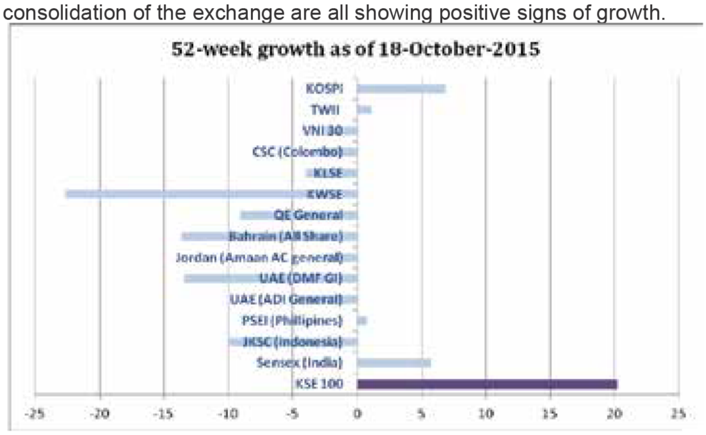
Pakistan is a market with dynamics of volatility and substantiated growth despite the various socio-economic problems which the country has faced since its inception. The landscape analysis throughout the region as illustrated in figure 1 shows that the overall return over one-year period is substantially higher than the countries in the region. The analysis of the economy shows indicators of development and positive growth over the past few years. The growth trend has been a hilly ride with peaks and troughs, but a gradual inclination towards the side of positive development. Pakistan, over the years has shown significant maturity in financial sector, with more structured investments and a drive towards growth, has been observed. The development of the central depository company alongwith the free flowing foreign investment regulation into the securities market followed by demutualization of stock exchanges and the upcoming consolidation of the exchange are all showing positive signs of growth.



(Figure 1) KSE Index Returns comapred with the regional indexes

Looking at the currency value in Pakistan, the value over the years has seen a roller coaster affect with sharp devaluation followed by valuation. This is mainly driven by the import requirements of Pakistan, which includes major commodities for power houses along with the additional impact of import demand. The factors relating to the volatility in the exchange rate are driven mostly by socio-political situations and natural elements that increase the demand.

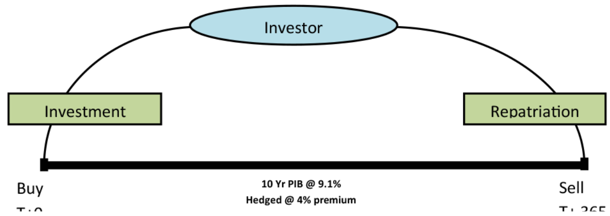
(Figure 2) PKR Devaluation over 52 weeks.

The devaluation of PKR over a year has been witnessed at around 7% which as compared to the inflation is slightly higher around 02%. Hence, generally, an investment done in Pakistani Rupees would devalue at around 7% but will gain an overall return of around 02%.which is equivalent to the differential in the PKR devaluation and the inflation.

State Bank of Pakistan allows the Foreign investor to hedge the risk of this currently devaluation for up to a year and that on the face value of the securities or the purchased price whichever is higher. There is a general grace period of one month for encashment and repatriation of the investment. This generally does not allow the investors to hold the instrument for long term but does provide adequate coverage for short term investment. The real value of this hedging can be in the government bonds (Pakistan Investment Bonds). The hedging under a forwards contract will allow the investor to materialize 04% to 05% based on the hedging structures as compared to the 02% return the un-hedged investment which will be impacted by the PKR devaluation.

One flexible instrument will be the availability of Options that can expire over year which allows the investors to take a decision of the investment repatriation at the end of the option expiry. Options over forward can allow greater tenor with back to back options for over a year. However such structure will require additional cost and will be subjected to stringent regulatory outlook.

Under a Forward arrangement the non resident investor can take advantage of back to back hedging-based repatriation of investment at the maturity of forwards contract followed by reinvestment into the same market. As illustrated in figure 3, the investor buying a 10 year PIB which yields at around 09% today can hedge the



(Figure 3): Investment structure based on reinvestment hedging cycle.

The hedging for investment into listed securities would however be a completely different scenario where sale of securities hedged under the forward cover will require to be precisely timed on maturity of the cover. This becomes difficult specially in case of illiquid securities. This particular mechanism in stock market can be used on Cash-settle futures or Deliverable futures contract which will need to match with the tenor of the Forward to ensure smooth execution. Complex structures for back to back cash-settle futures or the stock index futures maturing on the Forward cover date could allow the investors to benefit on the real return on the index. With the amalgamation of exchanges and the outline of priorities that the new exchange is promising the development of the Index Futures and the Cash-settle Futures, can give investors the opportunity for tapping on to the high-return market of the stock exchange with the added benefit of hedging the risk on currency devaluation.

Understanding the market regime in Pakistan and the performance it has delivered global investors can securely look into the investment into the securities market with the comfort of hedging the currency risk. Over the years it has been observed that foreign influx into the securities market fuels growth and positive valuation on PKR which can give the foreign investor additional return on the valuation of the currency along with the investment return on the security. This fuelling of growth has always short-lived due to balance of payments in Pakistan, which in-turn drives the devaluation of Rupee. The complex circle of events and within Pakistan and its economic growth are showing signs of stabilization in the long run based on the new political dynamics and growing maturity of the country as a whole.