

Chapter 1 : Giddy: Hedging Tools and Techniques

One of the more common corporate uses of derivatives is for hedging foreign currency risk, or foreign-exchange risk, which is the risk a change in currency exchange rates will adversely impact.

Etymology[edit] Hedging is the practice of taking a position in one market to offset and balance against the risk adopted by assuming a position in a contrary or opposing market or investment. The word hedge is from Old English hecg, originally any fence, living or artificial. The use of the word as a verb in the sense of "dodge, evade" is first recorded in the s; that of insure oneself against loss, as in a bet, is from the s. The market values of wheat and other crops fluctuate constantly as supply and demand for them vary, with occasional large moves in either direction. Based on current prices and forecast levels at harvest time, the farmer might decide that planting wheat is a good idea one season, but the price of wheat might change over time. Once the farmer plants wheat, he is committed to it for an entire growing season. If the actual price of wheat rises greatly between planting and harvest, the farmer stands to make a lot of unexpected money, but if the actual price drops by harvest time, he is going to lose the invested money. Due to the uncertainty of future supply and demand fluctuations, and the price risk imposed on the farmer, said farmer may use different financial transactions to reduce, or hedge, their risk. One such transaction is the use of forward contracts. Forward contracts are mutual agreements to deliver a certain amount of a commodity at a certain date for a specified price and each contract is unique to the buyer and seller. For this example, the farmer can sell a number of forward contracts equivalent to the amount of wheat he expects to harvest and essentially lock in the current price of wheat. Once the forward contracts expire, the farmer will harvest the wheat and deliver it to the buyer at the price agreed to in the forward contract. Therefore, the farmer has reduced his risks to fluctuations in the market of wheat because he has already guaranteed a certain number of bushels for a certain price. However, there are still many risks associated with this type of hedge. For example, if the farmer has a low yield year and he harvests less than the amount specified in the forward contracts, he must purchase the bushels elsewhere in order to fill the contract. This becomes even more of a problem when the lower yields affect the entire wheat industry and the price of wheat increases due to supply and demand pressures. Also, while the farmer hedged all of the risks of a price decrease away by locking in the price with a forward contract, he also gives up the right to the benefits of a price increase. Another risk associated with the forward contract is the risk of default or renegotiation. The forward contract locks in a certain amount and price at a certain future date. Because of that, there is always the possibility that the buyer will not pay the amount required at the end of the contract or that the buyer will try to renegotiate the contract before it expires. Future contracts are similar to forward contracts except they are more standardized i. These contracts trade on exchanges and are guaranteed through clearinghouses. Clearinghouses ensure that every contract is honored and they take the opposite side of every contract. Future contracts typically are more liquid than forward contracts and move with the market. Because of this, the farmer can minimize the risk he faces in the future through the selling of future contracts. Future contracts also differ from forward contracts in that delivery never happens. The exchanges and clearinghouses allow the buyer or seller to leave the contract early and cash out. So tying back into the farmer selling his wheat at a future date, he will sell short futures contracts for the amount that he predicts to harvest to protect against a price decrease. The current spot price of wheat and the price of the futures contracts for wheat converge as time gets closer to the delivery date, so in order to make money on the hedge, the farmer must close out his position earlier than then. On the chance that prices decrease in the future, the farmer will make a profit on his short position in the futures market which offsets any decrease in revenues from the spot market for wheat. On the other hand, if prices increase, the farmer will generate a loss on the futures market which is offset by an increase in revenues on the spot market for wheat. Instead of agreeing to sell his wheat to one person on a set date, the farmer will just buy and sell futures on an exchange and then sell his wheat wherever he wants once he harvests it. He wants to buy Company A shares to profit from their expected price increase, as he believes that shares are currently underpriced. But Company A is part of a highly volatile widget industry. So there is a risk of a future event that affects stock prices across

