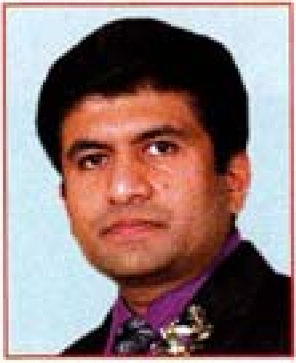


Understanding Hedging

By Jitesh Surendran

A hedge is a security transaction that reduces the risk on an already existing investment position. Although hedges reduce potential losses, they also tend to reduce potential profits.

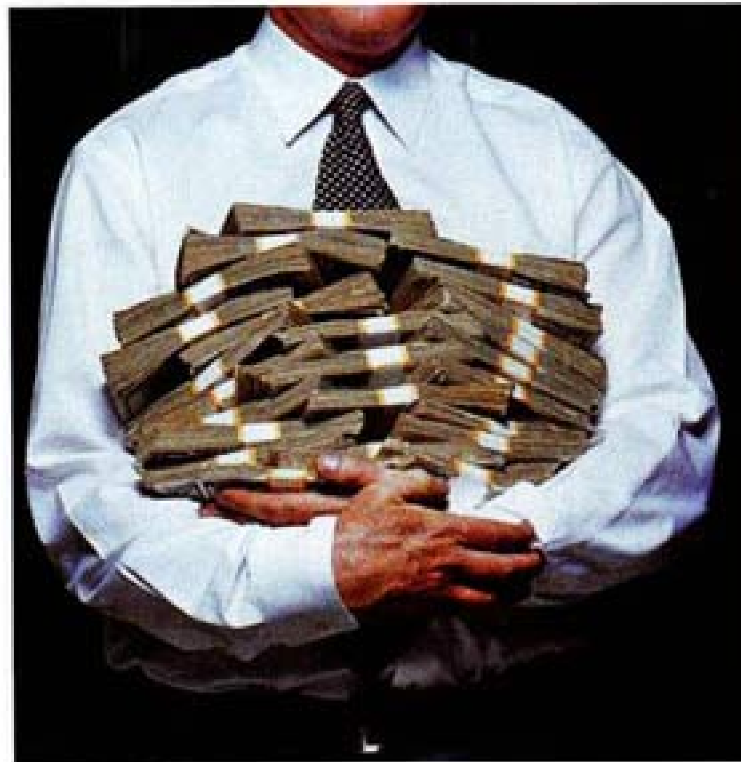
Hedgers establish an opposite position in a market (e.g. Futures or Spot) in an attempt to offset risk of exposure to price fluctuations in some position in another market (e.g. Physical) with the goal of minimizing one's exposure to unwanted risk.Hedging is a strategy designed to minimize exposure to an unwanted business risk, while still allowing the business to profit from an investment activity.

Futures contracts are one of the most common derivatives used to hedge risk. A futures contract is an agreement to buy or sell an asset at a particular time in the future for a particular price. The main reason that the companies or corporations use futures contracts is to offset their risk exposures and limit their risks from any fluctuation in price. Investors use futures contracts to perfectly offset their risks. In the real life however, this is often impossible and, therefore, individuals attempt to neutralize the risk as much as possible instead.

For example, if a commodity to be hedged is not available as a futures contract, an investor will buy a futures contract in something that closely follows the movement of that commodity.

Misunderstandings on hedging

Entering into both buy and sell (long and short position) for the same commodity contract of the same delivery month with similar principal is considered as trade locking in regard to commodity markets. Although a hedging approach is theoretically followed in these activities, it is different than a real hedge. This type of trading behavior is known as 'locking in the trade' although some traders consider it as a hedge. While locking in the trade locks in the profit/loss in the same contract, by the same buyer/seller, there is no transfer of contract while taking the opposite side of the trade. This means that a client, who originally took buy position, is actually selling, but both buy and sell positions are continued in the market. This means there is no actual transfer of contractual liability. This



type of activity can significantly reduce the amount of profit that could have been made if locking of the trade was not applied. The main reason of entering into a commodity market is to take advantage of the financial leverage that this market provides with efficient risk management. In most cases, speculators who enter into this market are risk takers and want maximum return with less investment. But taking both long and short position at the same time for the same commodity reduces the amount of return considerably. This is a major setback for most speculators who hold buy and sell position in the same contract.

The following case illustrates how this type of hedging affects the profit.

Suppose, a client takes 'buy' position in June for 1kg of gold contract expiring in three months. In order to hedge, he simultaneously takes 'sell' position in the same contract. Assume the current price of gold is Rs. 30,000 per 10 gms. Now let's presume that after three days the price of gold goes up to Rs. 35,000 per 10 gms. Mathematically, the client should profit. But since he has also taken a sell position, he is bound to face the same amount of loss as he has profited, unless he settles the buy position first and waits for the price of gold to go down in future. Let's assume now that the price of gold went down to 33,000 per 10 gms after few days. Still this client will suffer a loss. Now, the total net profit to the client in this hedging trade is fixed at the difference between the buy and sell rates. Hence, this clarifies that locking of the same contract in this manner significantly reduces the anticipated profit.

