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Managing risks by hedging and minimising the impact of losses

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Reducing the ramifications of long-term risks by putting in place control mechanisms and covering investment risks through hedging are among key risk management strategies

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Hedging transactions are entered into by risk-averse people while speculations are entered into by risk lovers

In today's volatile and dynamic world, risk becomes an unavoidable aspect of any business. It would never be possible to eliminate risk, but at best, its impact can be minimised. The risk factors can be internal to an organisation like high attrition or it can be external factors such as changes in consumer preferences or even geopolitical events that potentially trigger a host of consequential reactions. Here, the focus will be on the investment risk faced by a business.

Identifying risks and putting in place control mechanisms to reduce their impact is risk management, and the most prominent strategy is to cover investment risks through hedging. In simple words, hedging is an investment that offset the losses incurred in any other investment.

Process and premise

Hedging is a risk-neutralising strategy to downsize the potential loss. It is a fresh financial transaction to be entered, by paying the associated costs, which would move in the opposite direction against the movement of the asset or liability held. When an asset or liability held shows a downward or upward effect on account of various risk factors, it influences the inflow or outflow respectively. In these circumstances, a hedging transaction offsets the losses incurred on the asset or liability held. Hence, the net effect on the losses will be reduced to minimal or zero.

One of the primary ways to hedge is by entering into a derivative contract. Derivative contracts derive value from underlying assets such as stocks, indices, commodities, or foreign currencies. Stock derivative mitigates the fall in prices of a stock and index derivative minimises the fall in prices of a stock that

does not have a stock derivative. It is in the same way that commodity and currency derivatives eliminate the loss on account of volatility in the price of a commodity and foreign currency.

ADVERTISMENT

Benefits galore

Some of the commonly used derivative contracts are forward contracts, options, futures, and swaps. Each of the contracts is operated by a specific set of rules. To enter into a hedging transaction, the hedger has to pay a premium or a margin to avail of benefits. When the predicted risk does not materialise, the premium or margin shall be a sunk cost to the hedger and further leading to a no-loss situation for the asset or liability held.

The key benefit of hedging is the ability to mitigate risks by safeguarding the value of the underlying loss situation to the asset or liability held. Secondly, hedging will limit losses and prevent it from ballooning when the price fluctuates. Further, it removes uncertainty in the future price of an underlying asset.

While the objective of hedging is to neutralise risk, speculation is to earn profit from the potential price fluctuation opportunities. The principal difference between hedging and speculation is that in the case of hedging, there is underlying exposure while in

speculation that is not the case. Hedging transactions will be entered into by risk-averse people while speculations are entered into by risk lovers.

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