the whole industry, including the stock of Company A along with all other companies. On the second day, a favorable news story about the widgets industry is published and the value of all widgets stock goes up. But on the third day, an unfavorable news story is published about the health effects of widgets, and all widgets stocks crash: Nevertheless, since Company A is the better company, it suffers less than Company B: Value of long position Company A: Futures are generally highly fungible and cover a wide variety of potential investments, which makes them easier to use than trying to find another stock which somehow represents the opposite of a selected investment. Hedging employee stock options[edit] Employee stock options ESOs are securities issued by the company mainly to its own executives and employees. These securities are more volatile than stocks. An efficient way to lower the ESO risk is to sell exchange traded calls and, to a lesser degree,[clarification needed] to buy puts. Companies discourage hedging the ESOs but there is no prohibition against it. Hedging fuel consumption[edit] Main article: Fuel hedging Airlines use futures contracts and derivatives to hedge their exposure to the price of jet fuel. They know that they must purchase jet fuel for as long as they want to stay in business, and fuel prices are notoriously volatile. By using crude oil futures contracts to hedge their fuel requirements and engaging in similar but more complex derivatives transactions , Southwest Airlines was able to save a large amount of money when buying fuel as compared to rival airlines when fuel prices in the U. Hedging emotions[edit] As an emotion regulation strategy, people can bet against a desired outcome. A New England Patriots fan, for example, could bet their opponents to win to reduce the negative emotions felt if the team loses a game. People typically do not bet against desired outcomes that are important to their identity, due to negative signal about their identity that making such a gamble entails. Betting against your team or political candidate, for example, may signal to you that you are not as committed to them as you thought you were. The stock example above is a "classic" sort of hedge, known in the industry as a pairs trade due to the trading on a pair of related securities. As investors became more sophisticated, along with the mathematical tools used to calculate values known as models , the types of hedges have increased greatly. Examples of hedging include: The fraction of open positions has to be within the grey-blue hedging corridor at every instance of time. A hedging strategy usually refers to the general risk management policy of a financially and physically trading firm how to minimize their risks. As the term hedging indicates, this risk mitigation is usually done by using financial instruments , but a hedging strategy as used by commodity traders like large energy companies, is usually referring to a business model including both financial and physical deals. In order to show the difference between these strategies, let us consider the fictional company BlackIsGreen Ltd trading coal by buying this commodity at the wholesale market and selling it to households mostly in winter. Back-to-back hedging[edit] Back-to-back B2B is a strategy where any open position is immediately closed, e. This strategy minimizes many commodity risks , but has the drawback that it has a large volume and liquidity risk , as BlackIsGreen does not know how whether it can find enough coal on the wholesale market to fulfill the need of the households. Tracker hedging[edit] Tracker hedging is a pre-purchase approach, where the open position is decreased the closer the maturity date comes. If BlackIsGreen knows that most of the consumers demand coal in winter to heat their house. A strategy driven by a tracker would now mean that BlackIsGreen buys e. The closer the winter comes, the better are the weather forecasts and therefore the estimate, how much coal will be demanded by the households in the coming winter. A certain hedging corridor around the pre-defined tracker-curve is allowed and fraction of the open positions decreases as the maturity date comes closer. Delta neutral Delta-hedging mitigates the financial risk of an option by hedging against price changes in its underlying. This is performed in practice by buying a derivative with an inverse price movement. It is also a type of market neutral strategy. Only if BlackIsGreen chooses to perform delta-hedging as strategy, actual financial instruments come into play for hedging in the usual, stricter meaning. Risk reversal[edit] Risk reversal means simultaneously buying a call option and selling a put option. This has the effect of simulating being long on a stock or commodity position. Natural hedges[edit] Many hedges do not involve exotic financial instruments or derivatives such as the married put. A natural hedge is an investment that reduces the undesired risk by matching cash flows i. For example, an exporter to the United States faces a risk of changes in the value of the U. Another example is a company that opens a subsidiary in another country and borrows in the foreign currency to finance its operations, even

