

# ANATOMY OF A CARRY TRADE

## An essential guide for CFOs

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### What is a carry trade?

It is a **financial strategy** where an investor borrows in a currency with a low-interest rate and invests in a higher interest rate one.

The objective is to **profit from the interest rate differential** between the two currencies.

Carry trades can **significantly impact corporate finances** and investment portfolios, so are highly relevant for CFOs.

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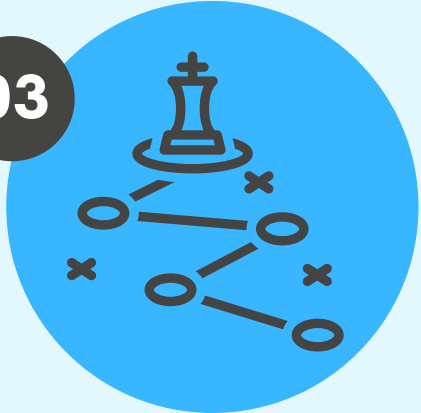
### Carry trade jargon buster

**Interest rate differential:** The difference in interest rates between the borrowing (funding) currency and the investment (target) currency.

**Borrowing currency (funding currency):** The currency with the lower interest rate.

**Investment currency (target currency):** The currency with the higher interest rate.

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### How does a carry trade work?

- 1 Borrow in a low-interest rate currency** (e.g. Japanese yen).
- 2 Convert the borrowed funds** into a higher-yielding currency (e.g. US dollars).
- 3 Invest the converted funds** to earn the higher interest rate.
- 4 Profit from the interest rate differential** after paying back the low-interest loan.

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### Risks and rewards

#### Risks

**Currency risk:** Fluctuations in exchange rates can erode profits.

**Market volatility:** Rapid changes in market conditions can impact interest and FX rates.

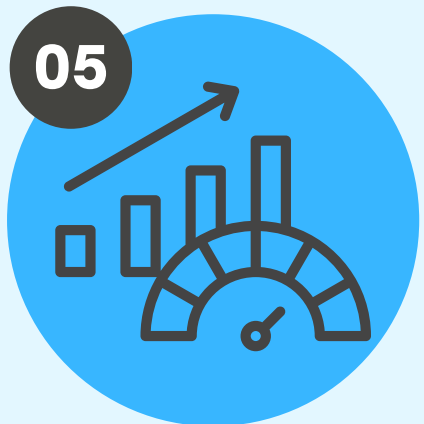
**Liquidity risk:** Difficulty in unwinding positions during financial stress.

#### Rewards

**Interest rate differential:** Higher the differential, higher the potential profit.

**Currency appreciation:** additional profits can be realised.

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### Corporate applications of carry trades

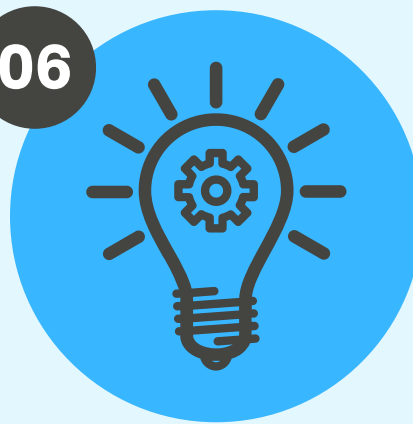
**Enhancing cash management:** Invest surplus cash in higher-yield currencies to boost returns.

**Hedging FX risk:** Use carry trades to hedge against adverse FX movements.

**Managing interest rate exposure:** Borrow in lower-rate currencies to reduce borrowing costs.

**Diversifying funding sources:** Tap into international capital markets for more diverse funding options.

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### Strategic points for CFOs to consider

**Risk assessment:** Evaluate all underlying risks, including FX and interest rate risks.

**Regulatory compliance:** Ensure adherence to local and international financial regulations.

**Liquidity management:** Maintain sufficient liquidity to manage potential risks.

**Continuous monitoring:** Regularly review market conditions and adjust strategies accordingly.