Now let's see an illustration how this type of hedging increases the risk of loss.

Let's assume that the trader takes a buy position of oil at $80 per barrel. But when the price goes down to $75 per barrel, the trader takes a 'sell' position in order to lock the loss that he will have to face, thus creating a fake hedge and with an intention to even minimize the risk of further loss. But in real sense, taking both positions this way will increase the threat of further loss when the trader actually tries to liquidate any one position.

In such scenario, when the trader wants to exit the positions, he will be looking forward to liquidate any one of the positions, either buy or the sell. In this event he needs to be very sure of two sided market directions. After he liquidates any one position, the market needs to move

in favour of the second position to make the loss less than the difference when the positions were locked. Hence, this type of practice is like a double edged sword with scope for probable loss on both sides thus increasing the loss more than the locked loss.

In many of the international markets, taking both long and short positions (buy and sell) in the same commodity of similar contracts simultaneously is illegal because this activity intends to negate market risk and price competition, and thereby avoids a bona fide market transaction and produces a virtual financial nullity. This type of trade is commonly known as wash sales. The CFTC (Commodity Futures Trading Commission of USA) defines a wash sale as "An illegal transaction made without intent to take a genuine, bona fide position in the market, such as a simultaneous purchase and sale of same commodity having same expiration designed to negate each other so that there is no change in financial position." As explained by the Commission, wash sales are serious violations, even if they do not result in customer harm or significant market effect, because "they undermine confidence in the market mechanism that underlies price discovery."

From the real life case study presented below, we can see how serious offence it is to get involved in such a hedge (wash sales activity):

In order to hedge its liquidity and risk management positions, SDG&E (San Diego Gas & Electric Company) established a long position in New York Mercantile Exchange (NYMEX) natural gas futures contracts for delivery months August 2006 through October 2006 (the "Futures Contracts"). On one or more occasions between January 26, 2006, and February 2, 2006, SDG&E gave instructions to an introducing broker to place offsetting sale and purchase orders with NYMEX floor brokers. Notably, SDG&E placed the order to sell and the order to buy in the same phone call with the introducing broker and specifically requested that the prices for each order be at or near the same price. These instructions had the effect of liquidating and immediately reestablishing the Futures Contracts previously held by SDG&E without materially altering its futures market position.

SDG&E paid $80,000 to settle a charge by the Commodity Futures Trading Commission (CFTC) on the charge of wash sales of New York Mercantile Exchange (Nymex) natural gas futures contracts in 2006.

The negative impact of the above mentioned type of hedging activity can be briefly explained as follows:

Wash sales are serious violations, even if they do not result in customer harm or significant market effect, because "they undermine confidence in the market mechanism that underlies price discovery.

Artificial increase in the volume of transaction: The wash sale activity will show artificial rise in the transaction volume which will indeed impact the sentiment of the genuine traders of the market.

Creates artificial price movement: When too many people go for this kind of hedging, the supply and demand factors of the commodity get manipulated. This results in the hypothetical fluctuations in the price of the commodity.

Bona fide market transaction: This sort of hedging practice discourages genuine clients since genuine market is affected by the artificial increase in volume and price movement.

Multiple transaction cost: This kind of hedging requires taking two positions simultaneously; therefore a client has to pay two times the commissions/ transaction fees which can be costly.

Hindrance of contract note transfer: In this practice, the contract note is not transferred to anyone else but to the same person, who takes both buy and sell position.

Defies a person's own logic: A trader will take a buy position with the expectation that price of a commodity will go up. Taking a simultaneous sell position questions his genuine interest of speculation and also his call on a particular commodity.

Disadvantages of taking buy and sell position (illegal hedging) simultaneously

1. Illegal Hedging involves cost that can eat up the profit.
2. Risk and reward are often proportional to one another; thus reducing risk means reducing profits.
3. For most short-term traders, e.g. for a day trader, hedging is a difficult strategy to follow.
4. If the market is performing well or moving sidewise, then hedging offers little benefits.
5. Trading of options or futures often demand higher account requirements like more capital or balance.
6. Illegal hedging is a precise trading strategy and successful hedging requires good trading skills and experience.
7. Illegal hedging in futures contracts will result in the position lock up until the market movement is favouring the trader on both sides, so the race is against the time, as futures contracts has an expiry date.
8. Illegal hedging in spot market gives opportunity to hold the position for longer time but holding such positions in spot markets will result in storage costs and will ultimately end up gulping the equity.

The main reason traders enter into these simultaneous buy and sell positions is that they want to avoid booking a loss, i.e. taking the actual loss, for accounting purposes. They somehow seem to think that taking an offsetting loss without booking it prolongs the fact that they have to take an actual loss. But it only delays the inevitable. *(The author is the CEO of MEX Nepal)*