though the foreign interest rate may be more expensive than in its home country: Similarly, an oil producer may expect to receive its revenues in U. One common means of hedging against risk is the purchase of insurance to protect against financial loss due to accidental property damage or loss, personal injury, or loss of life. Categories of hedgeable risk[edit] There are varying types of financial risk that can be protected against with a hedge. Those types of risks include: Since credit risk is the natural business of banks, but an unwanted risk for commercial traders, an early market developed between banks and traders that involved selling obligations at a discounted rate. Currency risk also known as Foreign Exchange Risk hedging is used both by financial investors to deflect the risks they encounter when investing abroad and by non-financial actors in the global economy for whom multi-currency activities are a necessary evil rather than a desired state of exposure. Interest rate risks can be hedged using fixed-income instruments or interest rate swaps. Volume risk is the risk that a customer demands more or less of a product than expected. Hedging equity and equity futures[edit] Equity in a portfolio can be hedged by taking an opposite position in futures. To protect your stock picking against systematic market risk , futures are shorted when equity is purchased, or long futures when stock is shorted. One way to hedge is the market neutral approach. In this approach, an equivalent dollar amount in the stock trade is taken in futures â€” for example, by buying 10, GBP worth of Vodafone and shorting 10, worth of FTSE futures the index in which Vodafone trades. Another way to hedge is the beta neutral. Beta is the historical correlation between a stock and an index. Futures contracts and forward contracts are means of hedging against the risk of adverse market movements. These originally developed out of commodity markets in the 19th century, but over the last fifty years a large global market developed in products to hedge financial market risk. Futures hedging[edit] Investors who primarily trade in futures may hedge their futures against synthetic futures. A synthetic in this case is a synthetic future comprising a call and a put position. Long synthetic futures means long call and short put at the same expiry price. To hedge against a long futures trade a short position in synthetics can be established, and vice versa. Stack hedging is a strategy which involves buying various futures contracts that are concentrated in nearby delivery months to increase the liquidity position. It is generally used by investors to ensure the surety of their earnings for a longer period of time. Contract for difference[edit] Main article:

Chapter 2 : What is hedging? definition and meaning - theinnatdunvilla.com

Corporate risk managers also face the difficult challenge of getting hedging tools (i.e., derivatives) approved by the company's board of directors. The purpose of this newsletter is to clarify both some of the basic misconceptions surrounding the issue of risk as well as the tools and strategies used to manage it.

He has attacked all derivatives, saying he and his company "view them as time bombs, both for the parties that deal in them and the economic system. Therefore, our constant assumption is that ACME sells 1, euros worth of widgets. As the dollar depreciates, the same number of widgets sold translates into greater sales in dollar terms. This demonstrates how a weakening dollar is not all bad: It can boost export sales of U. Alternatively, ACME could reduce its prices abroad, which, because of the depreciating dollar, would not hurt dollar sales; this is another approach available to a U. The above example illustrates the "good news" event that can occur when the dollar depreciates, but a "bad news" event happens if the dollar appreciates and export sales end up being less. In the above example, we made a couple of very important simplifying assumptions that affect whether the dollar depreciation is a good or bad event: So even if dollar sales increase due to depreciation in the dollar, production costs will go up too. This effect on both sales and costs is called a natural hedge: The economics of the business provide their own hedge mechanism. In such a case, the higher export sales resulting when the euro is translated into dollars are likely to be mitigated by higher production costs. For example, we ignored any secondary effects of inflation and whether ACME can adjust its prices. Even after natural hedges and secondary effects, most multinational corporations are exposed to some form of foreign-currency risk. The value of the futures contracts will not, in practice, correspond exactly on a 1: The company is effectively locking in the future interest rate. Fair Value Hedges - The Company [JCI] had two interest rate swaps outstanding at September 30, , designated as a hedge of the fair value of a portion of fixed-rate bonds. The change in fair value of the swaps exactly offsets the change in fair value of the hedged debt, with no net impact on earnings. We can illustrate these variable rate payments with a down-bar chart: The swap requires JCI to pay a fixed rate of interest while receiving floating-rate payments. The received floating-rate payments shown in the upper half of the chart below are used to pay the pre-existing floating-rate debt. JCI is then left only with the floating-rate debt, and has therefore managed to convert a variable-rate obligation into a fixed-rate obligation with the addition of a derivative. Note the annual report implies JCI has a perfect hedge: For related reading, see: An Introduction to Swaps. Commodity or Product Input Hedge Companies depending heavily on raw-material inputs or commodities are sensitive, sometimes significantly, to the price change of the inputs. Airlines, for example, consume lots of jet fuel. Historically, most airlines have given a great deal of consideration to hedging against crude-oil price increases. It uses futures contracts to hedge against the price increase of soybean and corn inventory: Changes in Commodity Prices: Monsanto uses futures contracts to protect itself against commodity price increases; these contracts hedge the committed or future purchases of, and the carrying value of payables to growers for soybean and corn inventories. We also use natural-gas swaps to manage energy input costs. There are many other derivative uses, and new types are being invented. For example, companies can hedge their weather risk to compensate them for the extra cost of an unexpectedly hot or cold season. The derivatives we have reviewed are not generally speculative for the company. They help to protect the company from unanticipated events: The investor on the other side of the derivative transaction is the speculator. However, in no case are these derivatives free. Even if, for example, the company is surprised with a good-news event like a favorable interest-rate move, the company because it had to pay for the derivatives receives less on a net basis than it would have without the hedge. How can derivatives be used for risk management? Trading Center Want to learn how to invest? Get a free 10 week email series that will teach you how to start investing. Delivered twice a week, straight to your inbox.

