How Companies Can Use Hedging to Create Shareholder Value

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How Companies Can Use Hedging to Create Shareholder Value[i]

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The key to companies successfully using hedging to create shareholder value is communication. It sounds simple, but the inability to communicate the structure and success of this risk management strategy could destroy – rather than preserve a firm's value. Risk management managers have to clearly articulate to top management and board members why the hedge is needed and the source of the potential benefit. Managers also must make investors aware that some losses may occur.

René Stulz, who holds the Reese Chair of Banking and Monetary Economics at Ohio State University's Fisher College of Business, addresses these issues in his paper "How Companies Can Use Hedging to Create Shareholder Value". He says communication challenges often stem from being unable to quantify results. Costs for risk management programs are explicit, but results are not. Investors often rely on gains and losses to determine if risk management strategies succeed or fail. However, those numbers on a stand-alone basis are irrelevant in assessing the success of hedges, Stulz says. The effectiveness of hedges can only be determined by shareholder gains from avoiding the risks.

For example, purchasing fire insurance seems like a logical risk management strategy, but the effectiveness of paying monthly premiums should not focus just on receiving an insurance payment for fire damages. The question firms would have to ask is whether the costs of fire damage would be worth the insurance premiums. Although this is a simplified example of a business risk, it requires answering the same questions as more complex financial risk strategies: Why does the firm need a hedge? What are the benefits? What is the source of the benefits? Answers to these questions need to be clear before entering the hedge and should not be dependent on future price movements or the profitability of the hedge itself.

Understanding the potential consequences of a loss is also important. For example, the paper looks at the "costless" hedge Morgan Stanley used against subprime risk. In a "costless" hedge, managers buy protection for the downside and give up the gain from the upside. Stulz concludes that Morgan Stanley created a bet to pay for the hedge and the bet ultimately caused the hedge to unravel. The paper uses "if … then" analysis to examine potential benefits and losses different scenarios could affect the

firms' hedges. This strategy also could benefit risk management managers as they explore options. Finally managers have to consider whether some hedges could produce unintended consequences such as counterparty risks when partner companies cannot fulfill their obligations. Managers have consider these options as they outline their "if …then" possibilities.

In conclusion, hedging can create shareholder value. Because derivatives losses are more heavily scrutinized than losses from other sources, risk management managers need to thoroughly investigate hedge strategies. They also have to clearly communicate those strategies to top management and boards. Without their support, risk management strategies cannot succeed. Their support also allows them to communicate with shareholders who need to understand gains and losses only help stabilize company's earnings and value by offsetting losses and gains elsewhere in the firm.

Creating shareholder value with hedges requires that risk management managers stay focused on the basic principles of developing and executing effective programs in order to decrease hedging mishaps. These principles include focusing on risks that are more productive and that offer a comparative advantage, and evaluating risks based on the long-term expected value and not short-term earnings. The fire insurance example above demonstrates how every risk management strategy needs the same level of scrutiny. The Morgan Stanley example demonstrates the need to know the benefits and all possible consequences of hedging. Finally, managers need to maintain focus on preserving their firms' value by trying to eliminate any consequences that could destroy it.

[i]Original article

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