

What is Hedging?

Hedging Defined

- ✓ Hedging is the process by which a consumer or producer protects against adverse price movements that negatively affect revenues or expenses
- ✓ Hedging involves transferring this adverse price movement to a third party
- ✓ Example: a company owns a fleet of vehicles whose costs/expenses are variable with respect to the price of fuel. Said company hedges by taking an offsetting position (i.e., transferring risk to third party) that protects itself from rising fuel prices
- ✓ Hedging involves converting a variable price risk to a “known” or fixed risk
- ✓ Hedging typically involves using highly correlated financial instruments that offset the physical consumer or producer product price risks.

Objectives of Hedging

- ✓ Hedging is utilized to stabilize costs/expenses (or revenues in the case of the producer)
- ✓ Hedging is designed to reduce volatility in one’s financial statements
- ✓ Hedging provides budget and expense predictability
- ✓ Once Hedged, company can focus on core competencies and optimization of business
- ✓ In some cases (but not all) hedging can be utilized as a competitive advantage

What is Hedging?

Proper Perspective on Hedging

- ✓ Hedging should not be viewed as an investment that has return characteristics. (unlike a stock or bond portfolio)
- ✓ Philosophically, hedging should be viewed in the same context and with the same mindset as buying insurance. While hedging involves financial instruments (i.e., hedging is not an insurance policy) the philosophy of hedging should be similar to buying insurance on one's facilities, assets, etc. In other words, the goal is not to receive a payout but to protect the business from adverse conditions
- ✓ Sound hedging programs involve implementing solid foundational discipline to enable sound strategy with appropriate tactical plan, proper structures, goodness of fit for hedge instrument, efficient pricing, solid mathematical support for decisions, quality audit trail, proactively managed accounting practices, communication within and outside organization, and proper philosophy of hedging program