Chapter 3 : Giddy: The Corporate Hedging Process

According to financial theory, corporate hedging can increase shareholder value in the presence of capital market imperfections such as direct and indirect costs of financial distress, costly external financing, and taxes.

At the heart of the confusion are misconceptions about risk, concerns about the cost of hedging, and fears about reporting a loss on derivative transactions. A lack of familiarity with hedging tools and strategies compounds this confusion. Corporate risk managers also face the difficult challenge of getting hedging tools i. The purpose of this newsletter is to clarify both some of the basic misconceptions surrounding the issue of risk as well as the tools and strategies used to manage it. Rather, it attempts to transform unacceptable risks into an acceptable form. The key challenge for the corporate risk manager is to determine the risks the company is willing to bear and the ones it wishes to transform by hedging. The goal of any hedging program should be to help the corporation achieve the optimal risk profile that balances the benefits of protection against the costs of hedging. This article will outline seven steps designed to help risk managers determine whether or not their companies stand to benefit from a hedging program. These risks will generally fall into two categories: For most non-financial organizations, operating risk is the risk associated with manufacturing and marketing activities. A computer manufacturer, for example, is exposed to the operating risk that a competitor will introduce a technologically superior product which takes market share away from its leading model. In general, operating risks cannot be hedged because they are not traded. The second type of risk, financial risk, is the risk a corporation faces due to its exposure to market factors such as interest rates, foreign exchange rates and commodity and stock prices. Financial risks, for the most part, can be hedged due to the existence of large, efficient markets through which these risks can be transferred. In determining which risks to hedge, the risk manager needs to distinguish between the risks the company is paid to take and the ones it is not. Most companies will find they are rewarded for taking risks associated with their primary business activities such as product development, manufacturing and marketing. For example, a computer manufacturer will be rewarded i. Most corporations, however, will find they are not rewarded for taking risks which are not central to their basic business i. Another critical factor to consider when determining which risks to hedge is the materiality of the potential loss that might occur if the exposure is not hedged. Unless the potential loss is material i. They believe hedging with derivatives introduces additional risk. In reality, the opposite is true. A properly constructed hedge always lowers risk. It is by choosing not to hedge that managers regularly expose their companies to additional risks. Financial risks - regardless of whether or not they are managed - exist in every business. The manager who opts not to hedge is betting that the markets will either remain static or move in his favor. For example, a U. In the process, the manufacturer is leaving itself exposed to the risk that the French franc will depreciate relative to the U. Conversely, hedging strategies designed to reduce risk often receive a great deal of scrutiny. Admittedly, some hedging strategies do cost money. But consider the alternative. To accurately evaluate the cost of hedging, the risk manager must consider it in light of the implicit cost of not hedging. In most cases, this implicit cost is the potential loss the company stands to suffer if market factors, such as interest rates or exchange rates, move in an adverse direction. In such cases the cost of hedging must be evaluated in the same manner as the cost of an insurance policy, that is, relative to the potential loss. In other cases, derivative transactions are substitutes for implementing a financing strategy using a traditional method. For example, a corporation may combine a floating-rate bank borrowing with a floating-to-fixed-rate swap as an alternative to issuing fixed-rate debt. Similarly, a manufacturer may combine the spot purchase of a commodity with a floating-to-fixed swap instead of buying the commodity and storing it. In most cases where derivative strategies are used as substitutes for traditional transactions, it is because they are cheaper. Derivatives tend to be cheaper because of the lower transaction costs that exist in highly liquid forward and options markets. This fear reflects widespread confusion over the proper benchmark to use in evaluating the performance of a hedge. The key to properly evaluating the performance of all derivative transactions, including hedges, lies in establishing appropriate goals at the onset. As noted previously, many derivative transactions are substitutes for traditional transactions. A fixed-rate swap, for example, is a

