

Hedging research paper samples

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The Right Way To HedgeShift in supply and demand dynamics and the global markets volatility have created unparalleled unpredictability in commodity prices in the recent past. Companies that produce sells or buys commodities have experienced dramatic swings in their returns. Many companies have accelerated the use of hedging in order to caution themselves against the volatility and to avoid situations that could jeopardize their survival. When executed well, the economic, strategic and the functioning benefit of hedging can not only help in avoiding financial distress but also opening up choices to preserve and generate value. If hedging is done poorly, it overwhelms the logic behind it and may destroy beyond the value that was at risk originally. Many hedging programs aims to protect the nominal risk of trade rather than the net commercial exposure of the combined risk across the general enterprise that include the subsidiary risk. At a large industrial company, one business unit decided to hedge its foreign exchange exposure form \$700 million of the sale to Brazil, unintentionally increasing the firm's net exposure to the fluctuations in the foreign currency market. The unit's manager had acted unawares of the company's second business unit which was sourcing approximately \$500 million worth of goods from Brazil. Consequently the company ended up with a net exposure of \$500million instead of the natural \$200million. Keeping in mind that the net exposure includes subsidiary risks which account for the rest of the company's overall exposure. Companies may be exposed to risks through business practices such as contracting terms with clients and market factors such as fluctuations in the competitive setting. Many portfolio managers underestimate the cost of hedging, normally focusing only on direct

transactional overheads such as bid- ask spread and broker fees. Such components are just a small part of the overall hedge cost, with the indirect cost being the largest of the overall cost. Companies should only hedge exposures that that poses a material risk to their economic health or threatens their tactical plans. Yet companies are often under pressure from the financial markets or individual ventures under conditions from managements to ensure earning certainty by adopting hedging programs that create little or no value to the shareholders. Effective risk management programs include a combination of financial hedges or non-financial levers to alleviate the risk. Yet only a few companies explore alternatives to financial hedging which may include commercial or operational strategies that can mitigate the risks more efficiently and reasonably. Hedging is normally meant to prevent losses rather than making profits, and it involves calculated moves. There are different influences that determine the outcomes of taking positions, some that are beyond control, such as the volatility in the markets, the globalization, speculation. Cases of illegal activities in instances where the reports that amount to economic events are leaked prior to their announcement.

Work cited.

Fisher, Bryan, and Ankush Kumar. " Insights & Publications." The right way to hedge. Mckinsey & Company, n. d. Web. 11 Apr. 2014.