

Remark 3.2

• Short hedges are appropriate when you know you will sell the asset in the future

• Long hedges are appropriate when you know you will buy the asset in the future

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Remark 3.2 (continued)

• Arguments for hedging: Minimizing risks arising from interest rates, exchange rates, and other market variables

• Arguments against hedging: Shareholders can do it themselves, risk may increase if competitors do not hedge, explaining a situation where there is a loss on the hedge and a gain on the underlying can be difficult

Example 3.3

Assume a hedge is put in place at time 1 and closed out at time 2, S<sub>1</sub>=2.50, F<sub>1</sub>=2.20, S<sub>2</sub>=2.00, F<sub>2</sub>=1.90.

If hedger knows that asset will be sold at time 2, what is the effective price that is obtained for the asset with hedging?

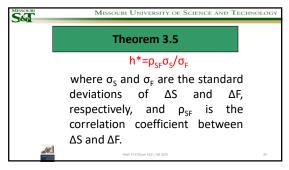
Definition 3.4

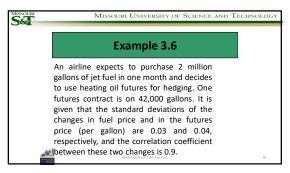
• Cross hedging occurs if the asset underlying the futures price is not the same as the asset whose price is being hedged.

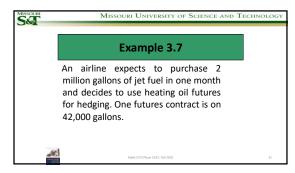
• The hedge ratio is the ratio of the size of futures contracts to the size of shares of the underlying held.

• The minimum variance hedge ratio h\* is the hedge ratio that results in the risk (measured by the variance) being minimal.

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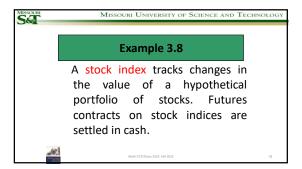


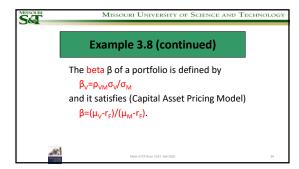




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	Example 3.7 (continued)						
	March	Change in fuel price per gallon x,	Change in futures price per gallony,	8	-0.007	-0.029	
	1	0.029	0.021	9	0.043	0.048	
	2	0.020	0.035	10	0.011	-0.006	
	3	-0.044	-0.046	11	-0.036	-0.036	
	4	0.008	0.001	12	-0.018	-0.011	
	5	0.026	0.044	13	0.009	0.019	
	6	-0.019	-0.029	14	-0.032	-0.027	
al	7	-0.010	-0.026	15	0.023	0.029	
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