substitute for the issuance of a fixed-rate bond. Thus, any money lost on the swap would have been lost if the corporation had issued a bond instead. However, the best hedging decisions are made when risk managers acknowledge that market movements are unpredictable. A hedge should always seek to minimize risk. It should not represent a gamble on the direction of market prices. Some managers view derivatives as instruments that are too complex to understand. The fact is that most derivative solutions are constructed from two basic instruments: The system, often documented in a hedging policy, establishes, among other things, the names of the managers who are authorized to enter into hedges; the managers who must approve trades; and the managers who must receive trade confirmations. The hedging policy may also define the purposes for which hedges can and cannot be used. For example, it might state that the corporation uses hedges to reduce risk, but it does not enter into hedges for trading purposes. It may also set limits on the notional value of hedges that may be outstanding at any one time. Hedging frees up resources and allows management to focus on the aspects of the business in which it has a competitive advantage by minimizing the risks that are not central to the basic business. Ultimately, hedging increases shareholder value by reducing the cost of capital and stabilizing earnings.

Chapter 4 : How Companies Use Derivatives To Hedge Risk | Investopedia

The right way to hedge Hedge net economic exposure Too many hedging programs target the nominal risks of "siloed" businesses rather than a company's net economic exposure"aggregated risk across the broad enterprise that also includes the indirect risks. 1 1.

Tools and Techniques by Ian H. We will use the following criteria for contrasting the tools. First, there are different tools that serve effectively the same purpose. Most currency management instruments enable the firm to take a long or a short position to hedge an opposite short or long position. Thus one can hedge a Euro payment using a forward exchange contract, or debt in Euro, or futures or perhaps a currency swap. In equilibrium the cost of all will be the same, according to the fundamental relationships of the international money market. They differ in details like default risk or transactions costs, or if there is some fundamental market imperfection. This follows from the unbiased forward rate theory. Second, tools differ in that they hedge different risks. In particular, symmetric hedging tools like futures cannot easily hedge contingent cash flows: Trading or "dealing" in each pair of currencies consists of two parts, the spot market, where payment delivery is made right away in practice this means usually the second business day, and the forward market. The rate in the forward market is a price for foreign currency set at the time the transaction is agreed to but with the actual exchange, or delivery, taking place at a specified time in the future. While the amount of the transaction, the value date, the payments procedure, and the exchange rate are all determined in advance, no exchange of money takes place until the actual settlement date. This commitment to exchange currencies at a previously agreed exchange rate is usually referred to as a forward contract. Forward contracts are the most common means of hedging transactions in foreign currencies. The trouble with forward contracts, however, is that they require future performance, and sometimes one party is unable to perform on the contract. When that happens, the hedge disappears, sometimes at great cost to the hedger. This default risk also means that many companies do not have access to the forward market in sufficient quantity to fully hedge their exchange exposure. For such situations, futures may be more suitable. Currency futures Outside of the interbank forward market, the best-developed market for hedging exchange rate risk is the currency futures market. In principle, currency futures are similar to foreign exchange forwards in that they are contracts for delivery of a certain amount of a foreign currency at some future date and at a known price. In practice, they differ from forward contracts in important ways. One difference between forwards and futures is standardization. Futures are also standardized in terms of delivery date. The normal currency futures delivery dates are March, June, September and December, while forwards are private agreements that can specify any delivery date that the parties choose. Both of these features allow the futures contract to be tradable. Another difference is that forwards are traded by phone and telex and are completely independent of location or time. But the most important feature of the futures contract is not its standardization or trading organization but in the time pattern of the cash flows between parties to the transaction. In a forward contract, whether it involves full delivery of the two currencies or just compensation of the net value, the transfer of funds takes place once: With futures, cash changes hands every day during the life of the contract, or at least every day that has seen a change in the price of the contract. This daily cash compensation feature largely eliminates default risk. Thus forwards and futures serve similar purposes, and tend to have identical rates, but differ in their applicability. Most big companies use forwards; futures tend to be used whenever credit risk may be a problem. Debt instead of forwards or futures Debt -- borrowing in the currency to which the firm is exposed or investing in interest-bearing assets to offset a foreign currency payment -- is a widely used hedging tool that serves much the same purpose as forward contracts. A German company has shipped equipment to a company in Calgary, Canada. Alternatively she could have used the borrowing market to achieve the same objective. She would borrow Canadian dollars, which she would then change into Euros in the spot market, and hold them in a Euro deposit for two months. When payment in Canadian dollars was received from the customer, she would use the proceeds to pay down the Canadian dollar debt. Such a transaction is termed a money market hedge. The cost of this money market hedge is the difference between the Canadian dollar interest rate paid and the Euro interest rate earned.

