Hedging strategy

Finance

Hedging strategy of the of the Is a hedging strategy the best plan of action? Clark should consider the Treasury bond futures hedging strategy because it is the most efficient fundamental tool of risk management for all the investors around the globe. If Clark plan to buy fixed income/returns securities in the upcoming period and is concerned regarding the probability of high prices, then he can purchase treasury futures as well as secure an utmost purchase price. By selling the Treasury bond futures, Clark can lock in a higher selling price as well as protect the worth of individual security or portfolio against likely decreasing prices. By considering the Treasury bond futures hedging strategy, he can minimise his risk as it is an effective instrument of risk control and can also enhance his returns. As Treasury bond futures cover up a broad range of maturities from the bonds of long term to short term notes, so it will help Clark to construct trades depending on the disparities in the movements of interest rates alongside the yield curve.

There is negative connection between the fluctuations in interest rates and the bond prices. The increase in the interest rates is bad for bonds because when the rate of interest rises, the shareholders or investors in the bond fund prefer to liquidate or settle their shares. Due to this, the finance manager might be compelled to sell its bonds prematurely to raise sufficient cash in order to meet its requests of redemption. This could have a pessimistic effect on the regular price of bond fund (Forbes, 2013). Conversely, a fall in the interest rates results in the increase in the bond prices. This happens because, if rates of interest fall after the purchase of bond, the worth of bond will rise as investors will not be able to purchase a new bond with a high coupon rate. In this situation, the value of bond will be

more than the actual value. Consequently, it will be traded at a premium (Bodie et al, 2009).

2. Consideration of short term strategy

Clark should consider the short term hedging strategy. Investment in the short term bonds is recommended because long term maturities bond would be hit tremendously when there is an increase in the rates of interest. Along with this, he should consider the individual bonds but require being cautious with the issuer's credit quality. Clark also needs to be sure that the company is monetarily strong and proficient to repay his principle on the maturity of bond. A short term bond is suggested because this will facilitate Clark not to become locked in a low interest rate for an extended period (Forbes, 2013).

3. Reason behind suggestion

The reason behind suggesting the Treasury bond futures hedging strategy is that Clark can lock in a higher selling price against the decreasing interest rates. Similarly, investment in short term Treasury bonds will allow Clark not to become locked in a low rate of interest. Assuming the maturity period of the bond is five years and the coupon rate is 10%. Clark will get return of $16, 500, 000 i. e. (15, 000, 000 + 10% of 15, 000, 000) after five years. Thus, Clark could lock himself in a selling price of $16, 500, 000 against $15, 000, 000. If the interest rates rises also, he will not suffer much loss because he will prefer investment in short term Treasury bonds.

References

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