According to the interest rate parity theorem, the interest differential equals the forward exchange premium, the percentage by which the forward rate differs from the spot exchange rate. So the cost of the money market hedge should be the same as the forward or futures market hedge, unless the firm has some advantage in one market or the other. This is costly, so the forward hedge would probably be more advantageous except where the firm had to borrow for ongoing purposes anyway. Currency options Many companies, banks and governments have extensive experience in the use of forward exchange contracts. With a forward contract one can lock in an exchange rate for the future. There are a number of circumstances, however, where it may be desirable to have more flexibility than a forward provides. For example a computer manufacturer in California may have sales priced in U. Depending on the relative strength of the two currencies, revenues may be realized in either Euros or dollars. In such a situation the use of forward or futures would be inappropriate: What is called for is a foreign exchange option: A foreign exchange option is a contract for future delivery of a currency in exchange for another, where the holder of the option has the right to buy or sell the currency at an agreed price, the strike or exercise price, but is not required to do so. The right to buy is a call; the right to sell, a put. For such a right he pays a price called the option premium. The option seller receives the premium and is obliged to make or take delivery at the agreed-upon price if the buyer exercises his option. In some options, the instrument being delivered is the currency itself; in others, a futures contract on the currency. American options permit the holder to exercise at any time before the expiration date; European options, only on the expiration date. The Japanese yen had recently fallen against foreign currencies and Yamamoto wanted to avoid any further rise in the cost of imports. He viewed the Australian dollar as being extremely instable in the current environment of economic tensions. His view, however, was that the yen was bound to rise in the next few months, so he was strongly considering purchasing a call option instead of buying the Australian currency forward. Yamamoto decided to buy the call option. This simple example illustrates the lopsided character of options. Futures and forwards are contracts in which two parties oblige themselves to exchange something in the future. They are thus useful to hedge or convert known currency or interest rate exposures. An option, in contrast, gives one party the right but not the obligation to buy or sell an asset under specified conditions while the other party assumes an obligation to sell or buy that asset if that option is exercised. When should a company like Frito-Lay use options in preference to forwards or futures? Taken alone, this would suggest taking a position. Options provide the only convenient means of hedging or positioning "volatility risk. To Yamamoto, the price is worth paying. This example highlights one set of circumstances under which a company should consider the use of options. For example, during the recent crisis in some European countries put options on the Icelandic Krone became very expensive for two reasons. First, high Icelandic interest rates designed to support the Krone drove the forward rate to a discount against the Euro. With movements much greater than in the past, the expected gain from exercising puts became much greater. It was an appropriate time for companies with Icelandic exposure to buy puts, but the cost would exceed the expected gain unless the corporate treasurer anticipated a greater change, or an even higher volatility, than those reflected in the market price of options. Finally, one can justify the limited use of options by reference to the deleterious effect of financial distress. Unmanaged exchange rate risk can cause significant fluctuations in the earnings and the market value of an international firm. A very large exchange rate movement may cause special problems for a particular company, perhaps because it brings a competitive threat from a different country. To avert this, it may be worth buying some low-cost options that would pay off only under unusual circumstances, ones that would particularly hurt the firm. Out-of-the-money options may be a useful and cost-effective way to hedge against currency risks that have very low probabilities but which, if they occur, have disproportionately high costs to the company. Conclusion Many corporate risk managers attempt to construct hedges on the basis of their outlook for interest rates, exchange rates or some other market factor. However, the best hedging decisions are made when risk managers acknowledge that market movements are unpredictable. A hedge should always seek to minimize risk. It should not represent a gamble on the direction of market prices. A well-designed hedging program reduces both risks and costs. Hedging frees up resources and allows management to focus on the aspects of the business in which it has a competitive advantage by minimizing the risks that are not central to the basic business. Ultimately, hedging increases shareholder value by reducing the

cost of capital and stabilizing earnings.

Chapter 5 : Corporate Hedging | Marex Solutions | London

Although the primary purpose of hedging is to reduce earnings volatility, corporate hedging may also increase firm value. Using publicly-available data, we found that hedging reduces the probability of financial distress, reduces the agency costs of debt, and reduces some agency costs of equity.

Chapter 6 : Hedge (finance) - Wikipedia

In our paper, Corporate Hedging and the Design of Incentive-Compensation Contracts, we examine how executives' ability to hedge risk that was previously difficult and costly to manage influences the design of their incentive-compensation contracts. Identifying the effect of risk on the design of executives' incentive-compensation contracts.